Guest Column By Eric Grover

Contemplating The Yin And Yang Of Payments

Highflying Square and processing Goliath First Data, with its burden of $22.5 billion in debt, are the yin and yang of the payments industry. Facing different challenges, both would like to do IPOs. Square must prove it can make money and is more than an ISO. First Data must revivify growth.

The payments space is hot. Acceptance in particular is enjoying a renaissance because it is relatively lightly regulated, fiercely competitive, has low entry barriers and enormous growth potential. A tsunami of new and nontraditional innovators bundling additional value for merchants around payments and employing new origination channels, are stressing traditional acquirers, processors and ISOs.

Tales Of Two Companies

While it wasn't the first to evangelize mobile acceptance, Square captured the public's and venture capitalists' imaginations, and spurred copycats and an explosion in smartphone-and-tablet-based acceptance. In 2011, roughly 4 million smartphones were being used for mobile acceptance. In 2012, 9.5 million were used and in 2013 the total reached 17 million. Mobile acceptance strengthens the existing payment system.

Nobody labors under any illusion First Data is going to disrupt the payments world. The processing behemoth will never be a nimble, highly-adaptive Silicon Valley-style innovator, nor should it be. Its competitive distinction is industrial-strength processing with multinational delivery.

It must, however, monitor the creative froth, sort the wheat from the chaff and by acquisition, partnership and copying and building, put new and relevant services into its humongous global distribution system.

Merchant acquirers increasingly combat pricing erosion and attrition by selling cloud and POS-based software to help retailers manage their businesses, risk management, marketing analytics, gift cards and rewards, making merchant relationships stickier and generating fees.

Square relies on the low-cost retail channel to originate small and casual merchants. In contrast, First Data employs a full suite of channels: direct sales reps, ISOs, bank-referral programs, bank joint ventures and VARs. Square doesn't provide live merchant support. First Data couldn't get away with a service-lite model and processes for many of the world's largest merchants and financial institutions.

Given the promise of enhanced models, a growth market, a path to tens of millions of merchants, and artificially low interest rates, not surprisingly great innovators and still unproven and even some dubious challengers are commanding nose-bleed valuations.

Businesses are worth what investors are willing to pay for them, which ultimately is based on a view of their discounted future cash flows. PayPal acquired PSP Braintree, serving Uber and AirBnB, for $800 million, and Stripe raised $80 million at a $1.75 billion valuation. They distinguish themselves with fast-and-easy integration, high-touch service, transparent pricing and flexible terms. A little edge is worth a lot.

In May, Vantiv announced an agreement to acquire Mercury Payment Systems for $1.65 billion, valuing it at a rich 7x 2013 revenue and 38.6x 2013 net income. Mercury's insight was to partner with software providers and developers to sell bundled payments acceptance, lowering origination costs, merchant attrition and price sensitivity. Revenue growth has been robust at 16.7% and 31.1% in 2013 and 2012 respectively.

New-age ISO Square's problem as it burns through the $367 million it's raised, is demonstrating it can be more than an ISO serving small businesses on smartphones and tablets, and that it has a path to building a business worth north of $5 billion.

Its investors bought a heady promise of what it might be. Square is losing $100 million a year. Its annual net merchant discount revenue has been estimated at between $110 and $165 revenue, implying a 30x-plus revenue valuation multiple, plausible for a venture starting to sell an Alzheimer's cure, but preposterous for a money-losing ISO serving small and tiny merchants.

In its 2007 LBO while KKR made overly optimistic valuation assumptions First Data's business and business model were concrete. It's a close call however whether the overleveraged payments mammoth is worth more than its outstanding debt, which is 2.1x 2013 revenue. Payment processors Total Systems, Vantiv, Global Payments and Heartland Payments Systems have valuation multiples of 2.7x, 2.1x, 2.1x and .7x of revenue respectively. But in 2013 Total Systems grew revenue 14% while First Data grew a paltry 1% - less than inflation.

First Data's paramount challenge is growth. With no or only low single-digit growth, an IPO isn't going to happen. Debt holders will take a haircut and investor KKR a loss. General-purpose-card-purchase volume in the U.S. increased 7.9% and globally 22% in 2013. First Data should match or slightly surpass market growth. With low to mid-teen growth, the payment Gargantua could grow out of its troubles.

Leadership Matters

Twitter co-founder Jack Dorsey brings Silicon Valley buzz to Square, ergo its stratospheric valuation and surfeit of venture capital. Worst case, the mobile acceptance phenom is an overvalued ISO, which will have to trim its sails.

Since its epic LBO, First Data has cycled through multiple CEOs. Saying at the Money2020 conference in Las Vegas "First Data is open for business," Frank Bisignano, current CEO, seems to have fire in the belly. The caffeinated New Yorker may be what the payments giant needs. Time will tell.

With different hurdles, the moment is upstarts' and incumbents' to seize. ■

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