Manole
Capital Management

How GPN Changed the Merchant Acquiring Biz
August 2017

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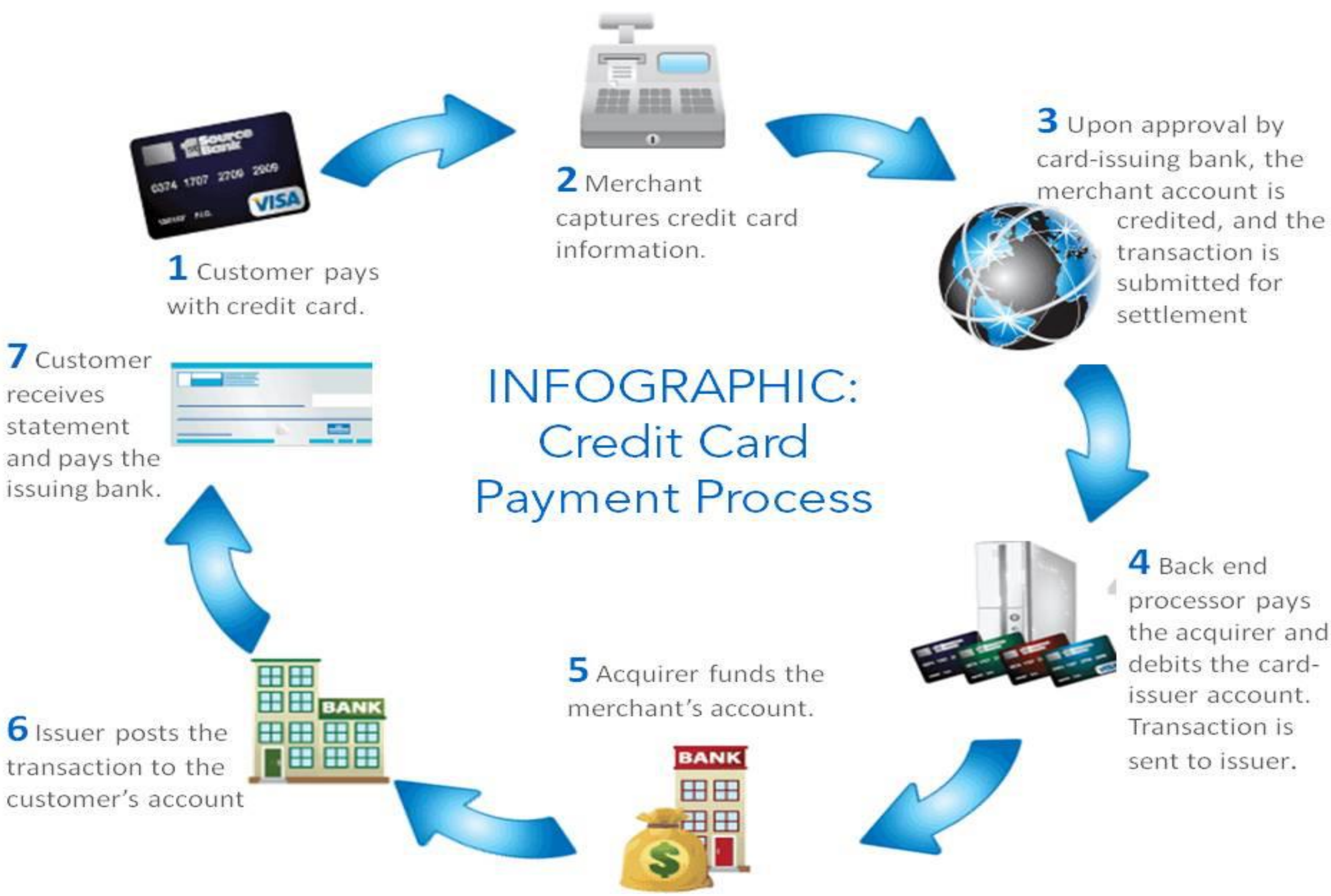
At the time, Global Payments (ticker GPN) acquisition of Accelerated Payment Technology (APT) for $413 million did not seem to be a milestone event. GPN's stock in mid-August of 2012 was roughly $20 per share, and the deal to acquire this fully-integrated software solution was met with a resounding yawn. Henry David Thoreau is not usually considered a luminary for financial or stock market wisdom, but we find one of his quotes quite appropriate: "It's not what you look at that matters, it's what you see." Five years after its modest APT acquisition, GPN has dramatically altered the traditional merchant acquiring industry. At $95 per share, up nearly 400%, GPN's stock reflects its 1st mover advantage.

Merchant Acquiring:

Most consumers expect card transactions to occur in a matter of seconds. With the adoption of EMV (Europay, MasterCard, Visa) standards, chip transaction slowed down the process, but the difference to the consumer and merchant has been mostly insignificant. Whether using traditional plastic, with its 50-year old magnetic stripe, or mobile-based payments, like Apple Pay, the process for merchants to accept card payments is fairly straightforward. Merchants are allowed to accept cards by creating and relying on a relationship with a merchant acquirer. While the authorization, clearing and settlement of a transaction occurs in seconds, it is a complex process between acquirers, processors, payment networks and card-issuing banks – detailed below.



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The Rate Card:

The total cost to the merchant to accept a card transaction is the MDR (Merchant Discount Rate). Interchange represents the fee the card-issuing bank earns for providing consumers this monthly line of credit. The rate card for card acceptance is complicated and varies depending upon multiple factors. What is the merchant processing method? Is the card present in the physical location, or is the card not present (CNP)? What kind of transaction data is provided? Is the expiration date, zip code or a security code captured? What is the Merchant Category Code (MCC)? This data helps frame the potential for fraud and charge-backs.

Payment networks like Visa and MasterCard publicly post their Interchange rates, but these forms are difficult to decipher. Just look below at Visa's rate card and realize it is 1 of 20 total pages. For a look at the entire rate card, click here. In addition to network charges and interchange, the merchant has to pay for the acquiring and processing of card acceptance. The companies that dominate this less-known space are JP Morgan's Paymentech, First Data (ticker FDC), Vantiv (ticker VNTV), Global Payments (ticker GPN) and Heartland Payments (acquired by GPN in December of 2015 for $4.3 billion).

Visa USA Consumer Check Card Exempt and Regulated Interchange Reimbursement Fees
Visa USA Interchange Reimbursement Fees

A Visa USA Consumer Check Card Exempt and Regulated Interchange Reimbursement Fees

Rates Effective April 22, 2017

Fee Program	Exempt Visa Check Card	Regulated Visa Check Card
Card Present Transactions		
CPS/Supermarket, Debit	$0.30	0.05% + $0.21*
CPS/Retail, Debit	0.80% + $0.15	0.05% + $0.21*
CPS/Automated Fuel Dispenser (AFD), Debit	0.80% + $0.15 ($0.95 Cap)	0.05% + $0.21*
CPS/Service Station, Debit	0.80% + $0.15 ($0.95 Cap)	0.05% + $0.21*
CPS/Small Ticket, Debit	1.55% + $0.04[1]	0.05% + $0.21*
CPS/Restaurant, Debit	1.19% + $0.10	0.05% + $0.21*
CPS/Hotel and Car Rental Card Present, Debit	1.19% + $0.10	0.05% + $0.21*
CPS/Passenger Transport Card Present, Debit	1.19% + $0.10	0.05% + $0.21*
Travel Service, Debit	1.19% + $0.10	0.05% + $0.21*
CPS/Retail Key Entry, Debit[2]	1.65% + $0.15	0.05% + $0.21*
Card Not Present Transactions		
CPS/Retail 2 – Card Not Present, Debit	0.65% + $0.15 ($2.00 Cap)	0.05% + $0.21*
CPS/Debt Repayment	0.65% + $0.15 ($2.00 Cap)	0.05% + $0.21*
CPS/Utility, Debit	$0.65	0.05% + $0.21*
CPS/Government	0.65% + $0.15 ($2.00 Cap)	0.05% + $0.21*
CPS/Card Not Present, Debit	1.65% + $0.15	0.05% + $0.21*
CPS/e-Commerce Basic, Debit	1.65% + $0.15	0.05% + $0.21*

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How Business Worked:

The vast majority of US merchants accept card transactions. Rarely, a consumer will encounter a business that only accepts cash. In fact, Visa recently began to promote a program incentivizing businesses to only accept cards and no longer accept physical cash. Manole Capital wrote a research note discussing the secular decline of cash and the slow, steady growth of card-based transactions (which can be read here).

Despite price affecting their bottom lines, most small to mid-sized businesses are not terribly focused on their costs of card acceptance. Many simply think it is the cost of doing business, no different than the cost of electricity, rent or insurance. Accepting cards is expected by consumers, and most merchants simply want the process to occur seamlessly and fast. In the event of a problem with a piece of hardware or PoS (Point-of-Sale) device, merchants want an acquirer to quickly fix the problem and keep the check-out process running. Most merchants are oblivious to add-on costs and fees. Monthly statements can be complicated and crowded with unidentifiable fees and charges. If business is good, the merchant can afford to ignore the costs. If business is soft, the business owner will likely shop competing acquirers, changing for a lower price.

How Things Changed:

With GPN's deal for APT, a massive shift in the marketplace occurred. Merchant acquirers are now attempting to get embedded into their client workflow. Through an elaborate network of value-added resellers (VARs), technology is being sold into all types of businesses. Software initially is developed and customized to fit one specific vertical, but can easily branch out and migrate to multiple industries. For example, APT was initially a wonderful dental software allowing dentists to efficiently manage their practices. It could handle client data, appointment scheduling, dental records and even store x-ray and digital images. When GPN acquired it, APT had grown to 30,000 merchants across 30 various verticals, in fields from dental to medical to pharmaceutical to veterinary. This single integration point and highly flexible platform enables all of these companies to effectively manage their business.

Almost as a by-product, this software had the capability to act as a gateway for securely handling payments. GPN handled roughly $8 billion in card transactions for APT, which was easily processed over its scalable payment platform. In its decision to acquire APT, GPN was probably looking to secure these card-based transactions over a long period of time. This was a good business decision for GPN, as each additional transaction riding on its payment platform has very high incremental margins. Also important, but not as clear to many in the market, was the retention factor. If GPN became ingrained into these merchants, it would no longer be at risk of losing clients to competitors because of cost. In fact, GPN changed the entire argument. By becoming an integral component in how business is run, GPN made the price it charges a merchant for accepting cards almost irrelevant. Merchants were no longer tempted to switch acquirers based upon a few basis points of lower card-acceptance costs because GPN became a vital element in running their businesses.

An Acquisition Wave:

APT was the first of several deals for GPN. In January of 2014, it acquired PayPros for $420 million. This deal added 1,000 technology-based software partners and over 58,000 new merchants. To quote Charles Caleb Colton, "Imitation is the sincerest form of flattery." Competitors noticed this ISV (Integrated Software Vendor) trend and responded. First Data, in October of 2013, acquired Clover for $56 million. It was a tablet-based PoS system that allowed merchants to download apps from an array of developers to help merchants handle specific business tasks like omni-channel sales, inventory control or payroll. Vantiv made a splash by acquiring Mercury Payments Systems for $1.65 billion in May of 2014. Mercury is a leader in software solutions that get embedded into PoS applications. Then in May of this year, FDC acquired CardConnect for $750 million. Not only should this decrease FDC's merchant attrition, but it gets them further into the ISV game. Just this month, GPN acquired The Active Network for $1.2 billion. Active is a cloud-based, mission-critical enterprise software solution, that just so happens to also handle payment solutions for its merchants.

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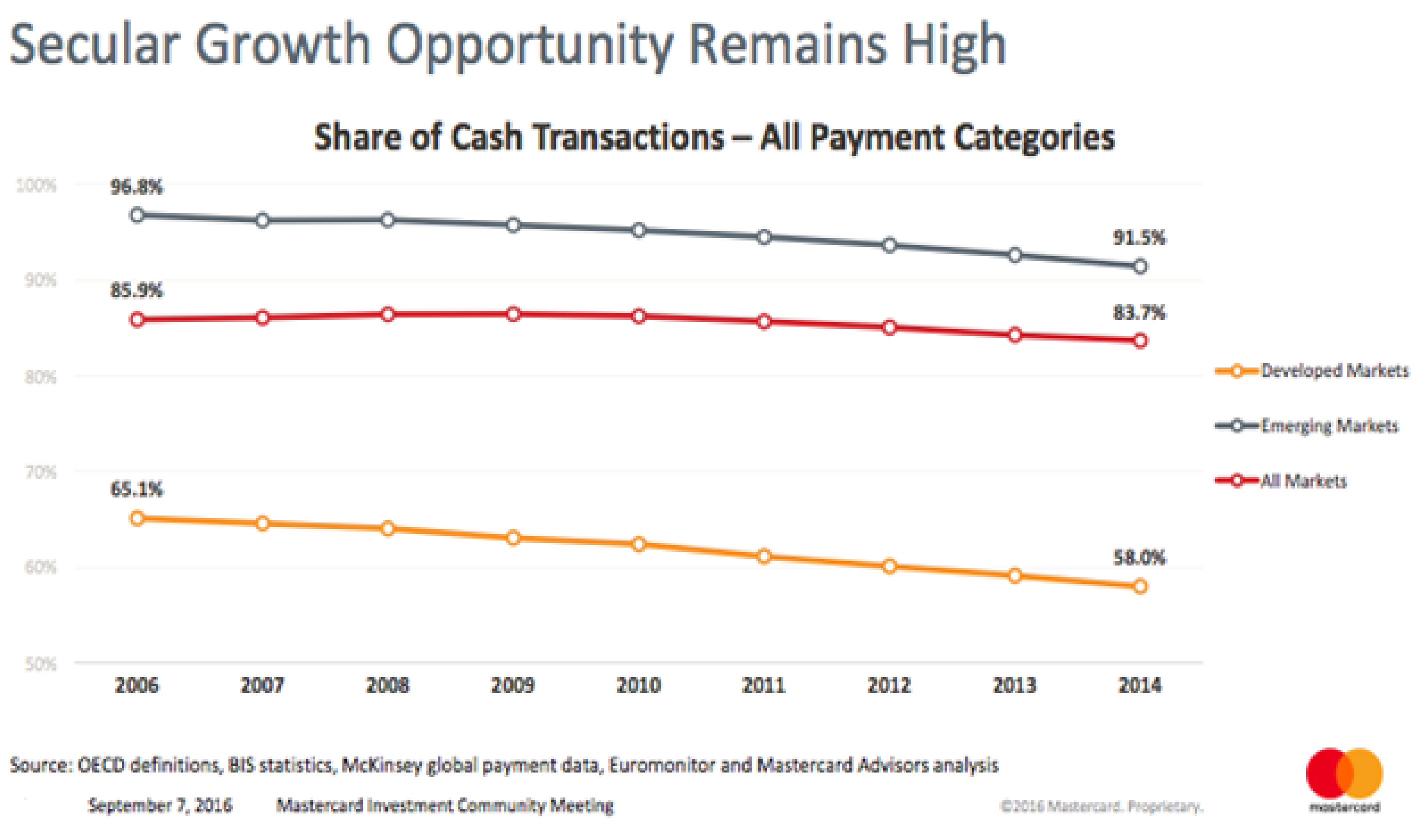
Conclusion:

Instead of simply competing in a price war, card acquirers are using technology to provide a better product. Software capabilities and integrated hardware devices are morphing this hyper-competitive industry into a technology battle. In years past, the barriers to entry were small. An acquirer could knock on the door of a merchant, lower price and win business. Now, technology and integration make this price battle nearly irrelevant. Businesses are not willing to switch operating platforms for a few basis points of card-acceptance savings.

The disappearance of cash and checks continues to create a strong tailwind for all participants. The secular growth of electronic and card-based payments will last for decades. MasterCard's slide (seen below) shows how the industry can grow for years. A deeper analysis reveals how certain players, if they maintain and expand the services offered to their clientele, can reduce attrition and successfully grow. GPN's acquisition of APT just had its 5-year anniversary, but few celebrated how this deal significantly changed the merchant acquiring landscape. Recent deals, at lofty valuations (a), indicate that GPN started a trend, and technology arms race, back in 2012.



Footnote:
(a) In August 2017, Vantiv announced its intention to purchase WorldPay for 16x fwd EBITDA or 25x fwd EPS

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