More Competition for Merchant Acquirers

August 6, 2020

Merchant acquirers—the initial gatekeepers in a digital transaction—present compelling investment opportunities. They are part of an industry that offers access to a truly enormous addressable market across the world, and varying global penetration creates opportunities for active managers. But they are not without risks.

The Gatekeepers

Previously, we explained that the global payments ecosystem consists of three primary components—merchant acquirers, issuers, and networks—and explained how they interact.

Merchant acquirers serve as the initial gatekeepers in a digital transaction, allowing the merchant to accept various forms of noncash payments from consumers.

Innovative, tech-enabled merchant-acquisition platforms are able to justify higher take rates—especially within e-commerce and small and midsize businesses (SMBs).

Recall from an earlier post, two of the most important concepts in understanding payments business models are the merchant discount rate (MDR) and the take rate.

MDR refers to the difference between what the consumer spends and what the merchant ultimately receives, net of the payments providers' fees.

Take rate refers to how the total MDR is divided among the various entities involved in the transaction. And despite higher take rates, competition within this fragmented space should ultimately drive fees lower.

What Merchant Acquirers Do

Merchant acquirers approve or reject merchants' requests for payment authorizations, based on data obtained from the issuing bank and from the network during processing.

The acquirer (which may be independent or bank-owned) deposits funds for approved transactions into merchants' accounts at regular intervals.

Merchant acquirers control a key aspect of the entire payments industry by setting the MDR for each merchant. The top five merchant acquirers have more than 80% market share in the United States. In Europe, the landscape is fragmented and idiosyncratic, and payment methods can vary by country.

How Merchant Acquirers Add Value

Merchant acquirers allow merchants to accept various forms of payment, giving their customers flexibility and greatly reducing the friction involved in transactions.

Acquirers also absorb merchant credit risk; if a merchant goes out of business before delivering a paid-for service (for example, if an airline abruptly ceases operations), the acquirer is responsible for refunding money to customers.

Newer, tech-savvy merchant acquirers offer value-added services that merchants are willing to pay more for, such as enhanced fraud protection and improved acceptance rates.

These capabilities are especially important for e-commerce. Overall acceptance rates for e-commerce transactions average about 80%, compared to 98% for in-store, card-present transactions, so merchant acquirers that can help online retailers close this gap offer a tremendous value proposition.

The development of new value-added services has helped the take rate remain stable or even increase slightly by preventing competition from eroding pricing power.

Risks to Merchant Acquirers

Competition—and its potential to cause take rates to compress—is by far the greatest risk facing merchant acquirers. The space is already highly fragmented and, thanks to relatively low barriers to entry, many new, tech-enabled entrants are rapidly gaining market share from legacy platforms.

This threat is especially acute for less innovative merchant acquirers focused on traditional merchants in developed markets and in-store transactions, as growth is slower in these arenas.

Innovative firms can counteract this threat of fee compression by offering more value-added services, and the opportunities to do so are significantly greater in e-commerce and for SMBs.

In terms of SMBs, smaller businesses are willing to pay higher fees because the ability to accept digital payments is often the difference between making and losing a sale.

In addition to enhancing acceptance rates and improving fraud prevention, many of the most disruptive merchant acquirers are adding services that accelerate sales growth and simplify critical back-office functions.

Merchant acquirers that embed their software into “integrated payments systems” with inventory management, payroll, accounting, marketing, lending, and other functions that SMBs need are seeing take rates three to four times higher than those that provide only transaction processing.

Many SMB-focused merchant acquirers are creating packages of services that are tailored to the needs of specific types of businesses, such as restaurants or beauty salons. This trend toward vertical-specific, integrated software is one of the prevailing themes across the broader financial technology industry.

Some U.S. merchant acquirers have become more aggressive in using acquisitions to “buy growth” and reduce competition; there have been several recent large-scale acquisitions among merchant acquirers. This may reduce competition risk in the short term, but increased competition will likely drive take rates lower over time. Separately, unexpected regulation limiting fees could potentially reduce MDRs overall, affecting acquirers’ profitability.

Outlook for Merchant Acquirers[1]

Profitability and market share in the merchant acquirers segment of the industry depend on scale, the ability to innovate with technology, and the firm’s mix of merchant customers—e-commerce vs. brick-and-mortar, and large vs. SMBs.

In our view, winners are likely to be larger entities that benefit from scale and tech-focused players that can grab market share by offering innovative features. This is a highly competitive segment where firms are likely to experience organic growth ranging from as low as 6% to 30% or more.

Focusing on the type of merchants a merchant acquirer serves is essential. Our ranking of the client types, from most to least attractive:

1. **E-commerce/online sales.** This customer base offers the highest growth for merchant acquirers, and attractive and growing margins (EBITDA margins that are typically 25% to 50%). Success in e-commerce is highly dependent on technology differentiation.
2. **SMBs, including integrated payment systems.** Merchant acquirers that focus on enabling small businesses to accept noncash payments enjoy a take rate that is three to four times higher than for large business transactions and are forecast to see double-digit top-line growth for the next three to five years. The ability to offer bundled services, including inventory management, lending, and payroll, in addition to payments expands the value proposition.
3. **Non-U.S.** Lower noncash penetration outside of the United States and certain other developed markets means higher growth potential internationally (generally 13%-plus revenue growth versus 8%-plus in the United States). The growth opportunity is especially compelling in emerging markets, with large numbers of small merchants and under-banked consumers eager to engage in the digital marketplace.
4. **Off-line traditional.** This segment of a merchant acquirer’s customer base is highly competitive and

typically offers lower growth (mid-single digits). Scale is key to profitability when serving traditional merchants.

Next Up

Of course, merchant acquirers are just one part of the global payments ecosystem, which also consists of issuers and and networks. Next up: networks.

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

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[1] Numerical ranges in this section reference the average ranges for companies within the payments universe on the William Blair eligibility list. The eligibility list is comprised of companies that meet our growth and quality thresholds.

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