ECONOMIC HEADWINDS AND MARKET TRENDS CREATE CHALLENGES AND OPPORTUNITIES FOR PAYMENTS INDUSTRY

2019 outlook and recommendations for private equity investors

The digital payments industry has been enjoying a period of robust growth and rapid innovation. Naturally, this dynamic has piqued investor interest. But the pace of change, as well as the sheer quantity of news and analysis on the industry, makes it difficult for investors and management to cut through the noise in order to develop, finance, and implement practical strategies.

AlixPartners' intent in publishing this overview is not to add to this noise, but to apply a manager's lens to market developments and provide business leaders with practical recommendations.

We base our perspective on our team's collective experience in payments and fintech operating and consulting roles, client and private equity investor discussions, and our assessment of publicly-available information.

Although there are numerous trends impacting the payment industry, we see five that will most impact investment in 2019:

1 LOOMING SLOWDOWN WILL CREATE OPPORTUNITIES TO BUY DISTRESSED PAYMENTS ASSETS, BUT ALSO REQUIRE GREATER ATTENTION TO RISK MANAGEMENT

The global macroeconomic environment looks increasingly challenging in 2019. Economic pessimism is growing. In the US, 49% of chief financial officers (CFOs) surveyed believe the US will be in recession by the end of 2019, and 82% believe a recession will have begun by the end of 2020.[1] In the rest of the world, CFOs are even more pessimistic.[2]

Additionally, a slowdown would come at a time of high consumer and business debt levels. US consumer debt now exceeds $13.5 trillion as of Q4 of 2018 (above the previous peak in 2008).[3] European consumer debt has increased steadily from recent lows in 2014. On the corporate side, Chapter 11 bankruptcies in the US have reached the highest levels since 2011 with a 62% year-over-year increase.[4] And, perhaps most ominously, debt in China, mostly at the corporate level, has ballooned to over 300% of GDP at a time when its economy is slowing and its current account dipped (briefly) into deficit for the first time in decades.[5]

These economic headwinds require greater attention to credit risk management and effective risk pricing at payments companies. Credit losses on such high consumer debt levels seem likely in the event of an economic downturn. Issuers of credit should prepare by optimizing underwriting, pricing, and collections and recovery operations.

And corporate bankruptcies would also likely increase in the event of an economic downturn and reduction in corporate earnings. Merchant processors that underwrite merchant payments as well as banks that finance trade and cross-border foreign exchange hedging may experience significant losses. Enhanced risk management through investment in predictive analytics and more aggressive hold and limit policies seem prudent measures to implement.

But in addition to these risk management imperatives, we believe a downturn will present potential opportunities for keen and well-positioned investors.

In such an environment, be prepared for discounted sales of

1 distressed portfolios of assets;

2 consumer credit providers and merchant processors that managed risk poorly; and

3 otherwise attractive businesses spun off from struggling parent companies.

In addition to these opportunistic acquisitions, investors should consider companies that provide collections solutions and drive scale and automation efficiencies to prepare for the increasing demand wave.

1. Duke University/CFO Global Business Outlook survey
2. 97% of African, 86% of Canadian, 67% of European, 54% of Asian and 42% of Latin American CFOs believe their countries will be in recession by the end of 2019, according to the Federal Reserve Bank of St. Louis
3. The Federal Reserve Bank of New York's Center for Microeconomic Data, Quarterly Report on Household Debt and Credit.
4. American Bankruptcy Institute
5. Martin Wolf, "China's debt threat: time to rein in the lending boom," Financial Times, July 25, 2018, https://www.ft.com/content/0c7ecae2-8cfb-11e8-bb8f-a6a2f7bca546

2 INTEGRATED, CROSS-CHANNEL POINT OF SALE SOLUTIONS WILL CONTINUE TO CREATE INVESTMENT OPPORTUNITIES TO DRIVE PAYMENT PROCESSOR SCALE AND MERGERS OF PROCESSORS AND INDEPENDENT SOFTWARE VENDORS (ISVs)

Traditional merchant acquiring/payment processing has become a commodity. Pressure from new entrants and merchants has decreased the revenue per dollar of payment volume by an estimated 5 to 7% between 2015 and 2017[6]. This per-transaction revenue pressure is likely to accelerate in 2019 with continued moves toward open banking in many countries enabling innovators to create new lower cost point of sale solutions. We believe there are investment opportunities to drive further payment processor consolidation, reduce costs, and build scale economies in basic transaction processing as evidenced by the recently announced Fiserv/First Data and FIS/Worldpay transactions.

Additionally, sellers' growing list of expectations include transparent and simple payment services pricing, global/cross-border payments acceptance, and full integration of payments processing across the customer channel experience and into back office systems. A variety of service providers will battle in 2019 to meet these needs in a differentiated manner thus justifying higher margins, including ISVs, payment processors like Square, Adyen and Braintree, and marketplaces like Amazon.

Building scale and reducing costs of payment processing in deeply integrated industry solutions within attractive verticals (like automotive, healthcare, and veterinary services) present significant investment opportunities while garnering higher margins.

3 EFFECTIVE ECOSYSTEM DEVELOPMENT AND MANAGEMENT BECOMES A DIFFERENTIATED CAPABILITY AS PAYMENTS CONTINUE TO DIGITIZE, CREATING OPPORTUNITIES TO INVEST IN DIGITAL LAGGARDS

While global digital payments transaction volumes and value are forecast to grow at about 12 to 15% annually between 2018 and 2023, we expect global digital payments revenue to grow more slowly at 7 to 9% over the same period. Two industry implications can be drawn:

1. Continued rapid digitization of payments will increase the consumer, corporate, and transaction data available for use in enhancing value propositions; and
2. Digital payments revenue per transaction will decrease, creating the need for payments companies to innovate new value propositions.

Industry adoption of APIs, the emergence globally of government-backed open banking standards, and new payment service provider licenses will create opportunities to share digital payments data easily across previously siloed systems, both internally and between ecosystem partners. Innovative new products are therefore likely to appear. Additionally, machine learning and AI advances have made it easier to analyze data, generate new insights and create innovative products and services from those insights.

Given these dynamics, we expect 2019 to bring enhanced ecosystem solutions in account aggregation, fraud detection and prevention, rewards, loyalty, deals and offers, and integrated payments.

We believe some payment processors who have not adapted to the new ecosystem-based world will struggle and present an opportunity to buy assets at a discount, invest to innovate, and sell them profitably.

Additionally, we believe high-fixed cost payments assets that are associated with non-digital payments and commerce (such as check processors, lockboxes, point of sale devices, ATMs, and armored car services) can be purchased at a discount and rolled up to a larger scale in order to process the long-tail of their payments.

6. AlixPartners analysis of publicly-available information

4 ECOSYSTEM INNOVATION WILL BE TEMPERED BY PUBLIC AND REGULATORY FOCUS ON DATA PRIVACY, SECURITY, AND MANAGEMENT

The corollary to the opportunities presented by open data is that the 'art of the possible' in innovation must be shaped by the 'art of the practical' with respect to data privacy, security, and management. The public has a heighted focus on data security as a result of high-profile data breaches, fraud experiences, and data misuse.

Regulatory mandates in some regions, like the General Data Protection Regulation in Europe, will force stronger data and privacy management.

Additionally with global fraud losses at approximately $0.06 out of every $100 of digital payments (varying by region from $0.03 to $0.13[7]), there will be additional industry investment in innovative solutions using biometrics, acoustic analysis, geolocation, and behavioral traits (swiping patterns on smartphone) that not only provide improved fraud prevention in customer authentication but also improve the customer experience over traditional easily forgotten passwords.

We believe there may be opportunities to buy companies at attractive valuations in a post fraud, breach, or regulatory censure situation.

5 ACCELERATED INNOVATION IN B2B PAYMENTS WILL CREATE INVESTMENT OPPORTUNITIES

Commercial payments users (CFOs, Treasurers) have high expectations of their treasury and cash management providers set by their own personal experiences with innovation in retail payments: transaction status and fee transparency, mobile transacting and reporting, cash flow insights, near-real time settlement, and rich payments information flow and integration into AP/AR systems.

Banks have been slow to invest in commercial payments due to less fintech competition and stickier corporate relationships. This dynamic has changed with innovations in faster payment networks globally, blockchain for cross-border trade and FX, standardized payments messaging around ISO 20022, and payment hubs.

In fact, according to ACI Worldwide, 81% of banks expect cash management technology spend to increase over the next 2 years. Expect those investments to focus on improved transaction status transparency, cash position reporting, fraud detection and prevention, AML/compliance efficiency, payments hub technology, cross-border/FX transaction streamlining, and API-based partnerships with back-office solution providers.

We believe investment opportunities exist to buy traditional cross-border B2B payments companies at attractive valuations, invest in their digital capabilities, and sell them at a premium.

7. According to the Nilson Report

SUMMARY: PERSPECTIVE ON INVESTMENT OPPORTUNITIES IN PAYMENTS

We see opportunities in four areas:

SCALE PLAYS

- Merge together traditional fintechs. Integrate and rationalize overlapping portfolios of technologies, build scale and reduce costs, and enhance collaboration and partnership with innovators to improve service offerings.
- Consolidate assets in declining payment sectors. ATMs, check processing and lockbox services, point of sale device companies, and armored car services, among others, are prime targets for consolidation as volumes decrease and the businesses are stuck with high fixed costs.
- Drive further merchant processor consolidation to take advantage of economies of scale.

INDUSTRY VERTICAL PLAYS

- Merge select ISVs and merchant acquirers/processors. Differentiated services in attractive verticals provide higher margin opportunities in an otherwise commoditized sector.

CYCLICAL PLAYS

- Invest in self-service tools and analytics in anticipation of a likely increase in demand for collections agencies. While some payments businesses will suffer, collections would certainly see an uptick in activity should economic conditions worsen. Investments in new technological tools for these businesses will pay dividends should that occur.
- Proactively identify attractive assets within highly-leveraged companies that may become available in the event of economic weakening. This could include portfolios of assets or entire operating businesses.
- Be prepared for opportunistic plays to purchase companies following data fraud, breach, or regulatory censure.

INNOVATION PLAYS

- Explore potential investments in B2B transaction businesses, particularly where there is an opportunity to digitize and optimize the experience. We expect to see accelerated innovations based on real-time, cross-border, improved settlement, and customer experience.

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ABOUT US

For nearly forty years, AlixPartners has helped businesses around the world respond quickly and decisively to their most critical challenges – circumstances as diverse as urgent performance improvement, accelerated transformation, complex restructuring and risk mitigation.

These are the moments when everything is on the line – a sudden shift in the market, an unexpected performance decline, a time-sensitive deal, a fork-in-the-road decision. But it's not what we do that makes a difference, it's how we do it.

Tackling situations when time is of the essence is part of our DNA – so we adopt an action-oriented approach at all times. We work in small, highly qualified teams with specific industry and functional expertise, and we operate at pace, moving quickly from analysis to implementation. We stand shoulder to shoulder with our clients until the job is done, and only measure our success in terms of the results we deliver.

Our approach enables us to help our clients confront and overcome truly future-defining challenges. We partner with you to make the right decisions and take the right actions. And we are right by your side. When it really matters.