McKinsey&Company

How Value Creation Is Reshaping the Payments Industry

Global Banking Practice

McKinsey&Company

How Value Creation Is Reshaping the Payments Industry

How Value Creation Is Reshaping the Payments Industry

From July through September of this year, eight payments companies announced European payments M&A deals totaling more than $20 billion (Exhibit 1, page 4). This brings total deal value in 2017 to nearly $40 billion so far, a huge jump from the total of $5.3 billion in 2016. This is just the latest surge in a wave of consolidation that has been building for months, ranging from the merger of major European and North American processors to the expansion of private equity stakes across the industry. What is behind all of this activity?

A significant shift in ownership of core payments assets

Over the last decade, a top tier of multibillion-dollar payments specialists and merchant services companies—fueled by aggressive M&A—has emerged across the world: Visa, Vantiv and PayPal in the US, Cielo in Brazil, and Worldpay, Worldline, and Nets in Europe.

Today, several of the largest payments organizations are bigger in market capitalization than leading banks (Exhibit 2, page 5). And a select number of fintechs such as Wirecard and Adyen have gathered momentum and are closing in on these leaders. These latter examples could represent the tip of the iceberg, as a non-trivial proportion of current and future revenues for some of the world's most valuable companies, such as Apple, Facebook, and Alibaba, is linked to payments and related transactions.

The drivers of consolidation

Two recent developments help explain consolidation in payments: (1) the progressive disengagement of banks from the "traditional" payments space and (2) the acceleration of growth through the digital revolution.

Exhibit 1

Between July and September 2017, there were over $20 billion worth of mergers and acquisitions in the European payments industry

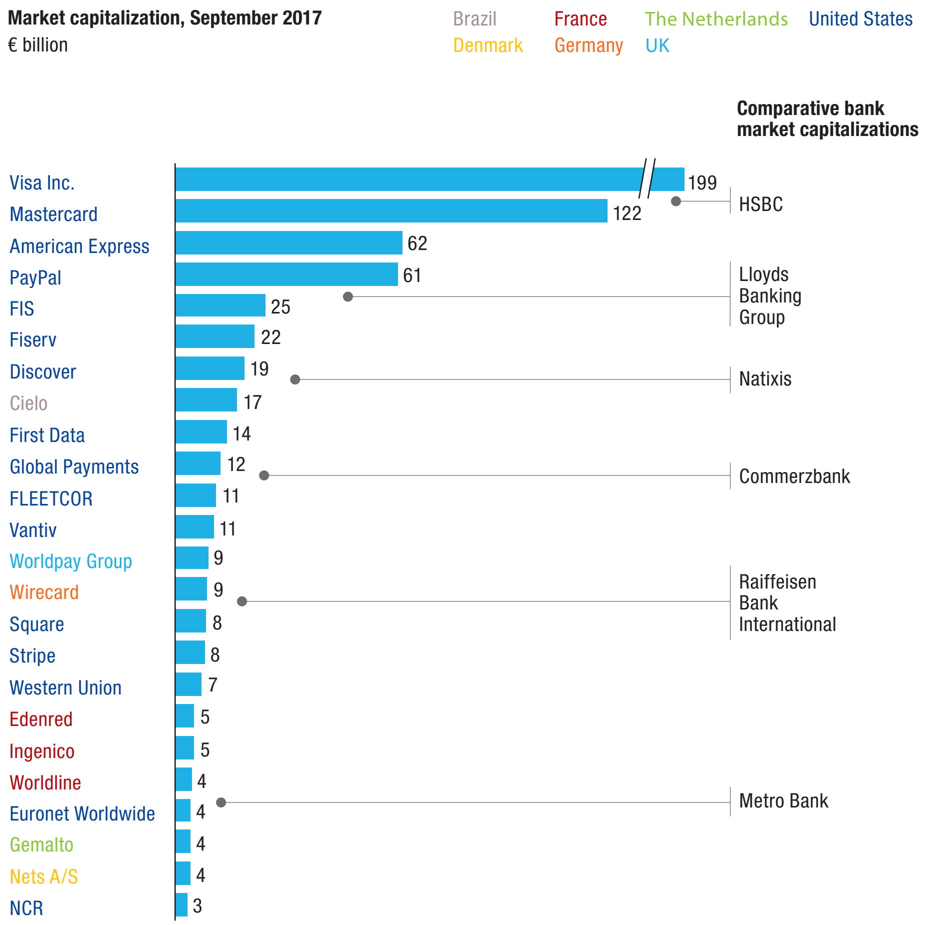
Target	Deal value ($ billion)	Acquirer	Deal rationale[1]
Worldpay	10.0	Vantiv	Create transatlantic acquiring giant SME client relations and volume consolidation
Nets	5.3	Hellman & Friedman	Accelerate international expansion
Paysafe	3.9	Blackstone and CVC Capital[1]	Accelerate presence in transaction processing, digital, and cash services
Klarna	2.8	Permira[2]	Target market growth from switch from cash to smartphone/mobile payments
Bambora	1.7	Ingenico Group	Expand acquiring capabilities and offer integrated and omnichannel solutions Leverage strong local tech capabilities
First Data Baltics and Digital Rivers	0.2	Worldline	Expand presence to Baltic countries, including banks in wider Nordic region Obtain additional international gateway capabilities
Dovetail and Monitise[3]	N/A	Fiserv	Offer broader range of intelligent data and processing services and real-time payments Mobile payments platform
Aduno Group	N/A	SIX Payment Services	Merchant services unit only Strengthen position in Swiss merchant services

[1] McKinsey analysis.
[2] Permira acquired a 10 percent stake.
[3] Monetise deal still pending. Dovetail deal value not disclosed.
Source: McKinsey analysis; press; company websites

1. **Banks' disengagement from payments.** Consolidation in the European processing industry has moved through three stages, the first dominated by international specialists and the second by bank-owned utilities. In the third and current stage, the impact of private equity funds is particularly strong (Exhibit 3, page 6). In the first stage (beginning in 2000), a small number of independent non-bank processing organizations, including First Data and Atos Worldline, launched an early push for global consolidation with a series of cross-border acquisitions. However, the impact on industry costs was limited. In the second stage (2006-12), formerly bank-owned utilities were spun off as independent commercial enterprises and began merging into increasingly large organizations. For example, Equens (formed by the merger between the Dutch Interpay and German TAI) and Nets (the merger of Danish PBS and Norwegian BBS) became the pre-eminent processors in their home markets and expanded into fast-growing markets in their region. The current stage is characterized by the expanding role of private equity funds. In 2012, Advent International acquired 51 percent of Fifth Third Bank's processing subsidiary for $565 million, leading to the creation of Vantiv.

Exhibit 2

Leading payments organizations rival banks in market capitalization



Source: S&P Capital IQ; press; McKinsey & Company analysis

Advent International joined with Bain Capital to acquire Worldpay from RBS in 2010 and Nets in 2014. Warburg Pincus bought the German processor Easycash in 2006; then acquired Network International and EMP, both, based in the Middle East. Nordic Capital created Bambora from the acquiring businesses of SEB and by combining several payments service providers (PSPs) across Europe, North America, and Asia–Pacific. The impact of private equity has become particularly pronounced in the past two years.

2. **The digital revolution has given further impetus to emergence of nonbank payments giants globally.** The first wave coincided with the expansion of cashless payment forms, which spurred sustained growth in transaction volumes. This wave peaked in 2006 with 36 deals totaling $5.6 billion. The second wave came about as digital channels strengthened card economics, particularly through higher fee revenue from online and mobile acquiring as well as from cross-border acquiring. Since 2009, the value of deals has risen

Exhibit 3

Private equity funds play an expanded role in the current phase of European payments industry consolidation

Stage 1

Pan-European consolidation through international specialists	
First Data	Many acquisitions across Europe (e.g., EuroProcessing International, TeleCash, GZS, APSS) JV with ICS (Fortis) in the Netherlands Created POSitivity, a merchant acquiring JV with BNL in Italy
Atos Worldline	Acquired Banksys
Elavon	Entered market with a JV (Bank of Ireland) and further expansion (Citigroup)
Equens	Merger between Dutch, German, and Italian processors

2000 - 2006

Stage 2

Regional consolidation through "bank-owned" players	
Nets	Merger with Nordito and PBS/Luottokunta acquisition
SIX Group	Consolidation in selected countries (e.g., Austria, Luxembourg)
Polcard & AIB MS	Acquired by First Data
SIA	Merger between SIA and SSB
Redsys	Merger of Sermepa with Redes y Procesos
CaixaBank MS	JV with Global Payments
Oberthur Card Services	Acquired by Advent
Ogone and GlobalCollect	Acquired by Ingenico Group

2006 - 2014

Stage 3

Global consolidation and entry of private equity	
Nets	Acquired by Advent and Bain
Worldplay	IPO
ICBPI	Acquired by Advent, Bain, and Clessidra
SIA	Acquired by Italian funds
2016	
Equens	Merged into Worldline
Vocalink	Acquired by MasterCard
BMPS[1]	Acquired by ICBPI
Setefi	Acquired by Advent, Bain, and Clessidra
Nets	IPO
2017	
Concardis	Acquired by Advent and Bain
Worldpay	Acquired by Vantiv
Bambora	Acquired by Ingenico
Klarna	Permira buying 10% stake
Paysafe	Acquired by Blackstone and CVC
First Data Baltics	Acquired by Worldline
Dovetail and Monitise	Acquired by Fiserv
Nets	Acquired by Hellman & Friedman

2014 onward

Note: Not exhaustive

[1] Banca Monte dei Paschi di Siena

on average 14 percent each year. The current surge is the combined effect of fintech start-ups undergoing serial M&A and global consolidation among existing champions in a relatively fragmented landscape (Exhibit 4).

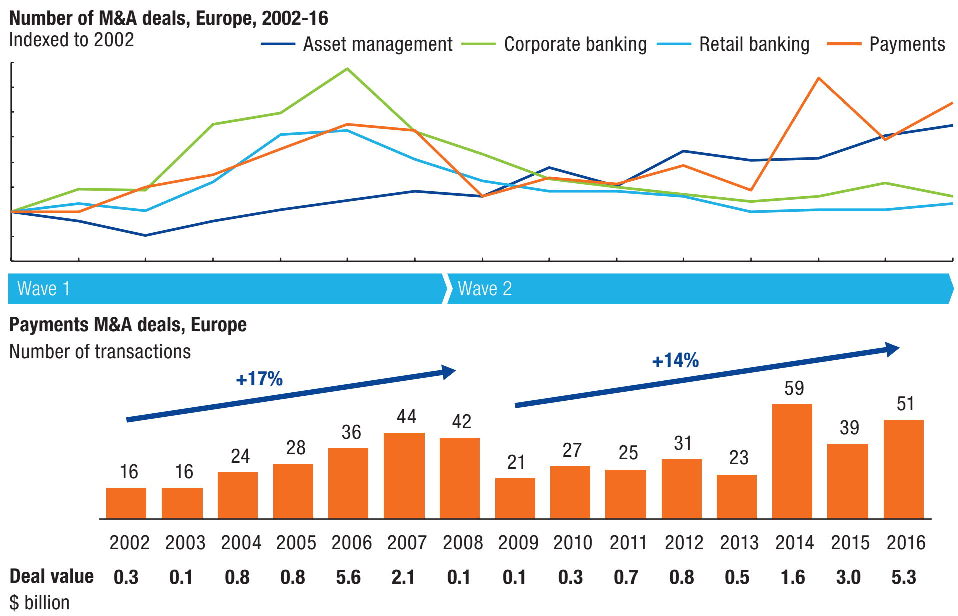
This year's surge may mark the beginning of a new wave of consolidation, as a broad range of mature companies stand ready to leverage their capabilities at scale. More than 40 percent of all fintechs tracked by McKinsey's Panorama Fintech database focus on digital payments and analytics, and no fewer than seven of the ten largest global unicorns provide payments-related services.

Fundamental strengths underlie value creation in the payments industry

With revenue growing 7 percent and profit 30 percent annually in recent years, the payments industry has systematically outperformed other financial services companies on the global market. These gains are the result of steady growth in

Exhibit 4

Successive waves of mergers and acquisitions are transforming the payments industry



Source: S&P Capital IQ; press; McKinsey & Company

transaction volumes and low dependence on interest rates. During the past five years, total returns to shareholders (TRS) from payments organizations have grown 15 percent per year compared to negative to low single-digit growth for retail banking, corporate banking and asset management (Exhibit 5, page 8). If interest rates start to creep up and the transaction growth tail-wind remains healthy, the growth in returns on payments services may continue.

The five value-creation levers in payments

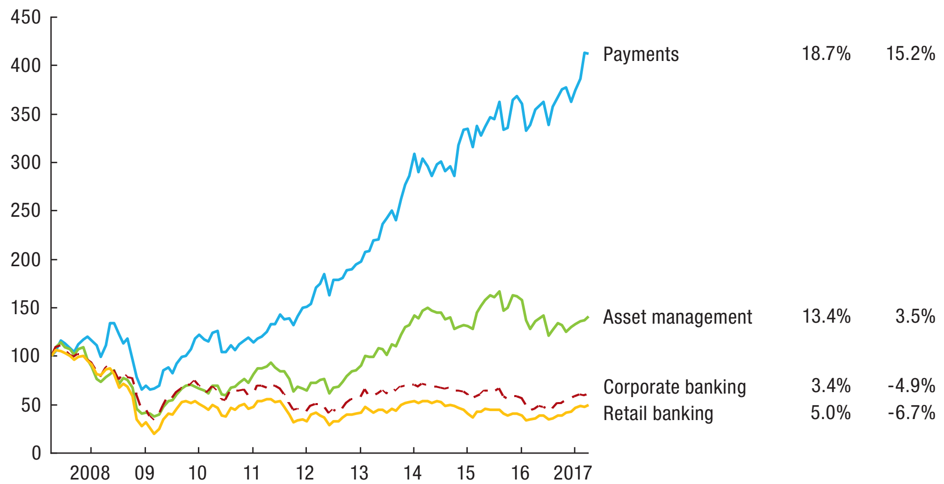
Five key levers contribute to creation of new value in payments, based on analysis of the financial statements of 135 public and private payments com-panies (Exhibit 6, page 9). By exercising these levers, the highly focused non-bank payments organizations included in our survey have increased value by 147 percent between 2011 and 2016. We expect that various types of companies will continue to focus on one or more of these levers to extend the industry-wide trend in value creation.

- **Organic growth:** Nearly half (48 percent) of the companies surveyed grew in volumes and revenue, largely through the substitution of electronic transactions for cash. This organic growth accounts for nearly 20 percent of the value created among surveyed companies over the five-year period 2011-16. McKinsey expects that this growth will remain strong. Overall, European non-cash transaction vol-umes are projected to grow 4.3 percent per year over the next five years, and a recent survey with executives in pay-ments issuing and processing showed they expect card volumes to increase by 10 percent per year over the next three years.

Exhibit 5

In total returns to shareholders, payments businesses have outpaced other financial services by a wide margin over the last decade

TRS performance of global financial services sectors
Indexed to 100 for April, 2007



Note: Cross section of international banking organizations currently publicly traded; payments N=27, retail banking N=20, asset management N=20, corporate banking N=5. 2017 YTD as of May.
Source: S&P Capital IQ

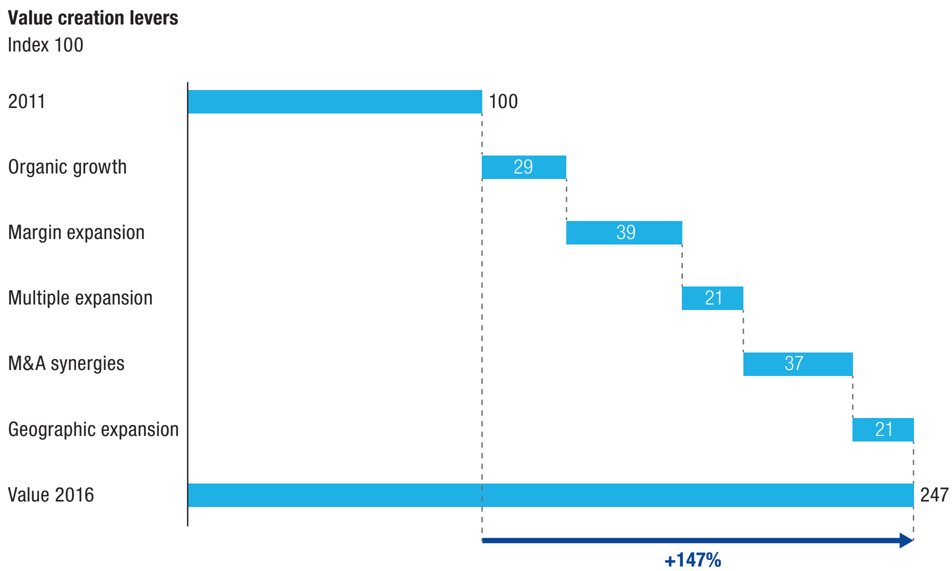
- **Margin expansion and operational excellence:** During a period characterized by low interest rates, the cap on interchange fees, and declining margins across the financial sector, it is surprising to see payments margins widening at more than half of the payments organizations we surveyed. These improvements account for more than a quarter of the value created among the survey group. How did they do it? The recipe combines strong pricing power by schemes, high fixed costs in payments operations leading to margin expansion as volumes grow, and a focus by private and publicly owned companies on managing pricing and costs. This is also likely to continue, as we expect price margins in the US to narrow to European levels rather than the reverse.

- **Valuation change by altering business focus:** By shifting the business mix, 53 percent of the payments organizations surveyed have succeeded in achieving higher multiples. For example, Wirecard has earned an above-average valuation by combining traditional payments revenues from prepaid or merchant acquiring with online and mobile innovation.

- **M&A synergies:** Estimated to account for seven percent of deal value, the cost synergies associated with M&A have been achieved largely through the combination of new technology and economies of scale. In the near future, faster payments, ATM consolidation, and branch closures will help to sustain and possibly accelerate resource optimization and value creation as more companies merge. This inorganic growth lever accounts for a quarter of value creation among the companies surveyed.

Exhibit 6

Payments firms have increased value by 150 percent in five years by applying five key levers



Note. Based on market capitalization and implied market capitalization of 135 public and private payments companies, including those in Exhibit 5.
Source: McKinsey Global Banking Pools

- **Geographic expansion:** A number of European organizations (e.g., Ingenico, Wirecard, Gemalto) have targeted less-penetrated markets. We expect that newly emerging regional champions will continue this expansion into economies showing potential for faster growth.

While our survey focused on companies that have undergone M&A, there are significant payments revenue pools that have yet to be consolidated and which, therefore, fall outside the survey group. Given the impact of the levers described above, we expect that more organizations across the industry will continue pushing value creation upwards.

Strategies for value creation

Payments companies fall into five categories according to the paths they have followed to create this new value (Exhibit 7, page 10).

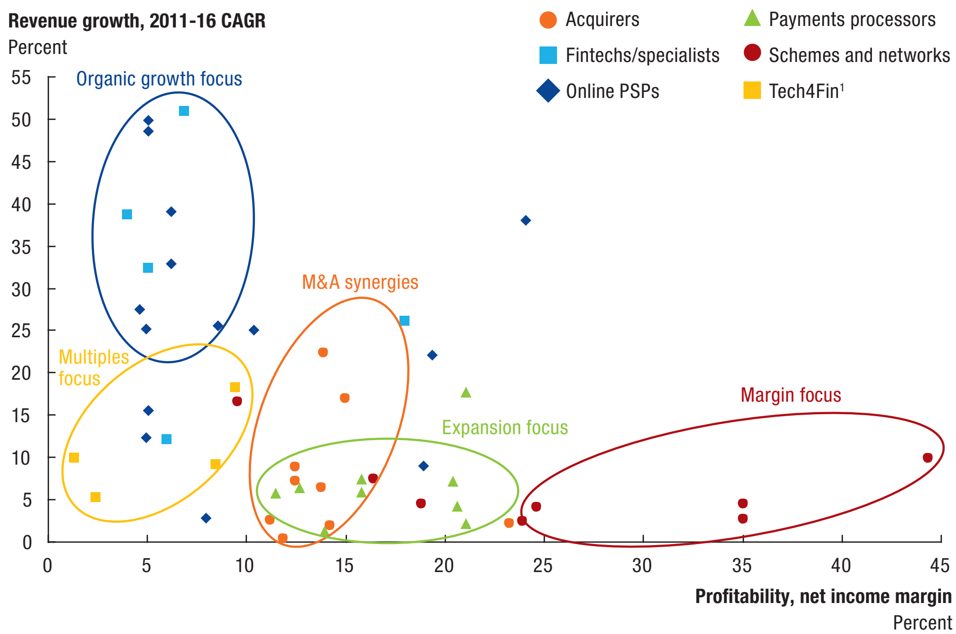
Emphasizing primarily organic growth, the newer *fintechs* and PSPs focused on online commerce have achieved the biggest gains in financial performance. They have created value by increasing their share in either specific markets (e.g., Klarna) or payments verticals (e.g., Adyen).

Tech4Fins are established payments technology providers (e.g., Ingenico, ACI, NCR) focused on delivering robust technology platforms and supporting hardware for payments processing to banks and non-bank payments organizations. Tech4Fin organizations typically create value primarily by increasing multiples.

While *payments processors* have relied largely on geographic expansion to less-penetrated markets, *acquirers* have relied primarily on M&A. These companies, many of which were formerly bank-owned utilities, have transformed themselves through progressive commercialization.

Exhibit 7

The market is characterized by a clear relationship between value creation lever, payments segment, and operational performance



Note: Based on market capitalization and implied market capitalization of 135 public and private payments companies, including those in Exhibit 5.

[1] Established payments technology providers focused on delivering robust technology platforms and supporting hardware for payments processing to banks and non-bank payments organizations.

Source: McKinsey Global Banking Pools

Not only have they reduced average cost per transaction with larger volumes, but they have also defended overall margins. Ingenico, for example, has transitioned from a traditional hardware provider to an e-payments specialist through more than 10 acquisitions and partnerships.

As noted above, *schemes* and *networks* have leveraged scale and market position to widen margins.

Competitive position in a changing landscape

Payments organizations will continue to rely primarily on the levers described above for the creation of new value. In particular:

- **Continued strong growth in transaction volumes** will drive profits up by 10 percent annually. Card processing and acquiring economics will strengthen further due to the combination of steady growth in consumer spending, continued displacement of cash, faster growth in digital payments, and lower costs per transaction.
- There is **significant room for further cost synergies**, as industry processing scale curves show. Only the top five processors operate close to critical scale, and banks still process half of European card transactions in-house. The impact of regional champions will continue to grow as they consolidate volumes across markets.
- **Multiples might increase**, as the anticipated strong growth will attract more fintech innovators and online specialists with the flexibility to target high-value segments.

Payments leaders should consider several different models as they think about their position in a changing landscape:

- **Non-focused owners should consider divesting assets**, comparing the current value held and the potential value to be created by a focused strategic partner or owner. Advances in technology and the fast growth of digital commerce are rapidly reducing the viability of legacy systems.
- **Schemes and payments processors should consider options for consolidation**, either with cost synergies achieved through acquisitions or extending service to less-penetrated markets. Upgrading platforms to take advantage of cloud services, machine learning and other recent technology advances can also produce significant gains in efficiency.
- **Serial acquirers should undertake research to identify potential targets**, which should be evaluated on the basis of both financial performance and strategic fit. It is also important to evaluate the technology architecture and options for integrating systems as part of the rationale for any deal.
- Most organizations should also **explore opportunities for specialization and renewed focus on core strengths**. Diverse and creative partnership models have emerged to speed up innovation in data analytics and new payments ecosystems, among other areas.

■ ■ ■

The current wave of consolidation in payments is part of a long period of value creation. Over the past 15 years, ownership of core payments processing assets has become more diverse, spanning banks, regional processors, and global organizations. In recent years, fintech innovators and private equity firms have also contributed significantly to the industry's rapid evolution. We expect the trend of value creation to continue as profits rise further on the basis of strong growth, the adoption of new technology, and increased efficiency. While the trend is to consolidate volumes across a smaller number of platforms, companies with cash to invest are likely to enter the market, making ownership of core payments assets even more diverse.

Contact

For more information about this report, please contact:

Olivier Denecker
Partner, Brussels
olivier_denecker@mckinsey.com

Tobias Lundberg
Partner, Stockholm
tobias_lundberg@mckinsey.com

Albion Murati
Associate Partner, Copenhagen
albion_murati@mckinsey.com

Marc Niederkorn
Partner, Luxembourg
marc_niederkorn@mckinsey.com