Transaction cleared: consolidation trend in the Payments Processing sector

Introduction

The payment processing industry has witnessed sincere interest from strategic and financial investors. Low barriers to entry have enabled newcomers to quickly establish themselves and net high valuation multiples. As a result, the sector is currently highly fragmented and presents good consolidation opportunities.

What do we mean by Payment Processing?

Payment processing guarantees the settlement of transactions between two parties. The full settlement process - payment authentication, transaction submission and authorization - could happen in a few seconds after a swipe through a credit card reader, computer chip reading, or manual input of information into a terminal, a computer or a website. This field of financial services is rapidly evolving in response to demands from consumers as well as regulatory authorities.

In an increasingly technological age, almost all standardized business operations are driven by the internet, wireless technology and devices to make commerce faster, easier and "smarter." Due to the technology-and-data-driven characteristics of the business, many start-up payment processing companies have been created and have developed edges in order to compete with credit card issuers – in this regard, we can confidently claim that the bulk of the FinTech disruption is taking place within this area of the financial services. The activities carried out by these players is pretty standard. Like intermediaries, they charge fees and in exchange they handle the task of collecting money as well as bear the risk transferred from online merchants. The authorization depends on their own marking system which involves payers' buying records and external data – something very similar to the standard credit card businesses. As such, payments processing improves its marking as the numbers of transactions processed increase and therefore the data gathered are more representative and reliable.

Industry Overview

Market shares of payments processing companies, when measured on a global basis, are quite small. Companies predominantly compete on a national or regional basis, principally serving merchants in their home markets. Due to the limited capital and investment requirements, it is not rare to find several small specialists operating in these sectors providing their innovative, technology-based offerings. On a global basis, however, competition in these markets remains fragmented, given this national or regional industry heritage. Furthermore, because of low barriers to entry, new challengers have easily penetrated the market. As a result, pure payment companies like PayPal have started competing with technology vendors such as Apple, Samsung and Google. On the one hand, this fragmented approach offers consumers a wide range of choices as well as better prices due to high competition. On the other hand, maybe counterintuitively, it has also contributed to a slow adoption as people, remaining unsure of which payment methods are best suited to them, cannot make a final decision.

Two overarching trends are shaping up the industry. The first is a regulation from the EU which will significantly contribute to reduce the mentioned market fragmentation. According to the Second Payment Services Directive (PSD2), which will go live in January 2018, payment processing companies will have the right to directly access payment accounts held at a bank with the aim of building a more integrated and efficient payment market across Europe.

The second one is the shift from cash payments to non-cash transaction, namely debit cards, credit cards and mobile wallets. Despite the recent growth that these payment methods have experienced, cash and checks accounted for 60% of transactions in developed markets and 93% in emerging markets. This means that most of the market for payment transaction companies remains untapped.

As a result of the aforementioned likely developments, expectations of a digital single market in Europe characterized by a vast room for growth have been materializing. Thus, the amount spent on deals for online payments processing firms have surged more than sevenfold in the last 12 months.

Rationale behind M&A activity in the payments sector

Globalization and Greater Geographical reach

For payments services companies, expanding their presence geographically is key to their growth ambitions. A larger footprint means lower costs for customers and merchants. Moreover, it helps retain merchants in the increasingly global world of e-commerce. Greater geographical reach also provides companies access to new jurisdiction from a regulatory standpoint. For a payments services company to be successful globally, its platform needs to obtain multiple licenses around the world to channel payments between countries and markets.

Traditional Companies hunting for new technology

Traditional companies are also eyeing the technology they once saw as disruptive as an opportunity to pick up new services that will help retain clients by making them more competitive in comparison to rivals and startups. Those traditional and often larger enterprises are using acquisition as strategic move to fight against the disruption brought about by this wave of new players in the payments services space. While traditional companies are hunting for new technology, some startups are looking to cash in on their strong valuations rather than weather the costs of reaching a profitable scale. The choice of "giving-up" their businesses seems even more ration if we consider the low-margin environment in which payments services providers operate. Just to name one of them, Mastercard's acquisition of the start-up VocaLink Holdings for $920m on July 21, 2017 is a standard example of a big Corporation acquiring the disrupter, to then innovate from within.

However, the industry has also seen some consolidation among the bigger players. On August 8, 2017 Vantiv, the largest U.S. based payments processing provider agreed to purchase 57% of the largest UK based payments processing company Worldpay for $10.4bn (397 pence per share). The combined enterprise value of the merged companies would be $28.8bn.

Private Equity Bets on Payment

Non-cash transactions grew 11% globally from 2014 to 2015, the highest growth in a decade. On the other hand, regulation and technology are driving marketplace changes and lowering barriers to entry as well as creating more competition, which together present opportunities for consolidation. PE firms, aware of this, are hunting payments services companies for their growth potential and are betting on buy and build strategies.

Blackstone and CVC acquiring Paysafe

Paysafe Group PLC is an online payments company which offers pre-paid cashcards and online wallets that are popular among online gambling customers. It has undergone a period of significant transformation and rapid growth. Between 2011 and 2016, Paysafe's revenues grew from $128m to over $1bn, and its EBITDA increased from $18m to over $300m.

On July 21, 2017, Blackstone and CVC Capital Partners reached an agreement to acquire Paysafe for a total cash consideration of £2.96bn ($3.9bn). Under the terms of the acquisition, each Paysafe shareholder will be entitled to receive 590 pence in cash per share. The acquisition price represents a premium of approximately 42% to the volume weighted average price per Paysafe share during the twelve-month period ended 30 June 2017 and 34% to the volume weighted average price per Paysafe share during the six-month period ended 30 June 2017. The sponsors' offer implied a P/E ratio of 3.9x. Blackstone and CVC, who initially approached Paysafe in early May -

when Paysafe's shares were worth around 450 pence each - made four unsuccessful separate bids. Eventually, the fifth offer was accepted. The deal was financed with both debt, provided by investment banks, and cash from Blackstone and CVC. Following the acquisition, Paysafe will divest its Asia Gateway subsidiary to Spectrum Global Limited for up to $308m payable over six years. The divestiture proceeds will fund part of the acquisition. Apart from online payments, the acquisition of Paysafe will also give Blackstone and CVC significant exposure to the online gambling and gaming sectors, which may be defined as an "ever-green" industry from the point of view of the demand.

Hellman & Friedman's takeover offer for Nets

Nets is the largest leading payments processor in the Nordic region, providing its digital payments services to consumers, merchants and to the public sector. Created from a merger in 2010, Nets has grown through acquisitions and was listed on Nasdaq Copenhagen in 2016 with a $4.5bn valuation. In the same year, more than $7.7bn transactions took place with Nets cards, which sum up to a total of $475bn.

On September 25, 2017, the Board of Directors of Nets decided to recommend the offer proposed by Hellman & Friedman, which valued the company at (Danish Krone) DKK 33.1bn. The all-cash offer at DKK 165 per share represents a 27% premium on the 129.50 DKK stock price as of June 30, 2017 - the day before Nets publicly announced their discussions with buyers. Other co-investors include Advent International and Bain Capital.

Permira buying 10% stake in Klarna

Klarna was founded in 2005 and formed into Klarna Group with the acquisition of SOFORT in 2014. It provides payments solutions including direct payments, pay after delivery and installment plans for 60m consumers and 70,000 merchants. Its services accounts for 10% of the e-commerce market share in Northern Europe. Klarna has been profitable since establishment as opposed to comparable start-ups. Having grown net income by 28% in 2016, it continued its record growth trend in the first half of this year. Moreover, it received a full banking license from the Swedish government in June 2017.

On January 21, 2017 Klarna announced an investment partnership with the private equity Permira which would acquire a 10% equity stake from existing shareholders General Atlantic, DST Global and Niklas Adalberth. The absolute amount was not disclosed and the valuation was reported by Financial Times to be approximately $250m. This transaction was the third investment received by Klarna in the last two months and it marked the entering in the FinTech field by Permira.