



## INDUSTRY INSIGHTS

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*A view from a T. Rowe Price  
investment analyst.*

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analysts provide insights from within  
their coverage areas that contribute to  
the informed investment decisions of  
portfolio management. This is the most  
recent installment.*

## Industry in Focus— Payment Networks

### KEY POINTS

- Industry cross-consolidation, the secular trend away from paper and toward electronic payments, and global regulatory changes have provided tailwinds for U.S.-based payment processing and service providers.
- These catalysts have also led to the emergence of many “fintech” companies, which leverage new technology to create improved financial services for customers and businesses.
- When assessing investment opportunities, we seek companies that we think can provide the next generation of payment options.
- Intriguing stocks within the industry include MasterCard and PayPal Holdings.

Historically, U.S. payment processing companies have occupied very defined roles within the industry, acting as either merchant acquirers, which sign merchants to card acceptance agreements and serve as the merchant's first point of contact; payment networks, which authorize the transactions between banks; or credit card issuers, which sell credit cards to consumers. However, assets, scale, and technology have afforded many key industry players the ability to become multi-sided networks, allowing them to establish relationships with both the merchant and the consumer. This has complicated the payment industry and increased competition among providers.

The secular trend from cash and other paper-based transactions to electronic payments has also provided a healthy tailwind for U.S.-based payment processing and service providers. Global noncash transaction volumes reached 433.1 billion in 2015, representing an 11.2% annual growth rate, the highest of the past decade.<sup>1</sup> This growth has allowed a number of new industry players to emerge. Some recent entrants provide smaller merchants, who previously could not afford to accept credit cards, with cost-effective means to accept cloud-based payments or payments through a mobile phone or tablet card reader. This has provided a large revenue opportunity for both merchants and payment

<sup>1</sup>World Payments Report 2017 Preview, Capgemini and BNP Paribas.

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networks. Supplementing this growth is the rising popularity of integrated payments, a streamlined process in which the payment capability is integrated into the software, allowing smaller merchants to enjoy the same payment systems as larger merchants.

Additionally, global regulatory changes have made it easier for U.S.-based payment processing and service providers to expand their businesses into non-U.S. regions. Over the past decade, the European Union (EU) has enacted several initiatives aimed at improving the way payments are made across Europe. The Single Euro Payments Area was designed to improve the efficiency of cross-border payments, while the Payment Services Directive and Revised Payment Services Directive set rules regarding electronic transfers and payments in 30 European countries. These initiatives increased pan-European competition and participation in the payments industry and made payments more secure and cost-effective.

#### MAJOR INDUSTRY PLAYERS

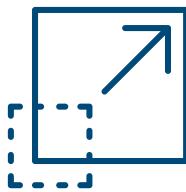
Companies within the industry are characterized by recurring revenues, high operating leverage, and robust free cash flow generation. We seek out payment networks and “fintech” companies that we think can provide the next generation of payment options, and we place a premium on companies that can expand their yields, or revenue per transaction, while economizing processing costs due to scale.

■ MasterCard (MC) is the second-largest payment network in the world. MasterCard is structured as an open-loop network, meaning it provides the infrastructure and services needed to facilitate electronic payments, but it does not issue credit and debit cards. Its services include merchant acceptance on its network,

#### ASSETS



#### SCALE



#### TECH



...assets, scale, and technology have afforded many key industry players the ability to become multi-sided networks, allowing them to establish relationships with both the merchant and the consumer.

transaction authorization, and facilitation of transaction settlement at financial institutions.

- **Assets:** Its primary asset is its payment network, which connects customers, financial institutions, and merchants in more than 210 countries.<sup>2</sup> In addition, the company's business model is not capital intensive, and the company enjoys high incremental margins due to the scale of its network.
- **Opportunity:** MasterCard has a strong commitment to its fraud and consulting services, and its willingness to invest in new capabilities, such as person-to-person transfers, could help it to grow faster than its competitors. The shift from cash to electronic payments has also fostered MasterCard's transaction volume, which has grown twice as fast as overall consumer spending and stands to benefit the company for many years to come.
- **Risks:** A potential headwind for the company is increasing regulatory scrutiny, as governments across the globe enact legislation to regulate payment service providers and international online payments. MasterCard also faces the threat of increasing competition from companies such as Apple, whose mobile payments service Apple Pay is gaining traction, and Amazon, which has hinted that it might develop its own payment service.
- PayPal Holdings (PYPL) is one of the world's largest Internet payment companies. The company, spun out of eBay in 2015, is commonly referred to as a pure-play digital wallet with a business model that is a combination of a merchant acquirer, an issuer, and an open-loop payment network.
- **Assets:** A key differentiating feature of PayPal's business is its industry-leading scale in online payments, with 197 million active customers, 6.1 billion payment transactions, and a total payment volume of US\$354 billion.<sup>3</sup> The company's addressable market includes most global e-commerce transactions,

<sup>2</sup>MasterCard's 2016 Annual Report.

<sup>3</sup>PayPal's 2016 Annual Report.

## We expect that the payment network industry—including both established firms and upstarts—may continue to benefit from global innovation.

which, according to market research company eMarketer, are expected to top US\$4 trillion by 2020,<sup>4</sup> over double the estimated growth in global retail sales for the same period.

- **Opportunity:** PayPal is also well positioned as a next-generation payment provider due to its ownership of Venmo, a peer-to-peer (P2P) money transfer application, and Braintree, a platform that enables Internet businesses to accept payments online or within their mobile applications. While it is unlikely Venmo will generate strong revenue as a standalone P2P

asset, the economics could become meaningful once PayPal begins allowing businesses to accept online and mobile retail payments via Venmo accounts. Furthermore, Braintree's unique ability to increase merchant acceptance of new payment products may increase the odds that Venmo's broader payment service could see better traction than competing products that have come to market in the last few years.

- **Risks:** Like MasterCard, PayPal faces the risk of increased regulatory scrutiny across the globe. PayPal also faces increasing competition from AliPay, which is gaining traction

as a global payment system, as well as mobile wallets, which can be embedded into operating systems and have a clear distribution advantage relative to PayPal.

### INDUSTRY OUTLOOK SUMMARY

We expect that the payment network industry—including both established firms and upstarts—may continue to benefit from global innovation. As technology advances and consumer preferences accelerate toward digital payment transactions and mobile wallets, we believe that entrenched payment network companies, such as Visa and MasterCard, may benefit from scale and improving unit economics, while newcomers like PayPal may benefit from convenience and next-generation technology. In addition to developed U.S.-based payment networks, we will continue monitoring other emerging payment trends to assess future opportunities.

<sup>4</sup>Emarketer article: [www.emarketer.com/Article/Worldwide-Retail-Ecommerce-Sales-Will-Reach-1915-Trillion-This-Year/1014369](http://www.emarketer.com/Article/Worldwide-Retail-Ecommerce-Sales-Will-Reach-1915-Trillion-This-Year/1014369).

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