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Networks: The Rails That Connect Digital Payments

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Now that we've discussed the role merchant acquirers and issuers play in the global payments ecosystem, which offers access to a truly enormous addressable market, we'd like to move on to networks—the rails that connect other aspects of the payments ecosystem—so we can better understand investment opportunities and risks in this segment.

The Rails That Connect

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

Networks are firmly entrenched around the world. Disruptive payment models that would completely bypass the networks are potentially a long-term risk, but networks are already using their massive resources to participate in these trends.

What Networks Do

Networks connect merchant acquirers and issuing banks, facilitating front- and back-end transaction processing, setting interchange fees (issuers' take from the MDR), and creating and enforce operating rules.

They work with merchant acquirers to enable acceptance at more merchants and help issuers gain customers.

The largest networks—namely Visa and MasterCard—serve all types of merchants, in all parts of the world.

How Networks Add Value

Networks are the most entrenched part of the payments ecosystem and a critical part of the infrastructure. Without the networks, card payment authorization wouldn't be possible.

In addition to providing fast and reliable connectivity, they also provide a layer of fraud detection.

Networks are investing in infrastructure to make it easier for consumers to shift payments away from cash. This includes investing in new types of rails to accommodate real-time/instant debit payments, which are seeing increasing demand from consumers and merchants, especially in emerging markets. The largest networks have been involved in smaller, bolt-on M&A to accelerate that trend.

Risks to Networks

Disruption in the form of alternative payment models that bypass the existing infrastructure—such as blockchain, certain types of digital wallets, Zelle, or real-time payment systems—potentially pose the greatest long-term threat to networks.

While long-term disruption risk shouldn't be ignored, the threat is likely lower in the short and medium term. Networks are well-resourced (strong balance sheets and massive cash flow generation) and aware of the potential for disruption, so they are actively investing in innovative segments and working with governments and large corporations to develop new solutions.

Furthermore, many of the so-called "disruptive" payment models, such as Apple Pay, are actually beneficial to networks because they use the networks' existing infrastructure and will likely accelerate the shift to noncash payments by offering consumers added security and convenience.

Looking beyond the next decade, it is conceivable that truly disruptive models that bypass networks could gain momentum, especially in emerging markets. But networks are so well-capitalized and ubiquitous that they will likely find a way to participate in these alternative methods.

Regulatory pressure is always a risk in the payments industry, but it is unlikely that regulators would focus outsized pressure on networks, which have the smallest take rate of any part of the payments ecosystem. Governments, by and large, see the networks as providing a "social good" by building critical infrastructure that enables commerce, brings service to the un-banked, and increases tax revenue by limiting the size of the underground economy.

A Key Question: Can China's Model Be Exported?

The payments duopoly in China consists of Alipay (owned by Ant Financial) and Tenpay (also known as WeChat Pay, owned by Tencent). Together, they capture about 90% of noncash payments in a country where mobile devices are used for virtually every type of purchase, from taxi rides to luxury goods.

These “closed loop” systems eliminate the need for a merchant acquirer and issuing bank by connecting directly to the user’s account.

Industry observers are watching closely to see whether a closed-loop system, such as Alipay or Tenpay, can gain traction in India, which is viewed as a tremendous growth market for the global payments industry.

While China and India are both emerging markets with massive populations, they are vastly different in terms of the payments landscape. The Indian government created a fast ACH system, Unified Payments Interface (UPI), that has attracted major investments from Google, Amazon, Ant Financial, and other tech giants looking to promote adoption of their digital wallets. Amazon now allows Indian consumers to pay their utility and cable TV bills through its smart speaker, Alexa.[1]

According to SensorTower, a research and marketing firm for the app industry, Google Pay was the most downloaded financial technology app worldwide last year, as Indian consumers use it to buy train tickets, pay bills, and even purchase food from street vendors.[2]

While credit card penetration rates are low outside of higher-income Indian consumers, digital wallet usage is increasing rapidly, driven by players such as Paytm, Reliance Jio, PhonePe, and Google Pay. The industry is watching India closely as the competition heats up.

Outlook for Networks[3]

The networks, outside of China’s closed system, enjoy what amounts to a global duopoly consisting of two large incumbents, with a handful of additional players.

They continue to experience organic growth in the low teens, which is quite impressive for a mature industry of massive scale, along with high operating margins (around 55% and more).

Because of the “network effect,” margins are likely to *increase* as the market size increases with the ongoing conversion to noncash transactions. Firmly entrenched, ubiquitous, and scalable, networks face a very low probability of disruption over the intermediate term.

The large incumbents are looking to stave off long-term disruption by using their ample free cash flow to acquire and invest in new fintech companies or alternative payment systems that have shown promise. Low interest rates, consistent revenue growth, and low-volatility returns have provided support for the high earnings multiples seen for these entities.

What’s Next?

We've now written seven posts about digital payments that highlight why the enormous market is so compelling. But we believe identifying those companies that will benefit from these trends requires an active approach.

Although the industry comprises distinct components with different services and business models, the companies in the industry often have exposure to multiple aspects of the payments ecosystem. We expect a continued blurring of lines, as many companies in the industry don't fit neatly into just one of the segments we have profiled.

As an investor, then, it is becoming increasingly difficult to invest in standalone merchant acquiring, issuer processing, or terminal manufacturing. There is a good chance a company will have exposure to more than one of those segments, which offers both diversification benefits and potential risks.

Understanding how all of the pieces and players interact is one of the ways our multisector, global approach to fundamental research and active management allows us to identify sustainable sources of value creation.

As the pools of profitability in the payments industry shift and grow at different rates around the world, we are focused on using multiple lenses to uncover opportunities for our clients.

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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

[1] TechCrunch. "Amazon Users Can Now Pay Their Utility, Mobile and Cable Bills with Alexa." October 16, 2019.

[2] *The Wall Street Journal*. "Cash May be King in India, but Google is Prince of Mobile Payments." September 19, 2019.

[3] 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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