

EQUITY

Standing Up to Disruption: The Future for Card Payment Systems

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Emerging technology and changing customer behaviour may pose an existential threat to credit and debit card payment networks, but Diana Keenan, research analyst, Franklin Equity Group, is nonetheless optimistic about the payment industry's future. She explains some growth opportunities for traditional payment networks and outlines some potential pockets of investment opportunity in the industry.

The payments ecosystem underpins the way we use credit and debit cards to buy goods and services, and it is undergoing significant upheaval.

The emergence of new technology in the space, along with modified customer behaviour, is driving these changes.

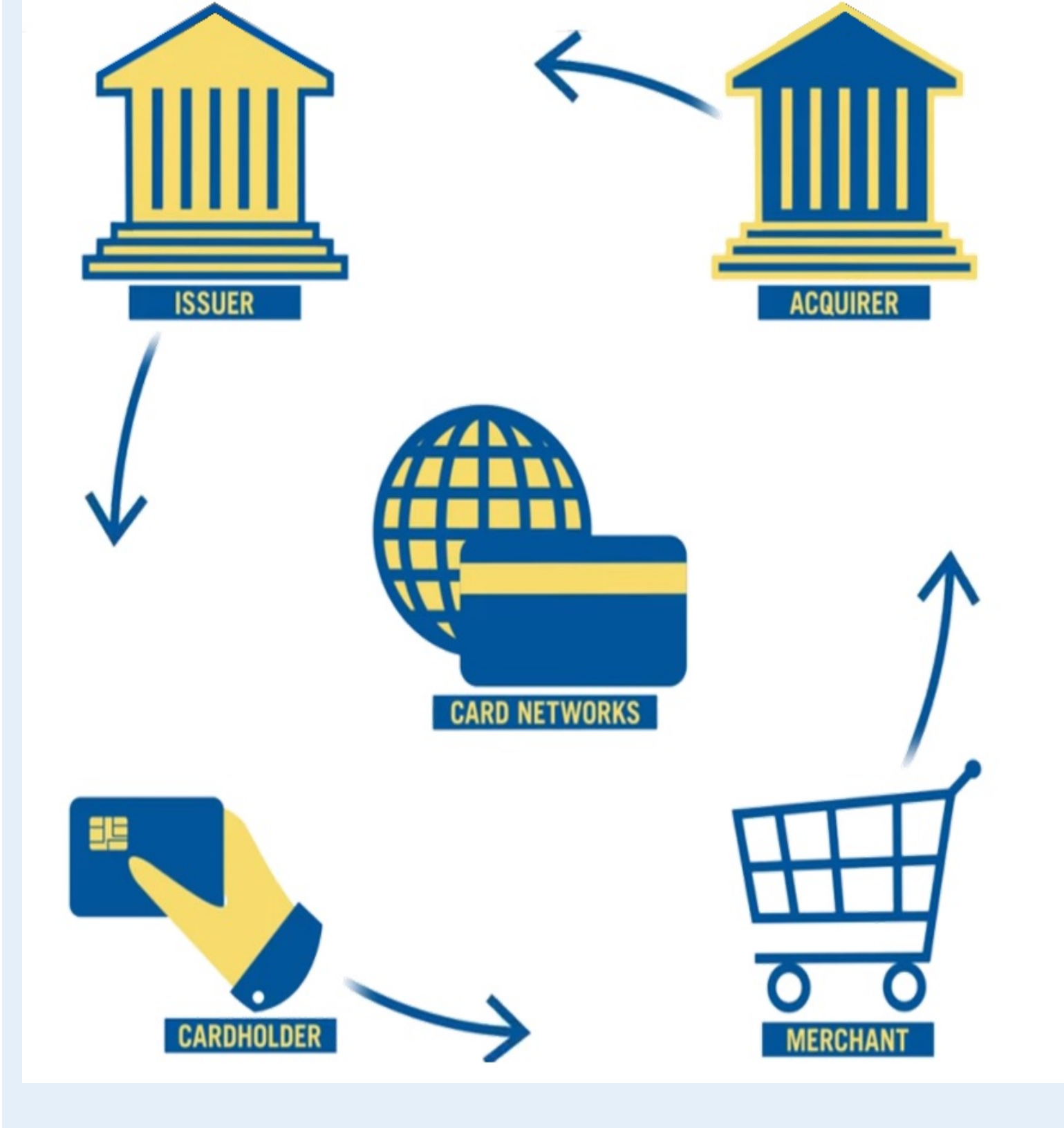
Despite the shifting landscape and potential threats to established players in the space, we believe card networks should remain well-positioned and could enjoy solid future growth for many reasons.

WHAT HAPPENS WHEN YOU PAY BY CARD

Card transactions rely on a payments ecosystem known as the four-party card system. As the name implies, there are four constituent parties involved:

- **Merchants:** Retailers that accept payment for goods and services by card.
- **Merchant Acquirers and Processors:** Companies that contract with merchants to accept card payments. The merchant acquirers and processors work alongside the card networks and provide payment processing and settlement services and reporting.
- **Card Networks:** The card networks, such as Visa or Mastercard, provide additional processing and operational systems and essentially act as a liaison between the merchant acquirers and processors and the issuing banks.
- **Issuing Banks:** The financial institution that issues the card to account holders.

Broadly speaking, each time a consumer swipes his or her card in-store or pays with a card online, the transaction will move from the merchant to the merchant acquirers and processors. Then it moves to the card network and finally on to the issuing banks for validation.



The Drivers of Disruptive Change

The evolution of e-commerce and growing smartphone penetration remain the two most often cited drivers for change in the payment ecosystem.

Smartphones are giving consumers more ways to pay in-store and online through digital wallets, QR codes and in-app payment capabilities. However, cards still largely fund these digital wallets, and mobile payment methods will likely help accelerate the replacement of cash with electronic payments.

That being said, certain changes in technology are introducing new risks to the payment ecosystem. For example, e-commerce is causing a new class of competitors to rise, including companies like PayPal. Despite current partnerships with card networks, these players could pose long-term disintermediation risks to the networks if an increasing amount of transaction volume were to become directly connected to consumer bank accounts.

Despite the changing landscape and potential threats, we believe there is still room for solid future growth ahead.

In developed markets, where there is high penetration of cards and widespread merchant acceptance as well as card-based loyalty reward programs, cards are still the preferred way to pay.

We believe the business-to-business market is another area with growth potential for card networks. It's a large market where checks are still used to make many payments. We feel there is a strong opportunity for the card networks to gain share here over time.

A New Front Opens in Emerging Markets

In addition, alternative local payment methods that completely bypass the traditional four-party card systems are becoming increasingly common in some markets, primarily in emerging markets with underdeveloped banking systems.

In China, for example, the retailing behemoth Alibaba has been able to extend its dominance in e-commerce to online and mobile payments with AliPay, its own third-party payment system.

Still, we believe card penetration still has room to grow globally even in emerging markets, where the card companies are aggressively working to ensure long-term success and avoid displacement from the alternative local payment methods.

Pockets of Investment Opportunities Remain

The merchant acquirer and processor space faces the most risk of disruption, in our view, as many new players are entering this market to simplify payments processing.

Conversely, we feel the card networks have wider scope than other players within the payments value chain and continue to present compelling investment opportunities at this time.

We believe there are pockets of potential investment opportunities among payment service providers with disruptive technologies and business models—those looking to consolidate the merchant acquirer and processor space with a single-platform approach—and companies with e-commerce platforms that have integrated omni-channel payments support.

To learn more about how cryptocurrencies, blockchain and digital payments are changing our world, visit: [Taken On Trust: Disrupting Money](#)

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