



As value creation reshapes payments, can banks catch up with specialists?

Over the past 12 months, European payments companies have announced M&A deals totaling more than €40 billion (Exhibit 1)—a huge jump from the approximately €8 billion to €10 billion over the previous two years. This is just the latest surge in a wave of consolidation that has been building for years, and ranges from the merger of major European and North American processors to the expansion of private-equity stakes across the industry.

Jeremy Borot
Reinhard Höll
Tobias Lundberg

In fact, the payments industry seems to be entering something of a golden age. According to McKinsey's Global Payments Map—a detailed analysis of payment volumes, flows, and revenues in more than 40 countries—payments revenues increased by 11 percent from 2016 to 2017. Payments specialists and banks alike should be paying close attention to industry growth, investment, and consolidation and asking: what lies behind all the activity, and why are banks barely involved?

This article looks at how asset ownership is shifting, using Europe as a case in point, and considers the actions banks and payments specialists could take to bolster their position in a rapidly changing landscape.

How the ownership of payments assets is shifting

The past decade has seen the emergence of a top tier of M&A-fueled payments specialists and merchant services companies, first in North America and then across the world. With valuations exceeding those of leading banks, these multibillion-dollar companies include PayPal, Vantiv, and Visa in the United States, Cielo in Brazil, and Nets, Worldline, and Worldpay in Europe.

In Europe, payment providers such as Wirecard (with a market cap in excess of €17 billion) and Adyen (more than €13 billion) are

no longer niche players, having gathered momentum and started to close in on traditional banks.¹ What's more, these ex-fintechs may represent only the tip of the iceberg. Some of the world's most valuable companies, such as Apple, Tencent, and Alibaba derive a substantial proportion of revenues from payments and other related transactions—a proportion that can be expected to continue growing.

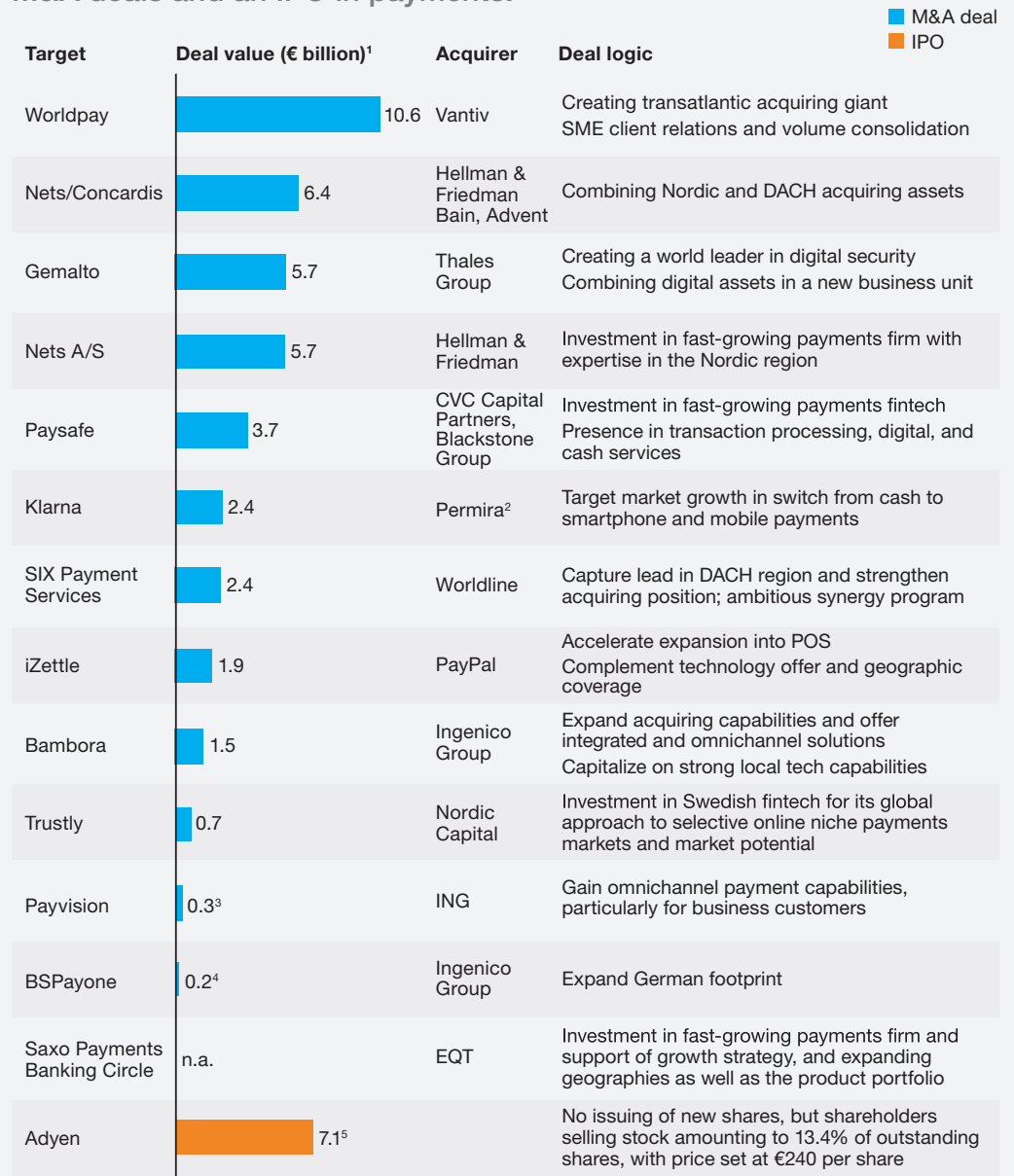
Conversely, cases of European banks taking over payment assets are relatively few and far between: ING's acquisition of a 75 percent stake in Payvision in March 2018 is a rare example. In fact, more banks are divesting payments assets than acquiring them: the sales by SIX of its payments unit in Switzerland, RBS of its 80 percent stake in Worldpay, and SEB of its card-acquiring business Euroline to a private-equity firm are a few notable examples.

Two recent developments help explain consolidation in European payments: the progressive disengagement of some banks from traditional payments and the emergence of payments giants as a result of technological and product shifts. Consolidation has happened in three stages, the first dominated by international specialists, the second by bank-owned utilities, and the third—which is still under way—by private-equity funds and local specialists.

¹ Valuations on July 1, 2018.

Exhibit 1

Between July 2017 and July 2018, billions of euros were spent on M&A deals and an IPO in payments.



¹ Enterprise value including cash and net debt; exchange rate of \$1US=€0.85554 as at June 29, 2018.

² Permira acquired a 10% stake.

³ ING acquired a 75% stake.

⁴ Estimated from publicly available sources.

⁵ As per IPO on June 13, 2018; €13.9 billion market capitalization as of June 29, 2018.

Source: Press reports

In the **first stage**, beginning in 2000, a small number of independent non-bank processing organizations, including First Data and Atos Worldline, launched an early push for global consolidation via a series of cross-border acquisitions. These moves had limited impact on industry costs, however. At the same time, cashless payments expanded, spurring sustained growth in transaction volumes. This stage peaked in 2007 with 56 deals totaling €1.4 billion.

In the **second stage**, running from 2006 to 2012, utilities formerly owned by banks were spun off as independent commercial enterprises and began merging to form larger and larger organizations. For example, Equens (formed by the merger between the Dutch Interpay and German TAI) and Nets (formed by the merger of Danish PBS and Norwegian

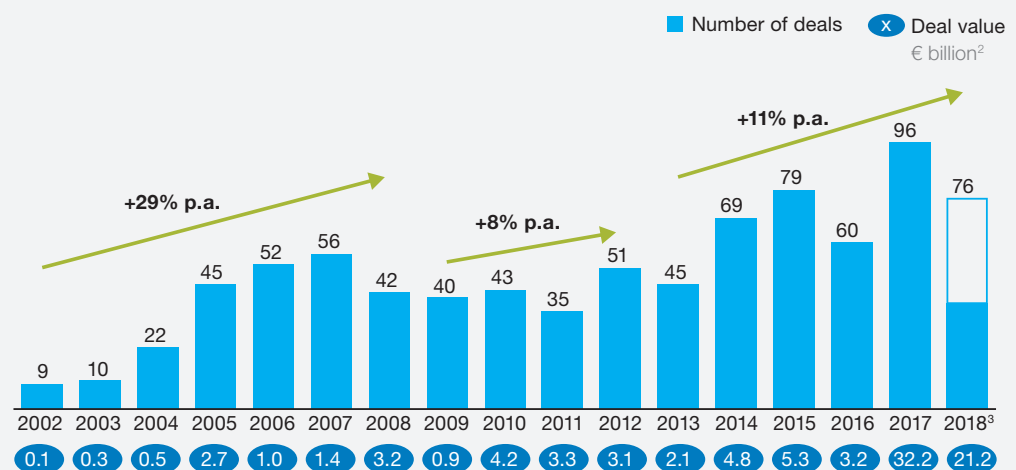
BBS) became the pre-eminent processors on their home turf and expanded into fast-growing markets across the region. Meanwhile, digital channels strengthened card economics, particularly through higher fee revenue from online and mobile acquiring and from cross-border acquiring, where changes associated with the Single Euro Payments Area (SEPA) caused a degree of standardization. The number of payments deals with European buyers remained relatively stable between 2008 and 2012, but their average value rose to €3 billion per year (Exhibit 2).

In the **third stage**, from 2012 to the present day, the role of private-equity funds is expanding and so, to a lesser extent, is the activity of payment specialists. Advent International's acquisition of 51 percent of Fifth Third Bank's processing subsidiary for

Exhibit 2

Successive waves of M&A are transforming the payments industry.

Deal value and M&A transactions for European payments companies¹



¹ Deals involving a payments company where the buyer is a European company.

² Calculated using exchange rate of \$1US=€0.85554 as at June 29, 2018.

³ Annualized based on data from first half of 2018.

Source: S&P; Capital IQ; press reports; McKinsey analysis

\$565 million in 2012 led to the creation of Vantiv. Advent had earlier joined with Bain Capital to acquire Worldpay from RBS in 2010, and went on to acquire Nets in 2014. Nordic Capital created Bambora from the acquiring businesses of SEB and by combining several payments service providers (PSPs) across Europe, North America, and Asia Pacific. Conversely, SIX Payment Services was acquired by Worldline and BS Payone by Ingenico. Momentum has accelerated in the past 12 months with large deals such as the acquisition of Worldpay by Vantiv. This surge in consolidation results from the combined effect of fintech start-ups undergoing serial M&A and global consolidation taking place among established champions in a relatively fragmented landscape. The increasingly programmatic M&A of specialists toward fintechs and smaller assets is a lesser factor in this process.

It is worth noting that while deal volumes have also increased in North America, the process has been less explosive and more gradual, and banks have played a more active role in payments innovation. As a result, fewer new US companies have joined the global payments vanguard: Vantiv and Stripe are the main examples, as against Adyen, Nets, Worldline, and Wirecard in Europe. Payments providers across the globe would be wise to keep a watchful eye on the payment activities of these emerging European specialists, as well as on technology giants such as Apple, Google, and Amazon.

Today's surge heralds a new wave of consolidation as a broad array of mature companies stand ready to take advantage of their capabilities at scale. More than 40 percent of fintechs tracked by McKinsey's Panorama

database focus on digital payments and analytics, and no fewer than seven out of the ten largest global unicorns provide payments-related services. Sidebar 1 "How the specialists are pulling ahead" examines what fintechs and other payment specialists are doing to outperform incumbent institutions in this dynamic market.

Can banks catch up?

So, what should European banks do about all this? It's worth noting that they have seldom managed to create value by increasing multiples, whereas former bank-owned utilities such as Nets and Worldpay have been able to transform themselves through progressive commercialization. Not only have they reduced average cost per transaction with larger volumes, but they have also defended overall margins.

But banks are far from helpless. They still possess significant payment assets across the value chain, and have opportunities to derive more benefit from them. As banks reorganize their payment activities, several new models are emerging:

- **Scale operators.** Banks such as Barclays and Crédit Mutuel are big enough to be payments specialists in their own right. They often put payments at the center of their ecosystem, aim to scale them, and see them as a key differentiator.
- **Front-end specialists.** Credit Suisse, Commerzbank, and others have thinned out their payment footprint by outsourcing part of their value chain (particularly in cards and issuing) or exiting it completely (often in acquiring). Even so, they still handle large numbers of transactions and see payments as a core customer offering.

How the specialists are pulling ahead

Since 2010, public payments businesses have outgrown other financial industry segments in Europe by 7 percent per year in revenues and 30 percent in profits, and enjoyed a clear lead in total returns to shareholders (TRS).² Over the past 11 years, payments providers' TRS grew by 16.4 percent per year, while retail banks, corporate banks, and asset managers saw low single-digit growth at best (Exhibit A).

However this was not solely the result of multiple expansion. When McKinsey analyzed the financial statements of 135 public and private payments companies, we identified five value-creation levers (Exhibit B):

1 Organic growth

Nearly half (48 percent) of the companies surveyed grew in volumes and revenue, largely thanks to the substitution of electronic transactions for cash. We expect this trend to continue, with Western European transactions increasing by 5.4 percent per year between 2017 and 2020 and helping to maintain payments' superior growth trajectory.³ This organic growth accounts for around 34 percent of the value created by the companies surveyed over the five-year period from 2012 to 2016. Part of this growth has come from successful efforts by newer fintechs and online commerce providers to increase their share either in specific markets, as Klarna has done, or in payments verticals, like Adyen.

2 Margin expansion

During a period characterized by low interest rates, a cap on interchange fees, and declining margins across the financial sector, more than half of the payments organizations we surveyed managed to increase their margins. This improvement accounted for about a quarter of the value created among the companies surveyed. How did they accomplish such a surprising feat?

The secret lies in a combination of factors. Given the high fixed costs in payments operations, margins expand as volumes grow. Both private and public companies focus on managing pricing and costs, and have strong pricing power. These factors are likely to continue globally, as we expect margins in the United States to narrow to European levels rather than the reverse.

3 Multiple expansion and shift in business focus

By altering their business mix, 53 percent of the payments providers surveyed have succeeded in achieving higher multiples. As a fintech, Wirecard has earned an above-average valuation by combining traditional payments revenues from prepaid and merchant acquiring with innovation in online and mobile payments. Established payments technology providers such as ACI Worldwide and NCR have expanded into delivering robust platforms and payment solutions for financial services companies as well as retailers.

4 M&A synergies

Estimated to account for 7 percent of deal value, synergies associated with M&A have been achieved largely through the combination of new technology with economies of scale. In the near future, faster payments, ATM consolidation, and branch closures will help to sustain or even accelerate resource optimization and value creation as more companies merge. This inorganic growth accounts for nearly 22 percent of value creation among the companies surveyed, and has been particularly relevant for acquirers.

² This analysis is based on companies for which information is publicly available; private companies' results are assumed to be broadly consistent.

³ Based on McKinsey Global Payment Map; payment transactions include cash, charge cards, checks, credit cards, credit transfers—Automated Clearing House (ACH), Real Time Gross Settlement (RTGS), debit cards, direct debits, prepaid cards, and other transactions.

5 Geographic, vertical, and segment expansion

A number of European organizations—in particular, acquirers such as Worldline and fintechs such as Wirecard and iZettle—have targeted less penetrated markets, be it countries, underserved segments such as micromerchants, or e-gaming verticals. Emerging regional, segment, and vertical champions are likely to continue expanding into economies that show potential for faster growth.

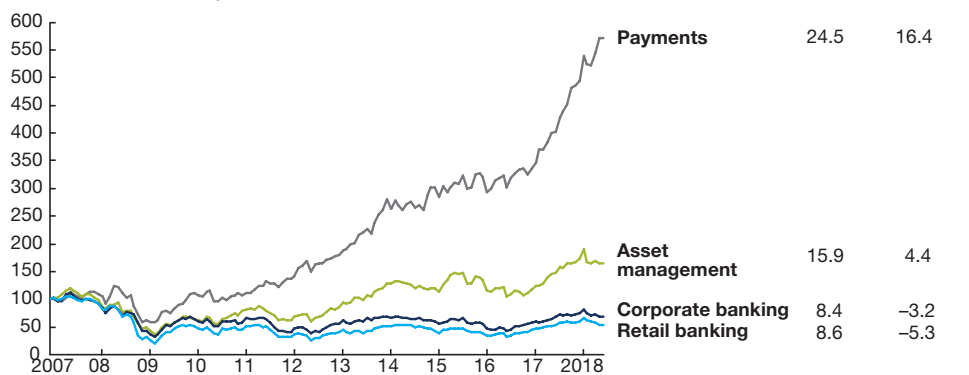
Pulling these five levers has enabled payments specialists to increase their value by 116 percent between 2012 and 2017. They can be expected to continue focusing on one or more of these levers to extend the industry-wide trend in value creation.

Exhibit A

Over the past decade, payments have far outpaced other financial services in terms of total return to shareholders.

TRS performance of European public companies¹

Indexed to 100 = January 2007



¹ Based on an analysis of public companies; custom indices (market-cap weighted) based on identified public European peers: payments N=24, retail banking N=20, asset management N=17, corporate banking N=5; 2018 data as of July.

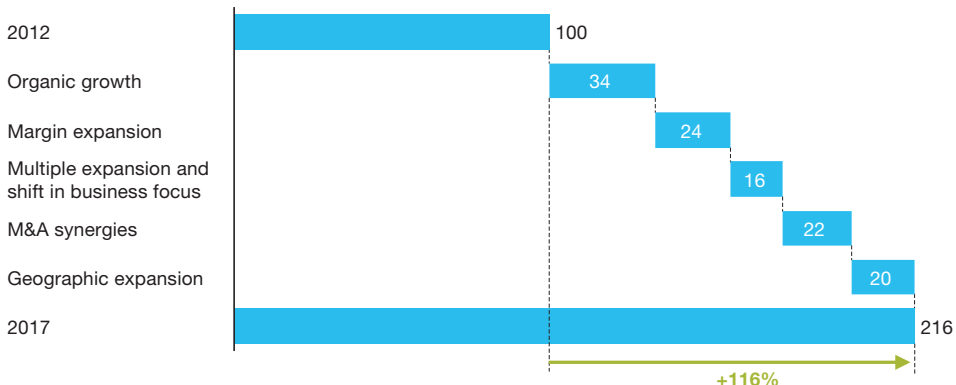
Source: S&P; Capital IQ; McKinsey analysis

Exhibit B

European payments firms have more than doubled in size since 2012 by applying five key levers.

Value-creation levers

Indexed: 2012 = 100



Note: Includes non-public companies, e.g., subsidiaries; based on actual or implied market capitalization of 141 firms.

Source: McKinsey Global Banking Pools

- **Global transaction banking (GTB) powerhouses.** Deutsche Bank and HSBC are among the leaders in a domain that remains almost exclusive to banks, albeit one that is rapidly consolidating.
- **Former payments providers.** The banks in this group have either exited payments completely (especially smaller and private banks) or view it as an outsourced product that needs to be offered via white-label corporate cash management or some other mechanism.

Yet evidence suggests that few European banks treat payments as a core differentiator, unlike some of their peers in the United States. Despite the evident importance of the payments business, neither banks nor equity analysts talk about it much (Exhibit 3). When we analyzed annual reports from 2017 and 2018 for 26 leading European banks, we

found that 85 percent of them did not report specific financial information on payments. Nor did they use consistent definitions for “corporate” and “retail” when discussing payments more generally.⁴

Similarly, analysts asked few questions about payments during investor calls: only 12 percent of the banks surveyed recalled being asked about payment-related matters. Most analysts paid little attention to payments in their equity reports, and usually adopted banks’ own breakdown of their businesses.

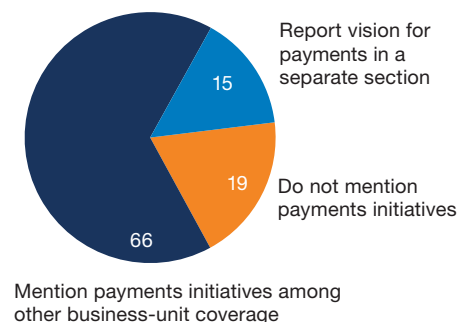
This suggests a misalignment in perceptions, given that the valuation of specialist providers indicates that markets view payments positively (Exhibit 4). Indeed, a fair sum-of-parts valuation of banks’ business suggests an uplift opportunity for the often-substantial payment component. Banks would be well advised to highlight payments

Exhibit 3

Few banks highlight payments as a differentiator, and even fewer analysts focus on payments.

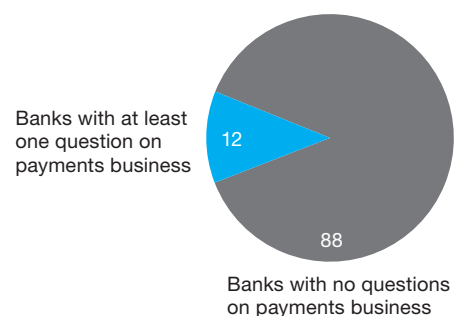
Review of investor presentations and annual reports for leading European banks¹

3Q-4Q 2017, %



Review of analysts’ transcripts for leading European banks¹

4Q 2017, %



⁴ “Corporate” could include transaction banking, global transaction services, and interbank transactions, while “retail” could include cards, customer transactions, and cash management.

Source: Banks’ annual reports and investor presentations for 2017 and 2018; investors’ call transcripts for Q4 (or, if not available, Q3) 2017, from SeekingAlpha.com and banks’ websites; n=26

in reporting to enhance transparency in financial markets and communicate a compelling equity story while acknowledging disruptive scenarios.

What to do now?

Banks in Europe and beyond should consider how to secure their position in a changing landscape, as discussed below; payments specialists should consider the analysis and actions outlined in “What should payment specialists do?” on the next page.

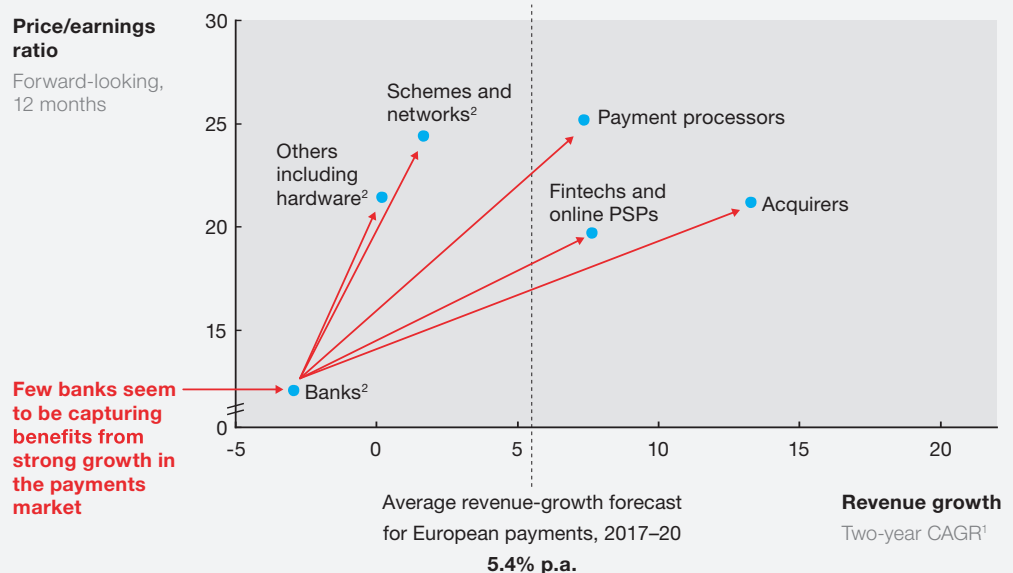
For banks, the best course of action will depend on their scale and the relevance of payments to their customer strategy. In a world increasingly dominated by open banking and

ecosystems, payments will be an anchor for customer interaction and a key driver of cross selling. Banks’ main actions can include:

- **Gather transparency around the operational upside and opportunity cost of not pursuing this.** This includes the pricing power and discount given, the ability to accelerate sales, new product and service propositions, further digitization, and so on. Even if banks run the payments arm as a cross-selling unit at lower margins the transparency of what the full operational potential is will help to inform if this should be run as a stand-alone profit center or as a cross-sales product to deepen customer relations.

Exhibit 4

Substantial differences in payments market valuations are only partly explained by growth.



¹ Year end 2015 to year end 2017.

² The P/E ratio of the respective unit's payments division.

Source: Annual reports; McKinsey Corporate Performance Analytics; McKinsey Global Payments Map; McKinsey analysis

What should payment specialists do?

A key step for specialists is to consider their high valuations and actively manage the associated expectations. McKinsey's analysis indicates that potential remains in each of the value-creation levers discussed earlier, and that:

- Further margin synergies should be achievable according to industry processing scale curves. Only the top five processors operate close to critical scale, and banks still process half of European card transactions in house. Regional champions will continue to make their presence felt as they consolidate volumes across markets. In addition, the ability to price and develop more differentiated propositions remains a large opportunity to drive margin upside or enable growth.
- Continued strong growth in transaction volumes will act as a tailwind. The economics of card processing and acquiring will strengthen further because of steady growth in consumer spending, the continuing displacement of cash, rapid growth in digital payments, and a reduction in costs per transaction. Key will be to capture these by accessing the right growth markets, and ensuring acceptance of the right payment models including new alternative models, which may require new acceptance and technology devices.
- Scope for further consolidation remains, and acquisitions (often of payment assets divested by banks) can help either to achieve cost synergies or to extend a provider's services to less penetrated markets. Payments specialists should take care to evaluate technology architecture and options for integrating systems as part of the rationale for any deal.

Specialists would also benefit from pursuing some of the actions suggested for banks—in particular, maintaining their focus on cost and revenue levers and doubling down on core strengths

- **Build or buy capabilities to become a large-scale payments provider** for the whole of the value chain or specific parts such as acquiring, ACH, and issuing, or specific segments such as omnichannel acceptance, vertical specialization, and so on.
- **Strengthen current position by intensifying partnerships** with fintechs and operating either as an ecosystem orchestrator, a digital bank providing additional services, or a niche specialist in selected ecosystems such as housing or B2B. Open banking, spurred by regulation such as the second Payment Services Directive (PSD2), and the proliferation of application programming interfaces (APIs) will accelerate such moves.
- **Divest assets** after comparing their current value with the value that could be created by a focused strategic partner or owner. Advances in technology and the fast growth of digital commerce are rapidly reducing the viability of legacy systems.
- **Drive for increased transparency of these payment assets** if these are distinctive units with clear growth trajectory.

GTB powerhouses face specific constraints as their model is even more dependent on digitization and economies of scale. They face three choices: becoming a top ten player; finding a regional, product, or industry niche (for instance, in European agriculture); or pursuing new partnership models with other regional players.

Banks—and for that matter payments specialists as well—should continue to evaluate cost and revenue levers such as a data-driven go-to-market strategy, a strong focus on sales and commercial excellence, focused operational leadership, and a relentless emphasis on security and compliance. Such levers can also help embed digitization and analytics in an organization: for instance, by replacing a traditional revenue-based segmentation with a data-driven customer approach. Omnichannel sales, rapid product development, and agile marketing become exponentially more powerful when blended with digital and analytical capabilities.

Incumbents—both banks and established payments specialists—will need to address their talent and people base. As key personnel approach retirement, organizations will need

to reskill their technical expertise with an emphasis on data-driven and digital competencies.

Most organizations should also explore opportunities to specialize and renew their focus on core strengths. Different forms of creative partnerships have emerged to speed up innovation in data analytics and new payments ecosystems, among other areas.

Finally, both banks and payments specialists should be aware of the potential for disruption if tech giants such as Apple, Amazon, Tencent, or Alipay were to use their financial might to invest billions of euros in the European payments market.

Banks must treat the shifts described above as a call to action to prevent value leakage. They need first to decide what role they want to play in payments and then to address opportunities more systematically. For payments specialists, the tide is in their favor, but they still need to manage high market expectations, continue riding favorable market trends, and be alert to responses from incumbent banks and new entrants alike.

Jeremy Borot is a consultant in McKinsey's Paris office, **Reinhard Höll** is an associate partner in the Düsseldorf office, and **Tobias Lundberg** is a partner in the Stockholm office.

The authors would like to thank Rita Calvão, Oliver Denecker, Kamil Dziwisz, Thorsten Ehinger, Natasha Karr, Wojciech Krol, Marc Niederkorn, and Jonas Wannefors for their contributions to this article.