Value-added merchant services: the new competitive imperative in merchant acquiring

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The prevailing logic within the financial services industry has been for the most part that its products are sold rather than bought. Although the industry has made extraordinary leaps in product, distribution and client experience innovation, B2B financial services have been slower to adapt to newer norms of client centricity.

This is changing fast, and the merchant acquiring industry has become a hotbed of competition, with value-added services (VAS) representing another chapter in the transformation of an industry long perceived as a laggard.

There are a number of factors adding to the rise of merchant value added services. The dual pressures of commodification and gradual erosion of traditional revenue pools in the face of regulation, fee caps and increased price transparency are fuelling the quest for new revenue streams. Value-added merchant services offer a valuable source of incremental revenue opportunities for players seeking to diversify their income base and grow.

1 Value-Added Services: A Primer

Figure 1: Outline VAS Taxonomy
Not exhaustive

Merchant needs	*Marketing*	*Shopping*	*Payments*	*Fulfilment*	*Post-sales*
Issuer			*• POS financing • ID&V • FX*		*• Merchant financing • Reconciliation*
Networks	*• Loyalty schemes • Stored value*	*• Digital wallets • Onboarding*	*• POS terminals • Multi-rail • FX*	*• Inventory connectivity • Analytics*	*• Fraud prevention • Charge-backs*
PSPs	*• Loyalty schemes • Personalisation*	*• Dynamic discounts • Onboarding*	*• New form factor acceptance • Xpress checkout*	*• Personalisation • Order management*	*• Transaction, sales analytics*

Sources: Kaiser Associates Analysis

Merchant value-added services encompass a wide range of discrete offerings, provided by a similarly diverse set of actors. The best known ones are in the realm of payment processing such as cross-border transaction processing, multiple methods of payment support and POS solutions. Yet, more innovative offerings such as machine learning and advanced analytics, as well as payments, and venture consulting are becoming prominent as providers endeavour to widen their merchant relationships.

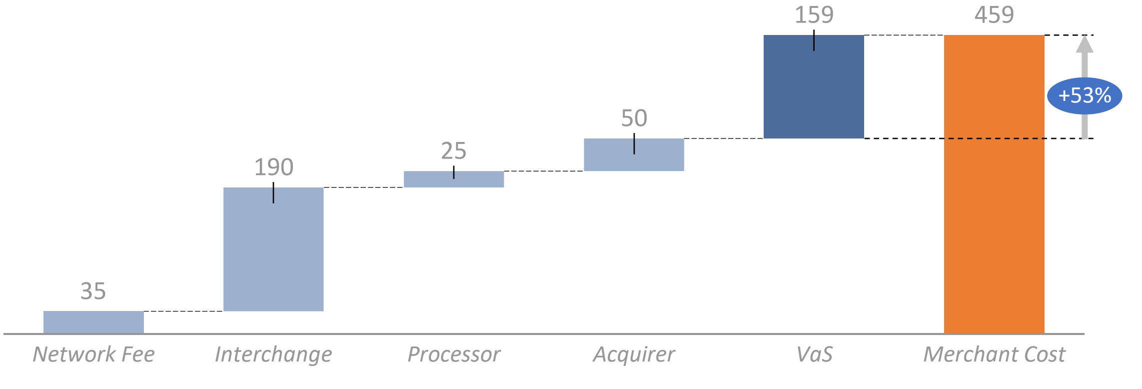
We see value-added service strategies deployed in a variety of competitive approaches, but by and large they tend to be highly correlated to a provider's heritage and scale.

For example, newer payment services providers seeking to aggressively grow share tend to have a central propositional hook, offered at lower- than average cost – for example processing fees. This is complemented with a menu of modular services, enabling them to develop matching strategies for niche merchant needs, and correspondingly, to develop new revenue streams. This is also well suited to newer payments providers who have a purpose-built technology infrastructure, enabling them to configure- and reconfigure products at speed and at scale.

Established providers, on the other hand will have a tendency to rely on more monolithic propositions, and will deploy value-added services selectively, to fortify the 'moat' effects conferred by their scale, diversification and established position in their clients' operations.

2 Creating Value by Adding Value

Figure 2: Stylised Payments Revenue Waterfall
basis points; US-based merchant, Ø revenue $1-2m



Sources: Provider websites, US Federal Reserve, Kaiser Associates Analysis

The merchant discount rate fee (MDR) structure has been the economic linchpin of the payments industry for years. Increasingly, its core components (network, interchange and acquirer fees) are straining, under the weight of a variety of regulatory and secular trends.

In 2015 the European Union introduced a blanket cap on interchange fees, thereby reducing interchange revenue pools by EUR 2.9bn per year, despite a 50% increase in card transactions per capita. In parallel, processor and acquirer fees are also subject to erosion, as a result of greater price transparency, and a number of new entrants selectively attacking legacy fee streams with aggressive pricing.

Value-added services is one of a number of value chain expansion strategies providers can pursue to create supplementary revenue streams to counter these trends.

A basket of Value-Added-Services (Figure 2) can add considerable scope for revenue growth. We estimate that this can generate an additional 25 to 180 basis points, or 30-60% of total merchant cost – a meaningful quantum for any participant in the payments value chain. Beyond this, value-added services can satisfy a wider range of merchant needs, deepening client relationships and creating a defense against client churn.

3 Build, Buy or Partner?

Figure 3: Value-added services capability routes
Not exhaustive

	1 In-sourced	2 3rd Party Enabled	3 Ecosystem
Benefits	*+ Retained IP/core capabilities* *+ Full value capture* *+ Control over the client experience*	*+ Best in class solution components (e.g. fraud)* *+ More diverse set of VaS* *+ Lower developmental costs*	*+ Faster route to market* *+ Unconstrained set of services* *+ Potential to access partner clients*
Trade offs	*- Speed to market* *- Capital intensity* *- Internalising execution risk*	*- Value redistribution to 3rd parties* *- Integration/interoperability* *- Non-core capability additive*	*- End client 'ownership'* *- Diminished control over client experience* *- Requires scale to attract the right participants*

Sources: Provider websites, Kaiser Associates market analysis

Capability development is one of the key decision points when it comes to executing a value-added-services strategy. Providers will face choices that fall in one of three categories: capabilities developed in-house, 3rd party-enabled solutions, or ecosystem of services, fulfilled in whole by specialist providers.

A provider's heritage and strengths are the logical starting point when deciding how to expand into adjacent service areas. While in house and outsourced approaches (such as partnering with security specialists in building anti-fraud capabilities) tend to be most common, ecosystem approaches are becoming more prevalent, as providers prioritise speed to market, and the overall market matures through improved standards and the dismantling of barriers to entry such as the introduction of Open Banking standards.

Key Implications:

The ultimate success of introducing, or scaling a value-added services proposition requires addressing multiple parallel priorities:

> Understanding the full extent of revenue replacement that VAS are intended to deliver, and the quality, persistency and scale of fee revenue arising from adjacent service offerings

> Realistic recognition of the complex competitive dynamics, and where VAS endeavours are most likely to gain traction

> Correctly assessing merchant needs based on where they are in their growth trajectory; developing targeted service propositions linked to discrete economic and operating outcomes – growth, cashflow, retention

> Establishing the right capability priorities, that balance the return on capital deployed and speed to market required to gain traction

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