

October 9, 2020

Dear Clients and Colleagues:

The COVID-19 pandemic has resulted in widespread structural dislocations in the global economy, largely due to unprecedented social distancing measures and lockdowns. At the same time, it has accelerated a secular shift towards digital payments that might have taken years otherwise. During this troublesome time, when a significant share of the global economic activity is migrating online, the payments industry plays an essential role, as it enables consumers, businesses, and governments to transact in the absence of face-to-face interaction.

The World Health Organization, governments, monetary authorities, and merchants worldwide urge using contactless payments over cash due to fear of spreading the virus and germs through physical money and cheques. Some emerging market (EM) countries went as far as sterilizing cash to help stop the virus from spreading. Credit card networks are increasing the limits for contactless transactions at the point of sale without entering a PIN code.

Meanwhile, consumers are adapting how they shop. The recent increase in digital payments is underpinned by the surge in e-commerce, home meal deliveries, and curbside pick-ups. People are currently testing the waters and some are placing their first online orders ever. Those who are familiar with the process will be inclined to continue using digital payments even when the pandemic winds down. According to Boston Consulting Group (BCG), in the early months of the pandemic, roughly 50% of consumers in the United States (US) were shopping online more frequently. SMEs are adapting quickly and have begun accepting contactless payments.

The widespread lockdown has had a terrible impact on most economic sectors, with some finding themselves on the edge of survival and awaiting governmental support. For example, discretionary spending, including restaurants, lodging, entertainment, and airlines, were hit very hard by the pandemic. According to JP Morgan's analysis, discretionary expenditures accounted for about 55% of total credit and debit card spending in the US in 2019. Therefore, most payment companies will face growth headwind in the near term. The impact will vary depending on sector exposure, client portfolio, and value proposition.

Looking past the pandemic, industry prospects in the medium and long terms remain buoyant. BCG sees payment revenues globally growing to \$1.8 trillion by 2024, from \$1.5 trillion in 2019. This implies a compound annual growth rate (CAGR) of 4.4%, which, although substantial, is still lower than the 7.3% CAGR the industry recorded over 2014-2019. The second half of the decade is expected

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to be more lucrative for the payments industry, as its global revenues growth should accelerate to 5.6% per year and reach \$2.4 trillion by 2029.

As the industry is becoming increasingly crowded, many emerging players leverage technological innovations to compete with incumbents and become the issuer, acquirer, network provider, or partner of choice. The likely winners in the post-pandemic period will be those who use this period to adapt, reinvent their business model, and rebalance the product and client portfolios to gain the scale and nimbleness.

While the digital payments' backbone is becoming almost invisible, there is a complex ecosystem of participants facilitating the transactions. In this commentary, we want to shed some light on the mechanics of the consumer-to-business (C2B) payments. Unlike business-to-business (B2B) and business-to-consumer (B2C) payments, which are predominantly handled by banks, C2B payments need to be processed in real-time. That is where credit cards come in handy with lots of value-added features. Therefore, the C2B space attracts the main interest of the payments industry players, and that is where they earn the most considerable portion of their revenue.

A regular C2B transaction involves several parties:

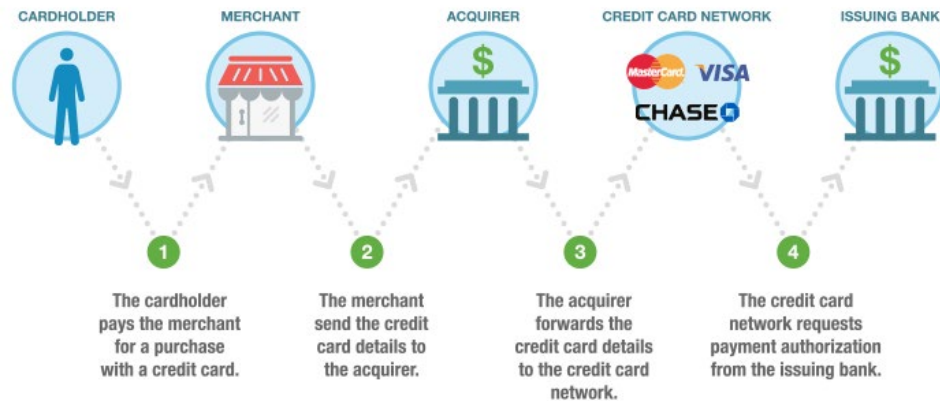
- the consumer (credit or debit cardholder);
- issuing bank or credit card lender (authorizes the transaction and guarantees payment on behalf of the cardholder);
- the merchant (business providing goods or services to the consumer in exchange for the payment);
- acquiring or merchant's bank (allows access to the network for the merchant, ensures that the merchant receives payment quickly and securely); and
- credit card network (connects all the counterparties to make the transaction possible, e.g. Visa, MasterCard or AmEx).

C2B transactions can be processed through different platforms, including brick-and-mortar stores, online stores, wireless terminals, smartphones, or other mobile devices. Every transaction has three steps: authorization, authentication, and clearing and settlement, as depicted in the following graphics.

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1 Authorization



2 Authentication



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3 Clearing & Settlement



Source: <https://wallethub.com/edu/cc/credit-card-transaction/25511/>

This complex interaction remains almost invisible and is completed within seconds. Depending on the platform used and type of merchant, payment processing rates will vary. For example, if a consumer swipes or taps their card at a coffee shop to pay for a purchase of \$10, the merchant collects only \$9.70. The balance is called the merchant discount rate (MDR) and is distributed between the issuer, acquirer, and network, with the issuer getting the larger chunk of MDR to compensate for the credit risk associated with the consumer.

Despite the payments industry becoming more congested, it appears challenging to find quality players in the small-cap space without neglecting mind-boggling valuations. One of our holdings, ACI Worldwide, is a provider of payment solutions for banks, financial intermediaries, billers, and merchants. ACI's products are the gold standard for the industry and facilitate the many of the steps described above. The company is well-positioned to benefit from the secular trends driving growth

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in the digital payments industry. As SaaS/PaaS revenue is gaining a larger share of the sales mix, the company will deliver a more consistent growth path and margins. A significant discount to peers that the market attributes to ACI stock presents an attractive opportunity with a comfortable margin of safety.

Have a great weekend.

The Global Alpha team

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