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Payments playbook — A guide to investing in Payment Processors

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Summary

Card-based payments have grown in popularity over time due to the benefits they provide, especially among consumers, displacing cash and checks. As consumers, businesses, and governments increasingly turn to cards to pay one another, we believe growth in global card volume will remain attractive, creating an opportunity for companies positioned to meet the demands of an evolving market.

Global Securities Research is favorable on Payment Processors, a sub-industry of the Information Technology sector. The goal of this report is to provide investors with an understanding of card-based payments, identify key themes influencing the sub-industry, and provide actionable investment ideas.

Cards 101 — A brief primer for investors

Types of cards

At a basic level, there are a couple ways to classify cards — by breadth of acceptance (general purpose or private label) and by funding method (credit or debit). A general purpose card provides broad acceptance while a private label card limits acceptance to a specific merchant. The most common general purpose cards are issued by Visa, Inc. and Mastercard Incorporated and are accepted wherever their logos are present. Conversely, a private label card issued by a home improvement retailer is accepted only at that home improvement retailer. Turning to funding methods, a credit card draws on a line of credit that must be repaid while a debit card draws from a linked checking account or prepaid balance.

Please see pages 7-8 of this report for Important Disclosures, Disclaimers and Analyst Certification

Parties to a card transaction

The primary parties to a card transaction include the cardholder, issuer, network, and merchant. Additional parties include service providers that help facilitate the card transaction between merchant and issuer and are commonly referred to as merchant acquirers and issuer processors.

The issuer is typically a financial institution that either extends credit or holds deposit balances that are the source of funds for a card transaction. Networks maintain the technology infrastructure, set rules for participation, and determine interchange (the primary economic transfer in a card transaction). The merchant acquirers enable merchants to accept card payments. As the name suggests, issuer processors provide transaction and account processing for issuers.

How a card transaction works

A card transaction typically involves the following steps:

1. Presentment — a cardholder presents a card for payment
2. Authorization — the merchant acquirer sends a message across the network to the issuer processor to make sure there are enough funds to complete the transaction
3. Clearance — once authorized, the transaction is completed and information about the transaction is shared over the network between the merchant acquirer and the issuer processor
4. Settlement — at the end of the day, money is moved across the network from issuer to merchant

How money flows in a card transaction

As mentioned previously, the primary economic transfer in a card transaction is from merchant to issuer and is called interchange. Although many of the largest merchants and issuers have agreements among themselves that specify the level of interchange to be paid, the networks set the default interchange rate when an agreement is not present. The level of interchange varies widely and is influenced by the type of card, merchant, and transaction.

Below is an illustrative flow of money in a hypothetical card transaction:

1. A cardholder spends $100 at a restaurant where there is a 2.5% interchange rate
2. The merchant (restaurant) receives $97.50 which equals $100 less the $2.50 in interchange it owes the issuer; the merchant also pays a fee to its merchant acquirer and the network for processing the transaction
3. The issuer receives $2.50, recognized as interchange revenue; the issuer pays a fee to its issuer processor and the network for processing the transaction
4. The merchant acquirer receives a fee from the merchant for processing the transaction
5. The issuer processor receives a fee from the issuer for processing the transaction
6. The network receives a small fee from both the merchant and issuer for processing the transaction

Sizing the card opportunity

In 2021, the four major U.S. networks generated more than $18 trillion of global card payment volume.[1] While seemingly massive, it represents only a fraction of the addressable opportunity across consumer, business, and government payments. In fact, according to Mastercard, global consumer payments totaled $45 trillion in 2021.[2] While most card-based payments today occur within the $45 trillion of global consumer payments, Mastercard has identified an additional $70 trillion of global consumer, business, and government payments where cards have only modestly penetrated today.[3] As a result, the $18 trillion of global card payment volume reported by the four major U.S. networks during 2021 represents only about 16% of the total $115 trillion addressable opportunity. Therefore, going forward, we expect annual global card payment volume to sustain its historical rate of low double-digit annual growth.

Key themes in payments

Software and payments converge

The emergence of cloud computing has supported the development of significant vertical-specific software-as-a-service (SaaS) solutions. Today, seemingly any business can affordably access a SaaS solution to help improve operations. The developers of vertical-specific SaaS solutions, commonly referred to as independent software vendors (ISVs), have served as an important channel for payments companies to reach small and mid-sized businesses. Businesses increasingly value the integration of payments within vertical-specific SaaS solutions, accelerating the convergence of software and payments. As a result, ISVs are moving more deeply into payments to capture additional revenue streams while payments companies are moving more deeply into software to protect and enhance current revenue streams. We favor companies that offer merchants the combination of proprietary software and payment processing.

Omni-channel commerce experiences

The pandemic accelerated the urgency for businesses to deliver omni-channel experiences to customers with seamless payments integration. This includes an in-store and online presence as well as shopping experiences that blend the two, including buy online and pick up in store as well as shop in store and ship to home. We favor companies that support merchant efforts to provide an omni-channel experience for their customers.

Business-to-business payments

We remain optimistic on the long-term growth potential of global card payment volume based on the emergence of new use cases for cards among consumer, business, and government payments. We are especially intrigued by the opportunity within business-to-business (B2B) payments, an extremely large market where card penetration is only modest today. Mastercard estimates nearly $40 trillion of B2B payments across commercial card spending at the point-of-sale and B2B accounts payable.[4] Companies are approaching this opportunity from a software and payment processing perspective. We favor companies that can capture a fair share of the volume opportunity with minimal capital spending and operating expense investments.

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1. The four major U.S. networks include Visa, Mastercard, American Express Co, and Discover Financial Services. The $18 trillion figure is based on company reports and includes $10.9 trillion for Visa, $6.0 trillion for Mastercard, $1.3 trillion for American Express, and $0.2 trillion for Discover.

2. Sourced from Mastercard's Investment Community Meeting presentation dated November 10, 2021.

3. Ibid.

4. Ibid.

Cross-border travel recovery

Cross-border travel was greatly reduced during the pandemic as countries limited foreign visitors and people were fearful of travel. As the pandemic has ebbed and countries across the globe have begun to open back up, cross-border travel has recovered to a degree. However, only recently has cross-border travel regained 2019 levels. We favor companies with exposure to the recovery in cross-border travel.

Actionable investment ideas

Visa, Inc. (V — $209.34) and Mastercard Incorporated (MA — $329.47)

We favor Visa and Mastercard based on their ability to fully participate in favorable long-term tailwinds influencing payments while benefiting from the recovery in cross-border travel over the near-term, which is an exceedingly profitable revenue stream for both companies. In terms of B2B payments, we see a lot of companies putting in the leg work — including monetary resources and time — to enable card acceptance and usage for B2B payments, which will ultimately benefit Visa and Mastercard as they see more volume move across their networks.

Fiserv, Inc. (FISV — $102.60)

We believe Fiserv is poised to maintain its momentum in merchant acquiring based on the success of Clover and Carat. Clover is the company's flagship solution for small and mid-sized businesses which combines business management software and its payment solutions. During the most recent quarter, Clover reported $233 billion of annualized volume, demonstrating significant scale with nearly 30% growth over the prior year. Fiserv is also seeing strong momentum with Carat, its omni-channel payments platform for enterprise customers.

Block, Inc. (SQ — $61.29)

Square, Block's ecosystem for sellers, offers a unique combination of hardware, software, and processing to sellers, resulting in sustainable market share gains among small and mid-sized businesses. Square offers vertical-specific solutions for restaurants, retailers, and service-oriented businesses. For the second quarter of 2022, Square reported that gross payment volume (GPV) grew at a 23% compound annual rate on a three-year basis, about twice the growth rate of the market. Finally, Square offers an online store builder and supports buy online and pick up in store, subscriptions, and digital invoicing, helping sellers provide an omni-channel experience to their customers.

Risks to consider

An economic slowdown or recession could result in a reduction in consumer spending, which may negatively impact global card payment volume growth. Inflation has various impacts on companies in the Payment Processors sub-industry, including positives and negatives. On the plus side, some revenue for companies are based on the dollar value of transactions, benefiting from high inflation. Conversely, some revenue for companies are based on the number of transactions. If high inflation reduces the number of transactions completed, it could potentially hurt revenue. Finally, like other firms, companies in the Payment Processors sub-industry may face elevated operating costs due to high inflation.

The Payment Processors sub-industry attracts significant attention given its favorable outlook. Legacy providers, financial institutions, and new entrants all compete in the space. The market is constantly evolving, and while we have confidence in the ability of some companies to maintain their competitive advantage, there is no guarantee this will occur.

Many companies in the Payment Processors sub-industry generate a meaningful portion of their revenue and earnings outside of the U.S., exposing them to fluctuations in foreign currency exchange rates. Given the recent strength of the U.S. dollar, revenue and earnings growth could be negatively impacted over the next several quarters.

Companies in the Payment Processors sub-industry are subject to regulatory and legislative risk. Additionally, these companies handle sensitive personal information. Inadvertent disclosure of this data or a breach of a payments company's information systems may result in reputational damage, monetary penalties, and elevated ongoing expenses.

Global Securities Research List Descriptions:

The **Core List** is comprised of blue chip, industry-leading companies that we believe can withstand the test of time. The objective is to provide a list of high-quality stocks that can be used to build a well-diversified portfolio or can be used to supplement an existing portfolio.

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The **Equity Select List (ESL)** includes companies which each Global Securities Research equity sector analyst believes are appropriate for long-term investment. It includes companies across all 11 economic sectors with representation across many sub-industries in the market, providing broad exposure to various shareholder return structures, with an overarching theme of selecting high quality companies. The list assumes a long-term holding period (five-plus years) and can be used to build or supplement a well-diversified equity portfolio.

The **Focus List** is a concentrated list of stocks that represents a combination of the equity sector guidance from the Wells Fargo Investment Institute (WFII) and security selection from our Wells Fargo Advisors Equity Sector Analysts. The objective is to exceed the total return of the S&P 500 Index over an approximate one-year timeframe.

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