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INSIGHT

Payment Services Potential

By Jakob Greisen, Portfolio Manager, C WorldWide Asset Management Fondsmaeglerselskab A/S.

Globally, more than 50% of all payments are still made in cash. It is estimated that annually, electronic payments grow c.10% driven by growth in global consumption and electronic payments at the expense of cash. The transition to electronic payments is supported by the increased consumption within e-commerce where new product categories from flight tickets, hotels, household staples, clothing, etc. are bought and paid for online. Also, it is easier and safer to pay electronically. This provides an attractive background for electronic payment systems globally and thus an interesting investment opportunity for the longer-term investor.

High barriers to entry and low marginal costs

Today, consumers can easily and safely pay through a payment system (e.g. Visa, MasterCard, American Express) because the underlying confidence in the system is high. This is the result of the large payment service providers having built-up an extensive network over many years, which is very difficult to replicate and thereby has high barriers to entry.

A robust and scalable network is paramount in order to enable more than 2 billion consumers with over 40 million businesses across more than 16,000 financial institutions with round-the-clock real time payments. This takes place through an extensive network with a vast number of different commercial and legal agreements each with variations to comply with legislation in the local markets, including adjustments for all the users' needs and flexibility in a world of constant change and new opportunities. Confidence and trust in the system is essential to long-term sustainable growth, and payment service providers invest large sums in encryption, person identification, consumption patterns, etc. In general, consumers are protected from fraud and misuse and have not experienced any major failures that have entailed significant costs.

The fixed costs of running a global payment system are high, but the cost of carrying out the individual payment transaction is close to zero. These conditions create high entry barriers for new suppliers, who must overcome considerable set-up costs and also gain consumer trust. On the other hand, the established players benefit from their market dominance and low marginal costs. This is reflected in the historical development over the last ten years, as illustrated by MasterCard and Visa. Earnings for these two companies in this period have increased more than six times – equivalent to an annual average growth of c.22%. The companies' share prices have risen even faster with compounded annual growth rates of c.25%.

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Innovation on top of existing infrastructure

The industry invests large amounts in developing new payment methods that make payment easier, more accessible and more secure to the advantage of both customers and the business community. Examples are new wireless payment offerings where the consumer pays through placing their payment card, smart watch or smart phone on the credit card terminal. Another advantage of contactless payment is that it lessens the "consumer's pain" or immediate impact of the payment, whereas this can be very tangible, when paying with cash. The less "painful" the payment is, the more money the consumer tends to spend. This is obviously in the interest of both the business community and the suppliers of the payment services, whereas the consumers need to prepare for more self-awareness.

Today, it is possible to transfer and return money directly between shop and consumer as well as between shops; it also enables public authorities to transfer money directly to the consumer. This helps to reduce corruption, especially in emerging market countries. India, for instance, is far advanced in the use of biometric iris recognition and fingerprints to use as person identification for transferring financial services.

The new innovative players within payment services, such as Apple Pay, Google Pay, and Amazon Pay are not direct competitors as their payment solutions rely on the existing big payment service suppliers. This is because the payment service providers have succeeded in developing their existing systems to support new payment opportunities. This way, the fintech companies are embraced as partners and not as competitors, which was an initial concern. The new players have acknowledged that the underlying infrastructure is hard to replicate and that it provides recognition to the customer and security in the payments by cooperating with the existing payment system suppliers.

Emerging markets growth and growing travel activity

As payment services are a vital infrastructure, not all countries welcome the existing suppliers or providers. China wants its own independent system and international payment services will probably never gain the same dominance in Asia as in Europe and the US. Despite all this, there is a massive growth potential driven by the rapid rise in the global middle class.

On top of this, there are structural tailwinds from the growing travel activity globally, as earnings from payment services are higher from foreign transactions due to extra foreign exchange earnings, among other things. In particular, tourism from emerging markets is growing rapidly. It is estimated that China accounts for almost 20% of the world's consumption among travellers – and the country has only just developed a taste for travelling abroad.

The value of predictability

While the use of cash as a form of payment may be an increasingly rare sight in many countries, there are still significant growth opportunities globally – with more than 50% of payments still being settled in cash. Revenue growth for payment services will be driven by growth in global consumption combined with the transition from cash to electronic payments. The leading payment service operators possess high barriers to entry – which will be hard to replicate – together with very low marginal costs. Therefore, their business models are unlikely to be eroded by new competition. New innovative payment opportunities should continue to appeal to consumers as they make life easier. This, in turn, will drive the ongoing transition from cash payments to electronic payments.

As active, long-term investors, we prefer structural growth themes, which enables us to focus on more sustainable earnings growth. Growth which is more predictable and thereby of higher quality resulting in a powerful compounding effect. The global payment services industry is a good example of this where companies like Visa and Mastercard are uniquely positioned over the long-term.

C WORLDWIDE ASSET MANAGEMENT FONDSMAEGLERSELSKAB A/S

Dampfaergevej 26 · DK-2100 Copenhagen

Tel: +45 35 46 35 00 · Fax: +45 35 46 36 00 · VAT 78 42 05 10 · cworldwide.com