Disruption and Growth in Digital Payments

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The digital payments industry offers access to a truly enormous addressable market across the world, and varying penetration across regions and countries creates opportunities for active managers. But disruption is always a consideration when analyzing an industry, and this threat varies significantly across the segments of the digital payments industry.

The global payments ecosystem consists of three primary segments.

Merchant acquirers are the entities that enable merchants to accept credit cards and other forms of digital payments. **Issuers** are the banks that issue credit and debit cards and the issuer processors that are either internal functions within banks or are banks' external partners. And **networks** are the "pipes" or "rails" through which all transactions flow, connecting merchants and issuers.

These different segments face different disruption risks.

Disruption Risk: Overstated?

For example, incumbent merchant acquirers face a major threat of losing market share to new, technology-enabled providers.

With networks, on the other hand, we believe that many investors are overestimating the near- and medium-term disruption risk facing the global duopoly of Visa and MasterCard. The existing networks are firmly entrenched, efficient, inexpensive, safe, and reliable.

In other words, there is nothing overpriced or inefficient about the current system that would make it ripe for disruption.

That includes digital currencies and blockchain, which are lauded by their ardent supporters as game-changers for many industries. We believe their potential to significantly disrupt the payments industry is low—at least in the near and medium terms.

First and foremost, the technology simply isn't capable of handling the bandwidth needed to support any sort of systematic shift. Estimates of the number of transactions that Bitcoin and its competitors can handle ranges from as low as five to a few hundred per second—a fraction of what existing networks such as Visa and MasterCard can handle.[1]

Facebook's planned digital currency, Libra, is primarily targeted at consumers in emerging markets with high inflation, where a large percentage of the population is under- or unbanked. However, most governments are not keen on the idea of an alternative currency that could interfere with their control of monetary policy.

While Visa, MasterCard, and PayPal were members of the original Libra consortium, all three have recently announced they are withdrawing in the face of government pushback.

Over the longer term, alternatives such as blockchain, real-time payments, and other models may have the potential to take volume from the existing networks, but many of the networks are preparing for this risk and using their powerful balance sheets to invest in alternative systems.

Another reason that near- and medium-term disruption risk across the payments industry is overstated is inertia. The methods individuals use to pay for goods and services tend to be firmly established, and consumer behavior is often resistant to change. Once people are accustomed to—and trust—their forms of payment, a disrupter would have to offer a truly superior alternative, not just a marginally better approach.

New entrants to the payments ecosystem in recent years have leveraged the existing system rather than attempting to replace it. Even if a superior approach that would bypass the existing system did emerge, adoption would likely be slow.

Technology Underpins Growth

At the same time, leading payments companies are using increasingly sophisticated technology to create value—and justify their fees—for merchants and consumers through enhanced fraud prevention, increased acceptance rates (i.e., lowering the frequency of rejected transactions), more sophisticated targeted marketing, and improved omnichannel experiences.

Companies across all three segments of the payments ecosystem (merchant acquirers, issuers, and networks) are using artificial intelligence and machine learning to enhance fraud prevention and detection. This is critical in encouraging trust in noncash payment methods, which is particularly important for app-based services and other forms of e-commerce.

Merchant acquirers are using data analytics to enhance merchants' ability to conduct targeted marketing campaigns, develop more effective customer loyalty programs, and create a more seamless experience for consumers across in-store, online, and mobile environments.

All of this is extremely valuable to merchants in helping to increase sales, driving volume for the payments industry.

How We Invest

When we evaluate technology companies, we look for sustainable growth and disruption potential, but also other factors. We are particularly attracted to ones that operate within systems that involve two mutually dependent and mutually beneficial components.

As each platform improves in functionality, the entire ecosystem becomes more appealing to consumers; as these platforms add more users, their infrastructure and development costs are spread over a broader base, driving the marginal cost of each additional transaction closer to zero.

Payments and mobile technology are a prime example of a two-sided system driven by the type of symbiotic relationship that we find so appealing.

Technology advancements continue to enable new services that improve consumers' lives, whether in the form of ridesharing, streaming video, or having food delivered to your door.

Without digital payments, these services couldn't exist in their current forms. All parties benefit from ongoing improvements to other parts of the ecosystem and are willing to pay a fee or make the necessary investments to make it work.

Up Next

Although digital payment transactions take only seconds to complete, there are different layers and numerous players interacting behind the scenes that make that phenomenon possible: merchant acquirers, issuers, and networks. In our next posts, we will explain how they interact, and offer some insight into the opportunities and risks each face.

Digital Payments Series

Part 1: Why We Find Digital Payments Compelling
Part 2: 5 Factors Driving Digital Payments Growth
Part 3: Disruption and Growth in Digital Payments

Part 4: Follow the Money in Digital Payments
Part 5: More Competition for Merchant Acquirers
Part 6: Digital Payments Issuers Face Regulatory Risk
Part 7: Networks: The Rails That Connect Digital Payments

[1] Hacknoon. "The Blockchain Scalability Problem & the Race for Visa-Like Transaction Speed." October 14, 2019. Blockchain.com.

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