

## THE CHANGING FACE OF PAYMENTS

BY BENEDICT BAERST AND AMIR GOLDMAN

The advent of digital wallets on mobile devices promises consumers increased convenience and expanded functionality. The industry attention lavished on these innovations, however, diverts focus from some significant friction on the road to digitization of transactions outside of the retail sector. Though card adoption has largely brought electronification to retail transactions, a quarter of total non-cash volume has yet to migrate from paper checks. This stubborn corner of the market consists of transactional relationships lacking the scale or volume needed to support a network of intermediaries peddling dedicated terminal hardware and risk management services. SaaS delivery models and Internet marketing, however, have drastically reduced the costs of acquiring transactional volume. Recognizing the opportunity, an emerging set of payments providers are just now beginning to court this segment with a host of highly targeted solutions.

### WHY DO CHECKS STILL EXIST?

Understanding the composition of this submarket helps explain its resistance to electronic payments despite the momentum of debit and credit. Card payments are tremendously beneficial for high-volume, large-scale merchants like grocery and department stores but are not always cost-effective for other businesses. A major obstacle is the need for dedicated hardware to realize the convenience benefits of cards. High implementation costs and physical swipe readers ward off field-based businesses, particularly those accepting payments on an infrequent basis or of significant value.

Data segmenting remaining check volume by payer and payee type helps tease out some distinctive characteristics of the holdouts. From 2006 to 2009, overall volume decline was concentrated around recurring transaction types: consumer-to-business and business-to-business payments at the point-of-sale.<sup>1</sup> On the other side of the spectrum, person-to-person check volume is actually increasing slightly above macroeconomic growth. The balance of check volume is composed of remittances, both B2B and B2C. Overall, the average value of check transactions continues to hover around \$1000; the

average card transaction, on the other hand, is closer to \$50.<sup>2</sup>

Square Inc, a venture-backed company that has received much press attention, can be credited with minimizing the implementation costs of card acceptance by leveraging ubiquitous hardware (mobile phones) and freely distributing swipe readers to drive merchant

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account openings. Percentage-based transaction fees, however, limit appeal to recipients of high-value payments. Given these factors—implementation and fees—many merchants find card acceptance unattractive despite consumer demand. Depending on the context, the value proposition of cards may skew in favor of either merchant or customer. For transactions above a certain value, the percentage-based fees make cards uneconomical regardless of the hardware costs.

Another barrier to merchant card acceptance, even among those taking small payments, is the difficulty of validating ROI. A taxi driver whose volumes can vary from 12 fares one day to 42 the next may not easily discern the subtle uptick in volume card acceptance promises. Even if he could, he might easily misattribute any improvement to a host of other factors, like economic growth (more business travel) or lousy spring weather (more rainy days).<sup>3</sup> A few percentage points clearly taken off of his monthly revenue number, on the other hand, is readily noticeable and directly attributable.

This issue with the “demonstrability” of ROI inhibits adoption in many analogous situations where the decision-maker weighing card acceptance lacks the dataset necessary to see the results.

As such, it is not surprising that cards initially gained their footing at national department stores. Small, independently-owned entities, on the other hand, were late adopters, remaining cash-only until customer demand became overwhelming. To those transacting low volumes of high value, cash was never viable in the first place—particularly when fulfillment and payment are not simultaneous. The plumber, real estate agent, or small accounting firm billing each of their customers several times a year may only accept several dozen payments a month. In these circumstances, a two percent or greater fee to PayPal or Square likely outweighs the friction of cashing checks. Likewise, the convenience of a card is considerably less pronounced in service-oriented settings. The burden of filling out a check may seem quite bearable to a consumer following a few hours of tax planning.

#### THE HIDDEN COSTS OF CHECKS

Courtesy of the Check 21 Act, presentment by image capture has significantly cut the costs of check processing, and depository institutions now clear 96% of volume electronically.<sup>4</sup> The small businesses depositing many of those checks, however, continue to incur their own processing costs downstream of their banks. Many of these costs are indirect, manifested in business metrics like collection time rather than bank fees. Fragmentation makes for lousy economics in the eyes of volume-driven payment processors who might otherwise inform the market of its needs. As SaaS delivery models become the norm, however, technology providers are beginning to fill the void, finally cracking open the market with solutions geared towards a wider set of inefficiencies.

Service-based practices, accounting for about two thirds of small businesses, are a particularly compelling end market for software providers to target. According to data collected by SGE’s portfolio company PaySimple, 70% of them do not accept any form of electronic payment at all. Owners have little time to study non-core operational concerns, and many opportunities to enhance productivity remain unexploited. In fact, 65% of these businesses track outstanding payments on spreadsheets or paper, and some

owners even handwrite invoices. Such approaches certainly cloud cash flow dynamics. Perhaps most dramatically, manual billing delays collection time by 60 to 90 days compared to automated systems. Given the tangible benefits of rapid cash collection—better terms with vendors, effective expense management, and certainty of payment—the value of automation is considerable once measured on an aggregate basis.<sup>5</sup>

The opportunity to payments companies, therefore, is much broader than transaction processing services. The market needs integrated solutions for all accounts receivables functions, not just payments acceptance. In fact, competitive research indicates that SMBs are far more receptive to solutions solving several pain points at once. Recurring billing, credit card acceptance, and eCheck processing all have their point solutions, but the value proposition weakens considerably as implementation grows increasingly complex.

Industry pundits have heralded the demise of check and cash payments for nearly two decades now, yet both forms of payments have proven surprisingly resilient. Mobile device penetration, electronic invoicing, and integrated platforms for merchant and consumer alike will all continue to erode check usage. Nevertheless, payments trends are driven by behavior, not innovation, and how we transact is a generational question as well as technological one. Unlike other industries, widespread change requires adoption by three parties, not one, and new forms of payment can only emerge incrementally.

The SMB market is so attractive because it represents a rare opportunity to bring electronic payment types, already accepted by consumers and banks alike, to the last remaining party, the merchant. Given the decades it took to pry open this market in the first place, even a modest foothold should prove amply defensible, and successful entrants will likely find themselves with a sticky, inaccessible, and fast-growing customer base. ■

1. *The Federal Reserve System. The 2010 Federal Reserve Payments Study: Noncash Payment Trends in the United States 2006-2009.* New York, NY, p. 12-22. Retrieved from [http://www.frb-services.org/files/communications/pdf/press/2010\\_payments\\_study.pdf](http://www.frb-services.org/files/communications/pdf/press/2010_payments_study.pdf)

2. For historical data, see: Gerdes, G., & Walton, J. *The Use of Checks and Other Noncash Payment Instruments in the United States.* (The Federal Reserve Bulletin: August 2002). New York, NY, p. 363. Retrieved from [http://www.federalreserve.gov/pubs/bulletin/2002/0802\\_2nd.pdf](http://www.federalreserve.gov/pubs/bulletin/2002/0802_2nd.pdf)