



## Driving merchant services and digital commerce: Findings from McKinsey's 2012 U.S. Small Business Acquiring Panel

Small businesses occupy a critical place in the U.S. economy. For payments, these small merchants not only account for the largest portion of acquiring revenues, they also play a major role in the current trend toward digital payments. For this reason, the real battle in digital payments as the economy recovers will not be for the business of the retail giants, but for that of small businesses. To be successful, merchant acquirers and other service providers will need to deliver new and better payments and commerce solutions to this diverse, fragmented merchant base.

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While “mom and pops” may seem insignificant compared to mega-retailers, their combined sales account for roughly half of all retail spending. Moreover, these businesses (there are roughly 25 million of them in the U.S.) generate an over-sized share of the retail and service industry’s new ideas and a major portion of innovation and growth.

### **Merchant payments services**

In the U.S., small business acquiring has long been the profitable anchor in the industry, generating roughly two-thirds of industry revenues on one-fifth of the volume (Exhibit 1). Small business is a dynamic seg-

ment, increasingly competitive, and a must-win for any player in merchant acquiring.

Several trends are reshaping small business acquiring. In the post-crisis recovery, small business sales volumes have been sluggish. As larger firms grow their volumes, the mix for many acquirers will shift to lower-margin segments and impact overall revenues. As small business recovers, however, this should provide a boost for acquirers. At the same time, pricing pressure in this segment is higher than ever. New entrants have promoted set pricing and stripped out fees, establishing new reference points for many

small businesses. The competition for this segment, therefore, will be rigorous.

Furthermore, a new set of players is reshaping the terrain. New age independent sales organizations (ISOs) such as Square and Groupon are aggregating small merchants with new business models, while value-added resellers (VARs) are making major gains by offering integrated services to specific verticals (e.g., physicians offices, restaurants), with payments as one feature. For acquirers, these channel partners can help grow processing volumes. But they do disintermediate the direct acquiring relationship. Finally, acquirers are facing a decision about how deep into value-added services they should venture. These serv-

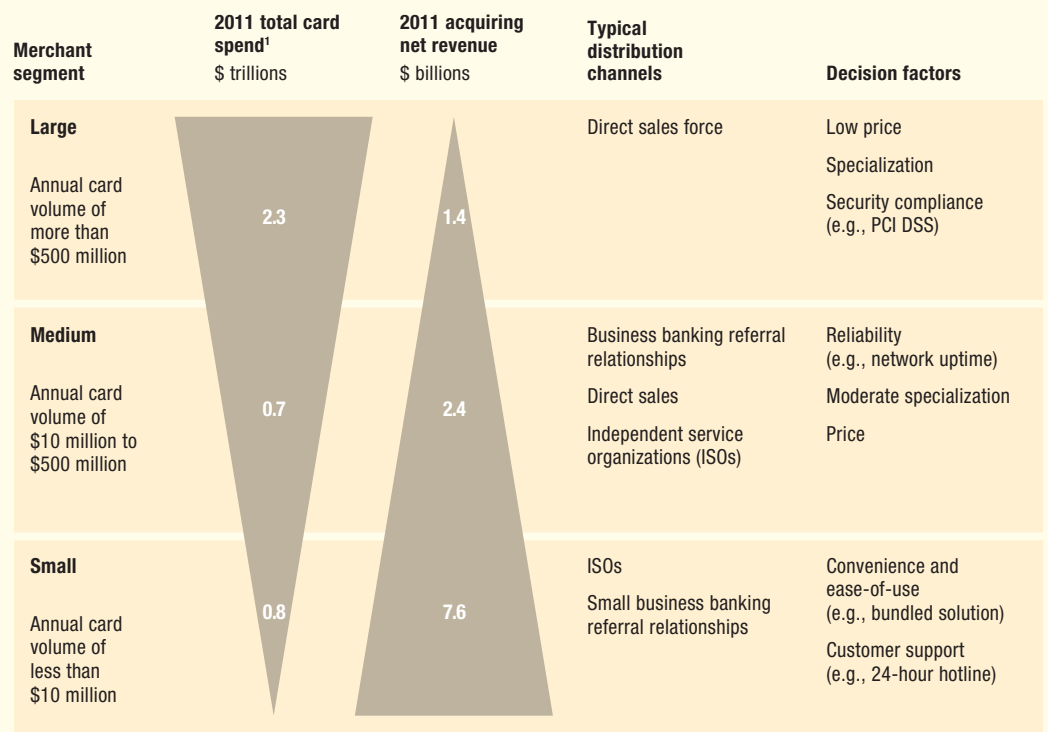
ices—e.g., inventory management, payroll, customer management—can have high margins but are often far from core processing competencies.

What do small businesses want from merchant service providers? As they grow, these entrepreneurs need to expand their offerings into new channels. Based on evidence collected by the McKinsey Small Business Acquiring Panel, they need the help of merchant acquiring partners for critical services ranging from bank card acceptance to loyalty program management. (See page 35 for more on the panel.)

But there is no one answer: Half of all small businesses reach their customers through a

Exhibit 1

**In the U.S., small business drives the majority of acquiring revenue, from a smaller base of volume**



<sup>1</sup> Includes C2B and B2B point-of-sale and bill pay spend using card instruments

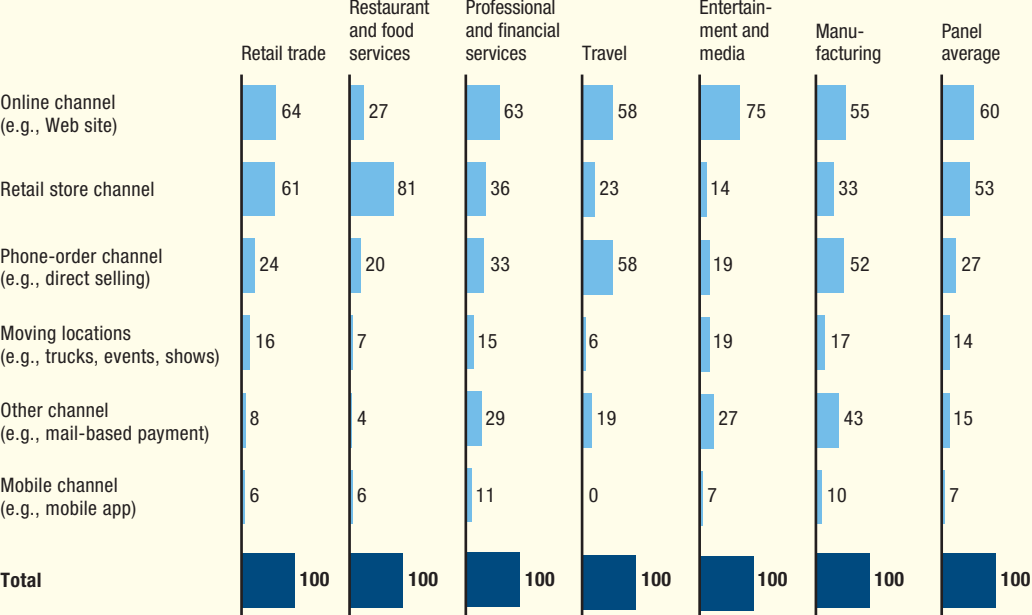
Source: Nilson Report, 2003-2008;  
McKinsey Payments Practice

Exhibit 2

Use of channels varies substantially by small business sector

Small business – use of channels (choose all that apply)

Percentage of respondents



Source: McKinsey Small Business Panel

Exhibit 3

Small business perspectives on retail POS merchant acquirers

Provider	Average rating	Perceived strengths from panel (select)	<div><div></div>Better</div> <div><div></div>Worse</div>
Bank of America	<div><div></div></div>	National bank partner for businesses Fast settlement and payout to merchant	
First Data	<div><div></div></div>	Fast settlement and payout Loyal customers with long-term relationships	
Chase Paymentech	<div><div></div></div>	Integrated customer service, support tools Fast transaction and payments settlement	
Vantiv	<div><div></div></div>	Quality customer service Relationship to primary bank (Fifth Third)	
Elavon	<div><div></div></div>	Fast payments settlement for merchants Competitive fees and pricing	
Global Payments	<div><div></div></div>	Dependable and high-quality service Integrated software and online access	
Wells Fargo	<div><div></div></div>	Large national banking franchise Breadth of product and service offering	
Heartland	<div><div></div></div>	Quality customer relationships, personal service Competitive pricing (e.g., cost-plus)	
TSYS	<div><div></div></div>	Dependable service Easy-to-use processes	
Square	<div><div></div></div>	Convenient, easy to use, accept payments anywhere Low fee, simple pricing structure	

Source: McKinsey Small Business Panel – June 2012

single channel such as in-store or online. The other half use a combination of channels, ranging from online and phone marketing to mail order (Exhibit 2). These particular merchants see integration across channels as a key to success. Since they have more complex payments needs, they need better technology to drive their business performance. In addition, these multi-channel merchants frequently fragment their business across several payments providers—often using one for store point of sale, another for online and another for mobile locations. There is a clear opportunity here to consolidate “share of register” into one integrated provider.

Who are the leading players? For retail POS acquiring, traditional providers such as First Data, Chase Paymentech and Bank of Amer-

ica occupy the top spots (Exhibit 3). They compete across several dimensions—dependable service, fast payout and pricing. In terms of online acquiring, dependability of service, platform security and fast payout (rather than pricing) are the top concerns (Exhibit 4). In this case, PayPal has emerged as the clear leader, with roughly half of all online payment services.

In either case, relationships count. For this reason, bank-based providers have an edge. Half or more of small businesses surveyed said they would use their primary bank’s merchant services solutions, if available. But even the best relationship can be ruined by poor responsiveness, costly and unpredictable service and complicated processes. Competitors that address these “pain points” should capture share and loyalty.

Exhibit 4

### Acquiring: Most important factors for retail and online channels

#### Retail channel

Ranking “Extremely Important”  
Percent



#### Online channel

Ranking “Extremely Important”  
Percent

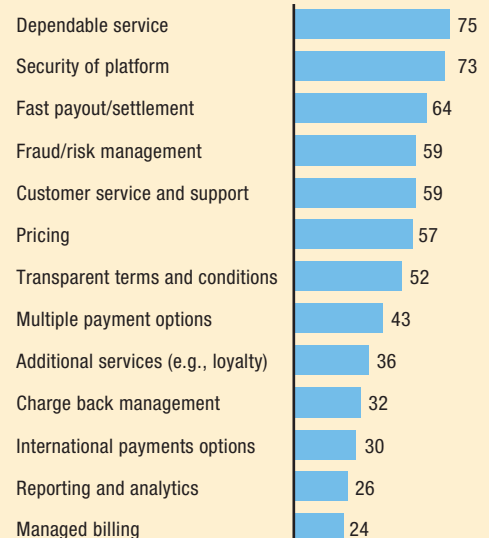
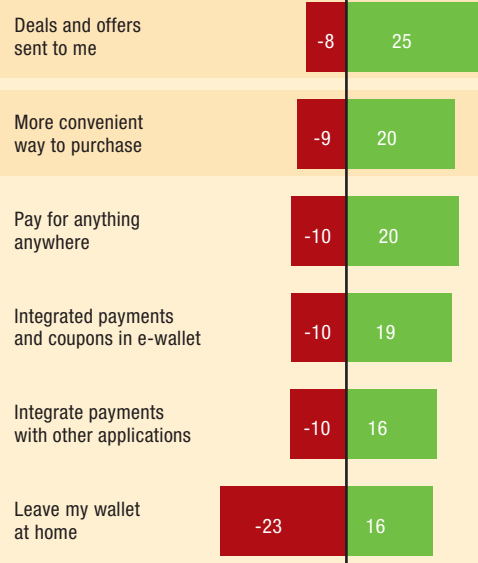


Exhibit 5

## Small business and consumers look to the same drivers for adopting mobile commerce

### Consumer results

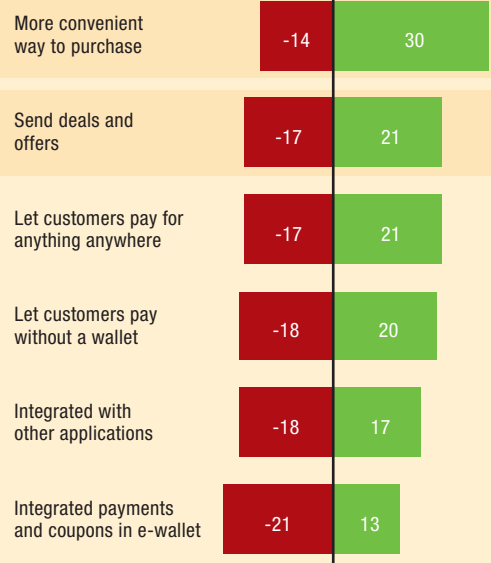
“Very excited” for driver  
Percent



### Small business results

“Very excited” for driver  
Percent

■ Not Excited  
■ Very Excited



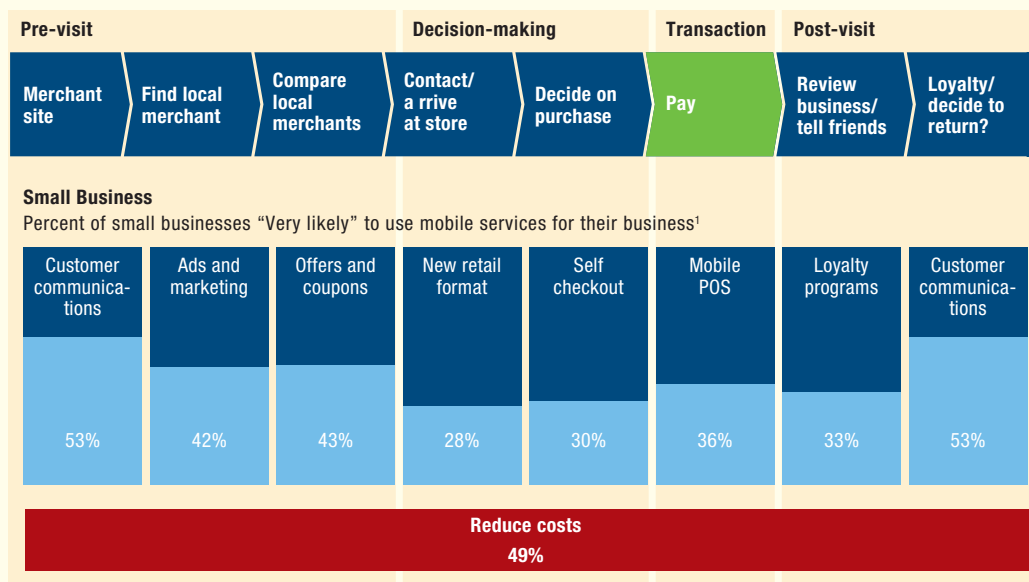
Question: “Thinking about the future benefits of mobile payments, what things are most exciting for you (1=not excited, 3=somewhat excited, 5=very excited)?”

Source: McKinsey Small Business Panel – June 2012

Exhibit 6

## Small businesses are planning to use mobile commerce to drive sales and customer interactions

### Consumer funnel



<sup>1</sup> Small businesses planning to use mobile commerce services in next 1-2 years (56% of respondents)

Source: McKinsey Small Business Panel – June 2012

### Digital commerce

Small business is the key to the success of digital commerce, as players like Square, PayPal and American Express are keenly aware. They realize that no digital wallet or mobile payments scheme can dominate if it is limited to the big box stores. Winning solutions have to reach the corner store as well, where they can be part of the customer's daily experience. The entire Social-Local-Mobile (SoLoMo) wave, in fact, hinges on *local* demand for offers, coupons and loyalty. As a result, local small business is critical to mobile commerce.

It is not easy to reach critical mass in the fragmented and fluid small business sector. Recent entrants have tried to sign up stores one at a time, with varying degrees of success. It is easier when small business bankers and acquirers have the advantage of existing relationships, but challenges remain.

One encouraging sign is that small business owners definitely see the mobile payments wave coming, expect it to be widespread at the point-of-sale (POS) in the next three to five years, and are aligned with consumers on major adoption drivers (Exhibit 5). These businesses indicate that better marketing and customer communications are a top priority; more important than mobile payments alone (Exhibit 6). Moreover, half of these en-

trepreneurs are willing to experiment with tablet- and phone-based POS systems, especially those that offer open platforms for new services, lower price and added convenience.

The youthfulness of many small business owners is another sign for optimism: Younger owners (25-35 years old) and smartphone users are twice as likely as the average business owner to embrace mobile commerce. Furthermore, business owners who are already multi-channeling their businesses, through the store and the Internet, are more likely to see the future in terms of mobile payments.

The digital commerce wave has major implications for merchant acquirers and other providers, because it will cause small business owners to demand new payments options, more fee transparency and better integration with other small business apps. In fact, it could lead them to switch providers entirely. Players like First Data and VeriFone have already seen this trend, and are opening more platforms to facilitate mobile commerce solutions. First Data is launching OfferWise, an open platform for new merchant applications, and VeriFone is promoting a more flexible, open platform for its terminal services.

For all the excitement, small business owners express considerable concern. They

### About the McKinsey Small Business Acquiring Panel

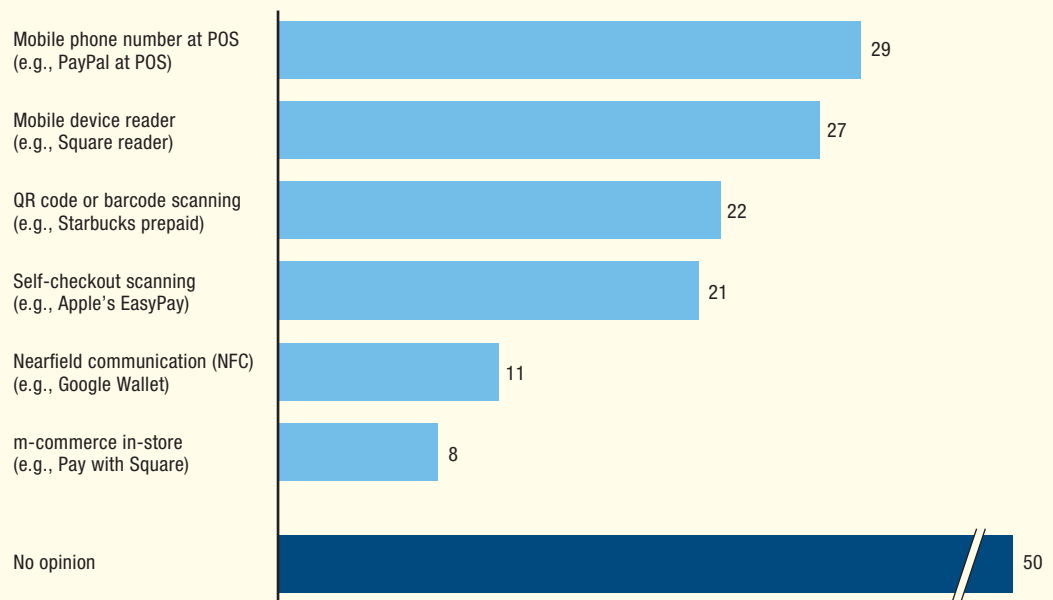
In June 2012, McKinsey convened a panel comprised of more than 1,000 small business owners, ranging from retail and professional services providers to manufacturers. The majority of respondents had annual sales ranging from \$500,000 to \$2 million, while the maximum was \$10 million. We asked the panel what they thought about merchant services, digital commerce and small business banking. Their responses provided the basis for this article.

Exhibit 7

**There is little consensus among small businesses on the POS technologies most likely to succeed**

### Which form of mobile payments do you think is most likely to succeed?

Percentage of respondents



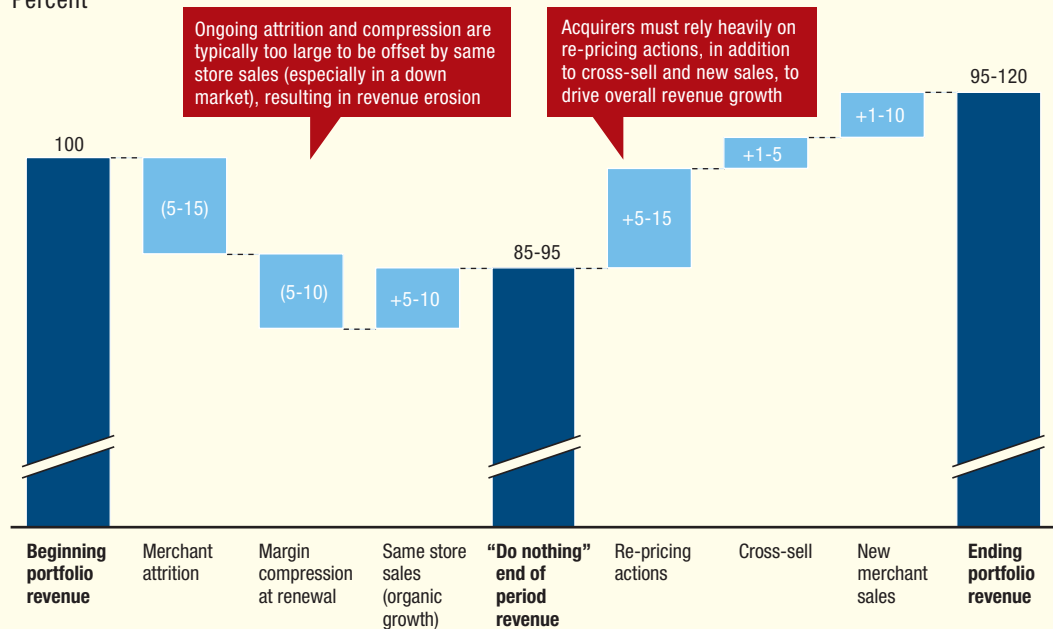
Source: McKinsey Small Business Panel – June 2012

Exhibit 8

**Pricing and new sales are needed to grow the portfolio and offset merchant attrition and margin compression**

### Example merchant acquirer annual run-rate revenue economics

Percent



Source: McKinsey Payments Practice

worry about confused customers, frustrated patrons and lost sales. When asked which mobile payments solution would succeed at the POS, half didn't know; they expressed confusion at the number of new players. Another half said that whoever the winners might be, they should keep their solutions simple, and base them on existing schemes such as mobile phone numbers or QR-codes (Exhibit 7).

### Capturing the opportunity

How should merchant acquirers navigate the new dynamics of this segment?

- **Help drive sales:** Business owners want the cash register (or the iPad register) to ring frequently. Mobile commerce applications should help the businesses drive new sales.
- **Keep it simple:** Small business owners are busy. New solutions must provide meaningful savings in terms of time and money. They must be easy to deploy and deliver value fast.
- **Review your pricing:** Pricing is critical and the market is constantly shifting. Repricing small business accounts can help drive 5 to 15 percent of revenue growth annually (Exhibit 8).
- **Forge new partnerships:** Channel partners are a critical source for volumes.

Aggressive partners that can integrate quickly will have the advantage.

- **Make a call on value-added services:** Vertical-specific solutions can secure business and grow margins, but can also distract from the core acquiring and processing business. Decide where to specialize and get ready to invest. Avoid “drifting” into new areas.
- **Leverage trusted advisors:** When small business owners find something that works, they tell other small business owners. Turning one small business customer into a “prosumer” who spreads the word is the way to grow.

\* \* \*

The success of mobile payments depends on small businesses. Since entrepreneurs are hungry for new tools to stimulate their growing businesses and are open to new ideas, merchant acquirers and others have an unprecedented opportunity. The shift to mobile commerce-enabled small merchants will challenge existing business models. Some relationships will be broken. But it will also be a time to deepen relationships and, ultimately, to deliver a better experience to customers and consumers.

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