What Makes Public Payments Companies Attractive?

September 2022

Throughout the economic ebbs and flows, certain verticals have fared better than others due to the elasticity of the product. One such industry that fits this mold is the Payments industry.

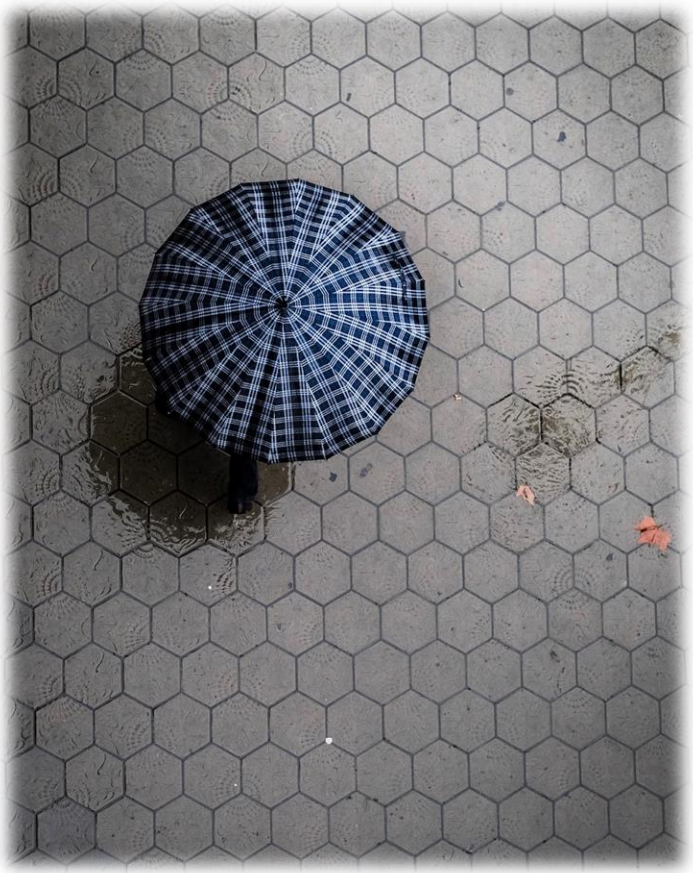
This mini-report, an excerpt from TSG's *Public Payment Companies* eReport, focuses on the question – what makes public payments companies attractive?

The Umbrella of Public Payment Companies

At its most succinct definition, a “payment” can be defined as “the action or process of paying someone or something or of being paid.” Despite the simplicity of this definition, a plethora of distinctive companies qualify to fit under the payments industry umbrella, all with unique go to business strategies, revenue models, and fundamental roles they serve within the payments ecosystem to make the act of purchasing and selling goods and services as straightforward as its definition.

In order to grow faster, create brand awareness, or achieve various other strategic objectives, some select participants choose to open themselves to the global investment community and become publicly traded.

The subject matter of this report will focus on global publicly traded direct participants of the payments ecosystem from the venerable stalwarts to the new entrant disruptors that maintain and improve upon the payment transaction lifecycle. Specifically, this includes entities that can be defined as card issuers, payment service providers (PSPs), payment networks, point of sale providers (POS), accounting/HR management software, and fintech/technology disruptors.



Sources: TSG analysis, Oxford Languages

What Makes a Good Investment Opportunity?

Whether you're a retail investor, a private equity firm, or a global asset management megacorporation, the oftly quoted cliche of "buy low, sell high" is the fundamental mantra of investing. Identifying these opportunities is easier said than done as a host of contributing factors influence each individual investor's determination of what is a "buy low" opportunity. Before an analysis of these opportunities can take place at the individual company level, investors first target industry groupings that share attractive economic traits across entities in that vertical. Stability, growth, innovation, inelasticity, profitability, and an effective revenue model are just some of the more prominent criteria being evaluated when making investment decisions. Fundamentally, companies within the payments industry check all these boxes.

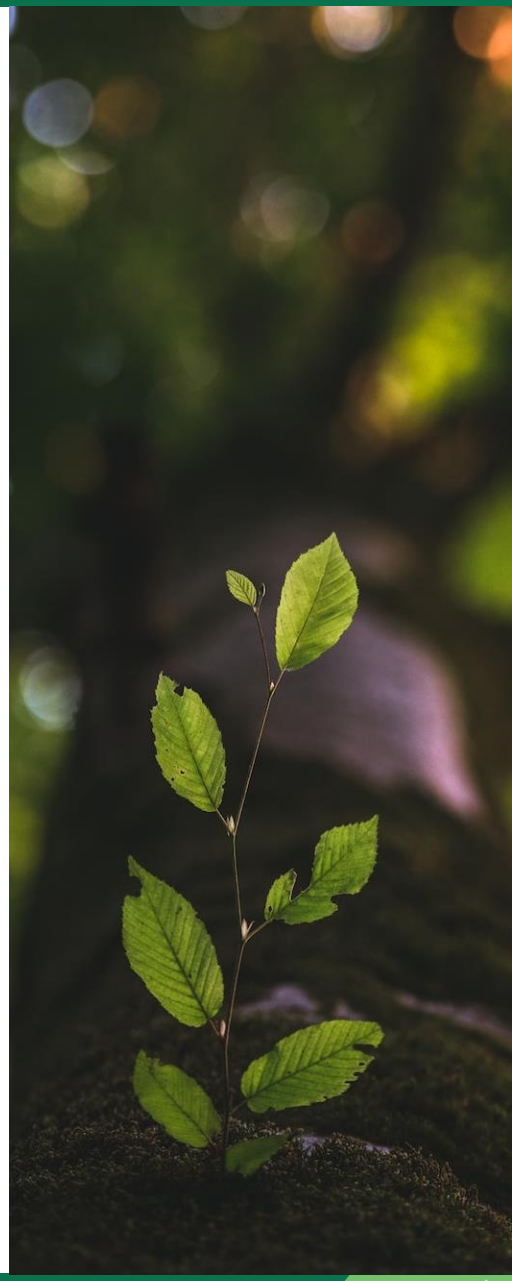
The electronic payments industry has evolved substantially over the decades, graduating from middlemen routing transactions between merchants and consumers to some of the most forward thinking and profitable fintech organizations that exist globally.

Sources: TSG analysis

Payments is a High Growth Industry

Prior to the COVID-19 pandemic, the U.S. electronic payments industry has seen payment volumes consistently grow 8% - 10% annually. Globally, cash usage has been gradually declining over the past two decades as eCommerce and card not present transactions have continued to grow in usage. This gradual trend combined with the COVID-19 pandemic has led to the increased popularity of several electronic alternative payment methods (buy now pay later/BNPL, digital wallet, order ahead/curbside pickup, etc.) allowing an ever-increasing group of payment companies outside of traditional merchant acquirers to profit off this consumer desire for digital solutions. In the U.S. alone, the COVID-19 pandemic led to an estimated 80% of all transactions in 2021 being noncash compared to 2019 where 70% of all transactions were estimated to be noncash. Globally cash has dropped in usage from an estimated 31% of all transactions in 2018 to an estimated 18% in 2021. While part of this trend is likely to shift back over time, there is still strong consistent growth in electronic payments.

In the same way that emerging alternative payment methods have sprung into usage, an increasing amount of new participant entities have emerged from an increased consumer demand to manage their money in greater ways digitally. From business uses like managing payroll virtually and issuing prepaid debit cards for payments, to embedded banking and integrated payments, increasingly there is no shortage of digital money management schemes and entities that are being developed.



Sources: TSG analysis, PPRO, Worldpay from FIS

Resilience in the Face of Current Events

The payments industry is resilient, with global supply bottlenecks exacerbated by the COVID-19 pandemic having minimal effect on the operational aspects of processing transactions. In an industry where anything less than a 99.999% uptime can be considered a gross operational failure, the payments industry has been built on the principal that the systems in place must overwhelmingly work 24 hours a day.

Despite the concerns of a recessionary economic cycle, the high rates of inflation exhibited thus far in 2022 are seemingly a net positive for entrants in the payments industry. As merchant prices rise with inflation, merchant acquirers and payment service providers are capturing that additional markup through their processing revenues. In a similar way that the price elasticity of demand explains why petrol and food staple purchases remain steady in an inflationary environment, this also explains why payment service providers are not negatively affected – the demand for the convenience of electronic payments remains regardless of the status of the economy.

Sources: TSG analysis

Efficient Economic Model

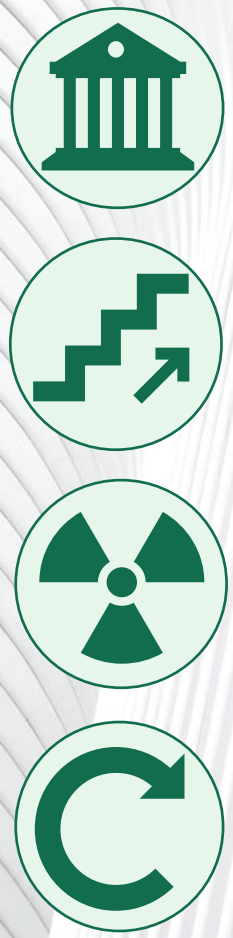
Comparable to other high growth technology and industry sectors, the payments industry has several characteristics that make entities within it a lucrative and attractive investment opportunity.

Minimal Capital Requirements – Across most business types within the payments industry, a low amount of liquid capital investment and inventory is required to achieve growth and profitability.

Scalability – The major capital needs that are required for payment companies are typically in initial software R&D or platform cost. With the growing trend towards SaaS and recurring revenue models, this upfront capital is more easily amortized in comparison to other industries.

Manageable Risk and Exposure – While certain merchant types are inherently riskier than others, this risk is largely manageable by the payment entity and safeguards can be put in place to limit or avoid unwanted risk. This can be done simply through targeting specific merchant industries that meet an entity's risk profile.

Predictability – Revenue is easily forecasted and expected across an existing book of merchants. Outside of holiday spending peaks, the payment volumes remain consistent and forecastable from year to year.



Sources: TSG analysis

Ecosystem Provides Opportunity

It's been established that the payments industry is reliable, profitable, and inelastic, but this exhibited consistency is not the most lucrative trait when comparing investment opportunities. Using the consistency of the industry as a jumping off point, all participants in the payments industry have an extensive runway to innovate and provide added product and services to enhance profitability.

Client Pricing Flexibility – Payment service providers largely have the freedom to quote and adjust prices variably as they see fit.

Ever-Evolving Technology – Whether its new payment methods, real-time payments, or QR payments, the payments industry is constantly evolving and building on the infrastructure that's been established over the past several decades.

Vertical Specific Solutions – The merchant community has consistently been moving away from horizontal one size fits all solutions and have increasingly been employing vertical specific software and services that is more applicable to the operations of a merchant's industry.

Expandable services – Businesses are constantly evolving, and as they grow and succeed, the requirements of the business fluctuate. Value added services such as loyalty, chargeback management, white glove technical support, employee management, and advanced reporting are only some of the services that can be upsold as merchants in a portfolio require them from their payment service provider.

Fragmented Market Provides Roll Up Strategy – Hundreds of independent sales organizations (ISOs), value-added resellers (VARs), referral banks, gateways, and fintech innovators give ample opportunities for large public payment companies to consolidate through acquisition.

Sources: TSG analysis

THE TSG VALUATION APPROACH

The TSG Approach

Understanding how to gauge value of a payments company is important for many reasons. Publicly reported statistics in investor relation reports can only tell a fraction of a company's story. TSG's experienced M&A team takes a unique approach to company and portfolio valuations focusing on three key components of value:

Three Primary Components of Value

- ***Portfolio of Merchant Contracts*** – Includes income from the back-book attriting portfolio, net of the expense incurred to support the income stream.
- ***New Account Sales Engine*** – Includes the income generated from a historically proven level of new accounts net the cost of the infrastructure and practices that produce new accounts.
- ***Proprietary Technology*** – Estimated market value of the technology package architecture, product, risk, and operation.

THE TSG VALUATION APPROACH

The Value of the Portfolio and Sales Engine is estimated using the discounted cash flow valuation approach based on a bottom-up cash flow pro-forma.

Analyze Historical Activity Trends and Drivers

- Gross Profit Profitability
- Attrition
- New Accounts
- Sales, Operating, and Administrative Expense
- Compare Activity Rates to Market Benchmarks

Develop Pro-forma Cash Flow Model

- Based on assumptions derived from the historical activity analysis
  - Back-book
  - New Accounts
  - Sales and Operating Expense
- Select appropriate net present value (NPV) discount rate
- Identify and assess sensitive assumptions

THE TSG VALUATION APPROACH

Our methodology provides a reliable valuation of a payments company:

- **Seasoned team of analysts**
- **Expertise working with businesses focused on a recurring revenue model**
- **Separation of value components provides a realistic growth curve and the ability to discounts at varying rates according to risk**
- **Assessment of historical growth components isolates attrition, retained, and new accounts**
- **Model facilitates “what if? “ sensitivity analysis**
- **Proven acceptance in the industry**

TSG is a fast-growing analytics and consulting firm. The company serves the entire payments ecosystem, from fintech startups to Fortune 500 companies. The firm provides its clients with advisory services, research and analytics to help them plan and execute their strategic initiatives. Based in Omaha, a recognized payments industry hub, TSG is an established leader in this high-growth, ever-evolving space.

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20+ YEARS AVERAGE ASSOCIATE EXPERIENCE IN THE PAYMENTS INDUSTRY

1000+ CLIENTS ADVISED, INCLUDING MANY IN THE FORTUNE 500

~4M CARD-ACCEPTING MERCHANTS IN TSG'S AIM ANALYTICS PLATFORM, DRIVING MILLIONS OF DOLLARS IN ROI FOR ITS USERS

250+ COMPLETED PAYMENTS COMPANY EVALUATIONS; AS WELL AS ~30 BUY/SELL/INVESTMENT ADVERTISEMENTS

40+ OF THE TOP 50 MERCHANT ACQUIRERS SERVED, INCLUDING 9 OF THE TOP 10

400+ COMPLETED MARKET INTELLIGENCE ANALYSES ON THE GLOBAL PAYMENTS LANDSCAPE, UNCOVERING HUNDREDS OF THOUSANDS OF DATA POINTS