



Optimizing merchant acquiring profitability



The six attributes of a profitable acquiring business

The merchant acquiring business is unique in that historically, it has required an acquirer to leverage economies of scale in order to build a profitable business, given the amount of capital and resources needed to be successful.

For example, acquirers need sufficient depth and breadth in their merchant customer portfolio to be able to balance lower revenue margin from certain segments of customers by charging higher margin fees for other customers, so that they can cover their fixed and variable costs of running a capital intensive business.

However, most merchant acquiring markets around the world are characterized by fragmented and overlapping players; typically several large acquirers dominate the market and perhaps operate profitably, while a large number of smaller sized acquirers are operating in a non-profitable manner given their strategy of targeting niche segments and focusing on supporting

their business banking customers. This is compounded by a perception amongst many acquirers that the merchant acquiring business is not sufficiently profitable to justify a greater investment or prioritization of resources within their organization, thereby relegating the business to a necessary evil to support more important business lines within the organization.

These market dynamics have restricted, to varying degrees, the number of merchants that are able to accept cards today, as acquirers in general have not invested in growing their business.



In This Report:



Attributes of Portfolio

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Optimizing Merchant Acquiring Profitability



Angela Lim
Senior Consultant,
Visa Performance Solutions, AP
anglim@visa.com



Based on extensive research and insights gained from working with acquirers across the world, this whitepaper will explore what Visa Performance Solutions believes are the basic themes for an acquirer to build a more profitable stand-alone merchant acquiring business.

Future whitepapers will address certain best practice examples within each of these areas.

The framework below outlines the attributes of a profitable acquirer and the key themes discussed in this paper.



1 Robust Merchant Acquiring Strategy supported by a P&L Framework

Successful acquirers invest in setting up strong foundations to support their business in three specific areas:

I. Establish a Well-Defined Merchant Acquiring Business Strategy and Plan:

With buy-in and support from the Board or senior management on an ongoing basis, the strategy should articulate the key areas of focus, including:

- Performance: Establishing targets and measuring results, having a strong segmentation discipline to evaluate the merchant portfolio
- Product: Building differentiation and innovation through a structured effort
- Channel: Ensuring the organization leverages all available channels to offer and cross sell relevant products to its merchant customers

Acquirers should regularly update their merchant acquiring strategy to reflect the opportunities and challenges at hand, with all the business units in the organization aligned in this effort

II. Supported by a Robust Organizational Structure:

Dedicated staff and resources should be accountable and deliver on their targets. A management function should be put in place to provide strategic direction and executive focus to this part of the business, which is often neglected in unprofitable acquirers. For example, best practice acquirers may have implemented a structure where the Merchant Services Division reports to a dedicated senior management executive who is responsible for the daily operations and profitability of the business, so that key opportunities or issues can be highlighted quickly and visibly to senior management. This enables the organization to facilitate quicker decisions, retain focus and foster a stronger appreciation of how the merchant acquiring business contributes to the organization. This is often overlooked by many unprofitable acquirers.



III. Strong Culture and Discipline of Measurement

Many acquirers have not established the required discipline and processes to measure the financial performance for their business, and this hampers the ability for the organization to appreciate and understand the contribution of the merchant acquiring portfolio. It is important to ensure that strategies are in place to assess the profitability so that revenue generated from the Merchant Acquiring Business remains healthy, rather than cross-subsidizing revenue to support the overall banking business revenues and returns.

Some acquirers exist solely to support their corporate customers without taking into consideration the profitability contribution of their merchant acquiring business. Leading players enter into the merchant acquiring business to achieve two primary goals of delivering net positive financial returns to the organization while providing a product / service that can serve their key institutional and small business customers.

Best practice acquirers have set up a clearly defined and standalone P&L framework that they own, where gross revenues can be accrued and direct and indirect costs from other parts of the organization are attributed, so that there is a complete view on how the business is performing, with autonomy, measurement and accountability.

Although having a consistent P&L structure should guide and inform management on the revenue or expense drivers that can be influenced to improve profitability, many acquirers that Visa Performance Solutions have worked with globally have not set up a proper P&L in order to achieve this.

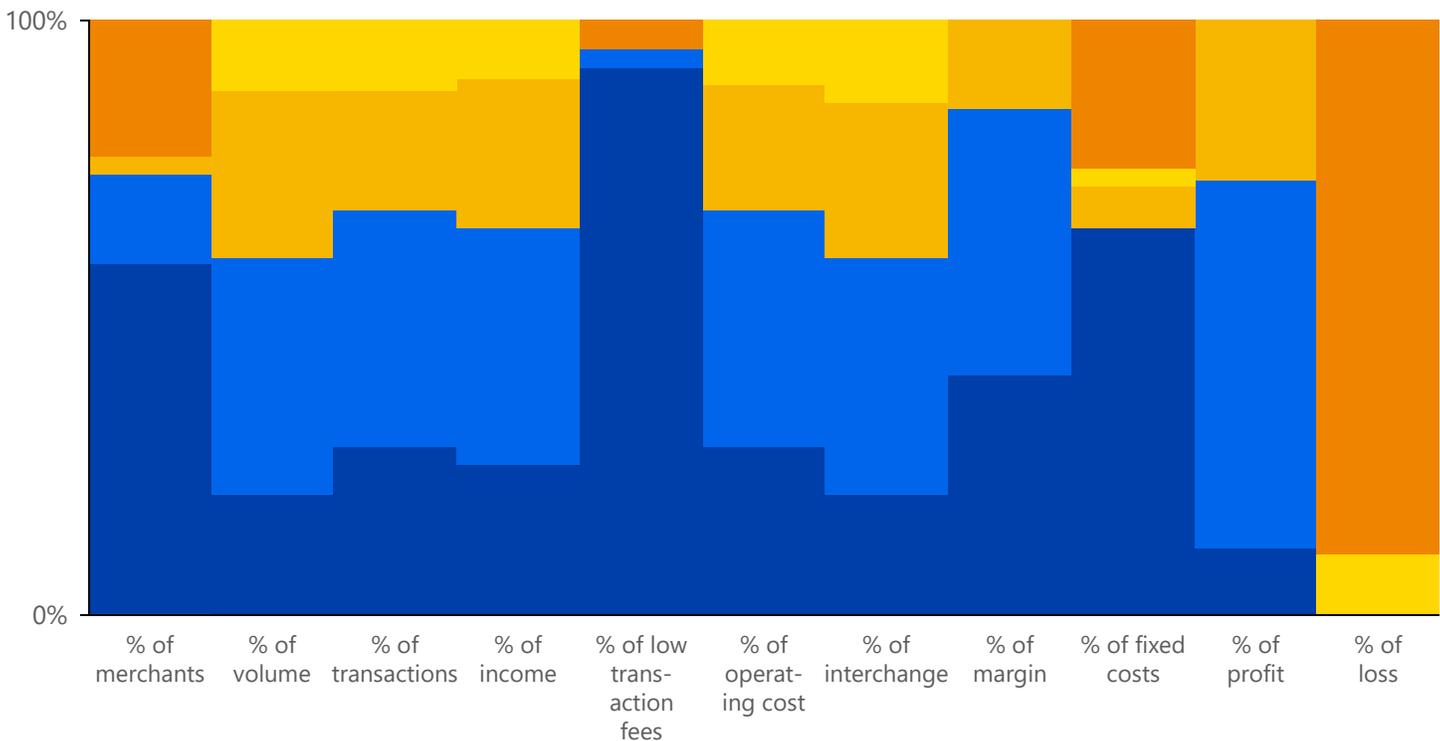


An example P&L structure should incorporate the measurement, tracking and reporting of the following revenue and expense drivers, so that management can have the required financial information and trends data to evaluate incremental revenue initiatives or explore opportunities to reduce costs.

Revenue Drivers	Expense Drivers
Merchant Service Fee or Merchant Discount Rate (MSF/MDR)	Interchange and Network Scheme Fees
Hardware / Equipment Driven Fees (e.g. POS rental, Hosting or Licensing fees, Communication fees)	Marketing & Sales (e.g. promotions, brochures, events)
Miscellaneous fees (e.g. minimum thresholds, exceptions, chargeback handling fees, manual processing fees)	POS Terminals and Networks (e.g. hardware and infrastructure, switching cost, communications, maintenance, installation, depreciation)
Value Added Service Fees (e.g. fraud monitoring service, project implementation fee, customized reporting tool, tokenization services)	Merchant Support (e.g. call center, dispute processing, underwriting, online portal, supplies, merchant training)
	Exceptions and Risk Control (e.g. chargebacks, fraud, fraud monitoring support)
	Settlement and Accounting (e.g. reconciliation, statements)
	IT Delivery & Operations (e.g. Acquiring systems, gateways, stationery, merchant and staff training)

Advanced acquirers perform P&L analysis on their portfolio by clustering merchants within each category or size, such as distributing small restaurants into different groups based on their respective behaviors. Such acquirers have invested in reporting capabilities to not only track the financial performance and key business drivers above, but have the capability to understand the profitability by specific merchant account and by certain segments, or clusters, such as the example highlighted below. Having such a view on the business will enable management to make more informed decisions on how to increase profitability.

Cluster 5 Cluster 4 Cluster 3 Cluster 2 Cluster 1



2 Well Defined Sales and Segmentation Strategy

Successful acquirers ensure they leverage the distribution channels available to them across the entire organization, to generate new merchant customer leads. Depending on the type of organization, some acquirers may not have access to as broad a range of channels such as a retail branch network, direct sales agents or even independent sales organizations. However, it should be in the interests of the acquirer to ensure their strategy includes a well thought out plan to leverage multiple sales channels in order to optimize profitability. An effective merchant acquisition strategy will have considered the following areas

I. Segmentation

It is essential for acquirers to manage their merchant portfolio through the use of segmentation, as this will allow them to prioritize and allocate their sales resources more effectively.

For example, most acquirers adopt a traditional approach of segmenting their portfolio based on size of merchant or business category, such as Merchant Category Code (MCC). Given limited resources and staff, this then enables the acquirer to identify the higher value and more profitable segments to acquire, or identify segment deficiencies that need to be addressed as part of their sales strategy. The importance of having clearly prioritized segments in the strategy will allow the acquirer salesforce to focus their efforts on the most impactful customers to recruit. Some acquirers focus their efforts primarily on higher margin segments as they may not have the resources to compete in merchant segments which require more complex solutions while other acquirers focus on priority clusters or industries (e.g. government, medical) because they might have a specialty there. Some acquirers in the US, for instance, place a high priority on education segment merchants given the average life of such merchants is found to be twice as long as a restaurant merchant.

II. Motivated sales force:

A key ingredient in driving incremental sales and profitability is having the right sales programs in place to ensure:

- All staff with responsibility for selling merchant product and services can be recognized financially and non-financially through a formal staff incentive program when they meet or exceed their stated merchant performance target. Leading acquirers have developed an infrastructure to not only track sales data like revenue per merchant, but have the ability to compensate sales staff through a tiered financial incentive structure based on profitability and revenue generated per merchant. These practices should be supplemented through regular internal communications to recognize merchant sales staff on a non-monetary basis as well, such as staff events, newsletters and awards.
- Sales staff across the organization understand the merchant acquiring product proposition and features, the benefits to corporate and small business customers, and have the knowledge and skills to explain to customers confidently and clearly. Visa Performance Solutions has observed that the most profitable acquirers have invested in comprehensive and effective merchant sales training programs delivered regularly, in an onsite, remote and online environment to drive sales staff awareness and confidence in the merchant acquiring products.



III. Leveraging new technology to drive sales

With the rapid development of technology and the expanding reach of mobile devices, acquirers can use these digital platforms to grow their distribution channels and therefore gain easier and more cost effective access to new and different merchant customers, which would not have been possible until recently. For example

- Instead of relying on driving the majority of new merchants through the traditional retail branch network, leading acquirers today are building more sophisticated online websites that not only provide comprehensive information to prospective merchants, but which incorporate an interactive workflow function that facilitates an efficient application experience for the merchant.
- Merchant sales staff also have access to intuitive online application portals, which they can easily use on their portable computer, mobile phone or tablet, to complete a merchant application alongside the prospective merchant. The availability of such solutions, enables the acquirer and their sales staff to capture new customers in a more timely and cost effective manner, thereby reducing the time of application to first transaction.

IV. Collaborating with third parties

With new merchant opportunities located in wide geographic areas and residing in many different industries, it has become imperative for acquirers to partner with entities outside their organization, such as Independent Sales Organizations (ISO's) and Third Party Processors (TPP's), to increase the sales reach and productivity. Although successful acquirers in the past have been able to rely on generating new merchants through their retail branch presence or their direct sales staff, with the proliferation of technology and players, it is becoming critical that acquirers build strong channel partnerships to tap into new customer pools. For example, acquirers can quickly understand the needs of specific industries by, developing partnerships with specialized software providers (e.g. accounting system providers, hospitality and beverage solution providers, car parking meter software solutions) and payment facilitators who aggregate payments on behalf of a community of smaller merchants (e.g. property rental merchants, small business enterprises)., This also helps them to differentiate themselves whilst driving incremental sales and profitability to their business.

V. Optimizing cross-sell opportunities:

For acquirers who have the ability to tap into large corporate or small business customers with other lines of businesses in their organization, this is a rich source of new customer leads. The cost of acquiring a new merchant customer can be high, and the ability to cross-sell a merchant acquiring product to an existing customer will drive improved profitability by eliminating such acquisition expenses. Best practice acquirers demonstrate the ability to leverage other parts of their organization to cross-sell their products and solutions, and have developed business plans and specific procedures to incentivize merchant sales staff in these areas. For example, workflow systems have been developed to support lead generation and data analytics reports are generated regularly so that a cross-selling target list is allocated to sales staff

3 Strong Discipline and Flexibility with Merchant Pricing

Perhaps the area that consumes the most attention when acquirers evaluate their profitability is around pricing, as this is typically the most visible area that delivers immediate impact to an acquirer's top-line financial performance. This usually involves an evaluation of the Merchant Service Fee (MSF) or Merchant Discount Rate (MDR). Visa's research from working with acquirers globally estimates that the MSF/MDR line item can contribute between 60-90% of an acquirer's total revenue. Profitable acquirers typically adhere to the following guidelines when it comes to merchant pricing:

Ensure that pricing (especially MSF/MDR) is competitive.

This is such a large revenue contributor in the market, however it is equally critical that acquirers



protect their MSF/MDR revenue stream to sustain their ongoing viability. If acquirers offer MSF/MDR rates well below industry average and or below the cost of interchange and direct costs, this may cause impact to the revenue stream expected merchant acquiring business. It is important for an acquirer to understand and appreciate their fully loaded cost per transaction, including direct and indirect costs, so that they know the fee levels they can offer to secure the customer without creating a commercially unprofitable situation.

Deliver flexibility in the MSF/MDR pricing

to accommodate for different types of merchants. For example, smaller sized merchants may prefer the simplicity of being quoted a bundled MSF/MDR for all card brands accepted or in some cases a fixed fee per month (based on achieving a certain number of transactions per month) as this often allows for easier reconciliation for the merchant. However, some merchants may prefer to have more visibility on pricing for different card brands and even card types and are prepared to deal with different MSF/MDR, by brand, channel or even card type. In some cases, other merchants may prefer to be given wholesale pricing plus markup otherwise referred to as "interchange-plus margin" fees, or request for volume-based pricing options that provide for lower fees as processing volume increases. It is therefore critical for acquirers to be able to accommodate as many MSF/MDR options as they feasibly can, so as to attract and / or retain valuable customers. In order to achieve this, acquirers need to have access to a merchant acquiring system that caters for these pricing permutations, as well as underlying pricing policies and procedures to support this.

Establish a transfer pricing mechanism

between functions dealing with corporate, business or small business customers and the merchant acquiring P&L, to acknowledge the value the acquirer is bringing to the customer even if it is an internal cost to the organization. This type of arrangement builds accountability and visibility to the acquirer so that the full value of the service can be accounted for, and reported as part of the P&L. For the acquirers who have not implemented such a practice, it undervalues the service that the merchant acquiring function is bringing to the overall customer relationship, and therefore runs the risk of the merchant acquiring function being treated as simply a support function or an expense item, rather than a revenue contributing business to the organization.

Develop the capability to levy a wide range of fees outside of the MSF/MDR

Despite their financial contribution to the P&L, best practice acquirers recognize that MSF/MDR revenue is not everything to their business and continually look at ways to generate other revenue sources to match the value added solutions and services they deliver to merchants. For example:

- Consider imposing POS terminal fees (rental / purchased) to ensure merchants appreciate the value of the facility they use
- Account inactive fees should be considered to discourage merchants from not utilizing their account and facilities, therefore incurring additional fixed costs for the acquirer
- Fees for the usage of value-added functions such as secure storage, tokenization, multi-currency processing on a pay-as-you-use basis.
- Consider imposing or pass on the indemnity of fraud and chargeback fees to discourage merchants from being negligent in managing their payment acceptance channels.

Leading acquirers have a comprehensive merchant pricing policy and structure set up that caters for flexible pricing models and allows additional fees to be charged for value-added-services or pricing discounts. As customer expectations grow (e.g. being offered transparent pricing or pay-as-you-use pricing) and access to more advanced technology becomes easier, the merchant pricing landscape will continue to evolve.

For example, in the most developed merchant acquiring market in the United States of America, the largest acquirers, especially those who use third-party providers for front-end authorization and back-end settlement services, are levying many “per merchant” and labour intensive fees, such as customer service, terminal help desk, chargebacks and retrievals, as they look to offset lower transaction pricing¹.

In order to improve the profitability of their business, acquirers need to not only review their P&L regularly to dynamically determine the merchant pricing needed to achieve financial returns while remaining competitive, but also be proactive in developing innovative pricing strategies to support their sales and marketing efforts.

4 Offer Diversified Range of Products and Services

In an industry where traditional payment processing has evolved into a near-commodity being offered by many entities, payment processing, clearing, deposit processing and basic reporting is increasingly adding less value to merchants who are looking to acquirers to offer more. It is therefore imperative that acquirers look to develop the capability to not only offer a more complete suite of payment acceptance choices to their merchant customers so that they can consolidate their business and minimize the risk of going to competitors to look for payment types or services which their incumbent acquirer is unable to provide, but also offer:

- **A range of integrated payment solutions through** Software providers who serve the needs of specific industries. For example, leading acquirers may have established commercial partnerships to integrate their payment solutions with companies who specialize in delivering proprietary software solutions to merchants such as small businesses, event management, car park operators and hospitality companies.
- **Value added services** to merchants, which will inherently deepen the acquirer’s relationship with its customers and provide the opportunity to derive incremental revenue as well. By providing value-added services such as analytics or a loyalty program on top of core payment processing capabilities, acquirers can begin to close the gap, drive profitability and strengthen these relationships. Some acquirers are supplementing these capabilities by developing their in-house services or partnering with third party providers. Merchants want one relationship for all payment related needs and services across the physical space and online, and across geographies, and if an acquirer can identify the type of non-payment services that its customer base truly values, they will be in a much better position to drive profitability to their business.

1 The Strawhacker Group, Merchant Processing Pricing Benchmark Study, 8th Edition, 2016

Visa Performance Solutions recommends that in order to offer a wider range of products and services, acquirers should invest their efforts to target the best in class software providers in selected industry types, and develop closer processing and support offerings with them to expand their portfolio of services. This approach is sometimes called “vertical integration”. Acquirers today cannot build and offer every relevant and customized merchant solution by themselves; , the ability to offer such solutions through a partnership (ideally an exclusive partnership) with a diverse range of specialty providers will increase the number of merchants who use these solutions and will use the acquirer’s services as a default integrated payment service.

- **Merchant and agent monitoring:** Ensuring adequate resources and procedures are in place on a daily operational basis to monitor merchant and third party agent activity to identify abnormal business activity that might indicate potential fraudulent behavior
- **Merchant training and education:** Ensuring merchants and third party agents are provided with necessary education and training, including awareness of local and international payment policies and guidelines
- **Managing third party agent risk:** Ensuring all external third party agents are identified and that appropriate due diligence is performed, including appropriately registering them with the corresponding payment networks.

5 Merchant Risk and Fraud Management Discipline

The obligation to manage and monitor merchant and third party agent relationships has been a long standing critical requirement of acquirers to ensure their day-to-day risk operations and practices are optimized, thereby minimizing any significant impact from risk and fraud related expenses. It is imperative that acquirers pay close attention to this area given it has the potential to have a significant negative exposure on the acquirer P&L if the appropriate controls and practices are not in place. In this regard, leading acquirers have invested in the following areas:

- **Policies:** Acquirers should consistently review policies to ensure they include the minimum standards established by the local governing bodies or by the respective payment networks to mitigate risk to the payment system
- **Merchant underwriting and agreements:** Ensuring sound processes are in place to utilize merchant agreements that meet the necessary disclosure requirements with clearly defined obligations on behalf of both the merchant and acquirer
- **Funding and reserves:** Ensuring all funds related to merchant payment acceptance, including settlement, reserves, holdbacks and other funds are safeguarded and controlled by the acquirer

As merchant fraud patterns continue to evolve with the changing technology landscape, it is equally important for acquirers to stay ahead of the curve by tapping into the latest fraud mitigation methods and data available in the industry. For example, with the implementation of stronger authentication methods such as Chip in the face-to-face environment, there has been a corresponding trend of fraud migration to the card-not-present space, primarily in eCommerce. In countries such as the United Kingdom and Australia where stronger authentication methods have been implemented in the card-present channels, the rate of card-not-present fraud has increased correspondingly. Acquirers facing such trends in fraud activities on the card-not-present channels, may want to consider adopting enhanced fraud mitigation tools such as Tokenization and 3D-Secure. Acquirers have to invest in the right tools in order to minimize the liability in their P&L and be in a confident position to detect potential fraud.



6 Supported by Streamlined Merchant Operations

The obligation to manage and monitor merchant and third party agent relationships has been a long standing critical requirement of acquirers to ensure their day-to-day risk operations and practices are optimized, thereby minimizing any significant impact from risk and fraud related expenses. It is imperative that acquirers pay close attention to this area given it has the potential to have a significant negative exposure on the acquirer P&L if the appropriate controls and practices are not in place. In this regard, leading acquirers have invested in the following areas:

Merchant underwriting and on-boarding:

Leading acquirers employ end-to-end workflow and clearly defined procedures to drive the efficient on-boarding of new merchants between the business units that need to perform reviews, checks, underwriting, approval and setup of a new merchant application. Global best practice also includes the use of technology and third party providers to customize the onboarding process e.g. for "lower risk" merchants, acquirers may conduct a streamlined set of checks and allow the merchant to transact within 24 hours; while for higher risk merchants, they may require additional information, collateral or security before the merchant is able to activate their facility or gain access to funds in their account.

Transaction processing support:

Having clearly delineated responsibilities and policies for staff to perform chargebacks and dispute management on behalf of merchants. This incorporates the exchange of information through online channels to ensure that it is faster and less costly to submit Request-For-Copy inquiries, streamlining dispute resolution with intuitive questionnaires, leveraging electronic storage to eliminate paper and storage, accessing timely reports to track back office activity.

Merchant servicing

Deploying best-in-class customer service in the area of call center and staff education is equally important in driving profitability for acquirers as this can minimize attrition risks, improve merchant satisfaction and deliver cost efficiencies to the acquirer. Leading acquirers have invested in deploying ongoing training programs geared toward customer service and technical support staff. These include easily accessible online training and information guides, clear Service Level Agreements (SLA's) governing the standards in which support staff are supposed to meet, making available self-service functionality to merchants to address the most frequently asked questions and leveraging interactive voice recognition (IVR) technology to facilitate inbound calls.

Account settlement, statements and reconciliation:

Ensuring the latest technology is used to support the generation and delivery of transaction and account information to merchants, including the use of online portals or via email statements. Many acquirers continue to generate paper statements, which results in higher costs due to printing, paper material and postage.

The more an acquirer can leverage new technology and adopt best practices in the areas identified above, the better placed they will be in streamlining their acquirer operations and in driving overall profitability.



Discipline, continuous improvement

Acquirers are facing a merchant payments landscape that has evolved quickly and become highly convoluted, with financial institutions and non-financial institutions competing to deliver a profitable business to their merchant customer base. This paper has broadly outlined the key business practices, on which an acquirer should focus in order to

contribute profitably to their organization; this ranges from opportunities to derive incremental revenue or decreasing costs by implementing streamlined operational and support areas, leveraging improved access to data and technology.



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