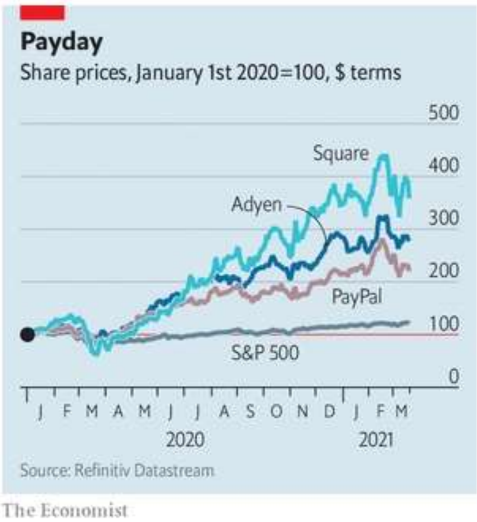
America used to be behind on digital payments. Not any more

A LITTLE OVER a decade ago Patrick and John Collison founded Stripe, a company in Silicon Valley that helped other tech startups accept online payments. It has since outgrown them all. On March 14th the firm said it had closed a fundraising round valuing it at $95bn—three times its valuation a mere 11 months ago, and enough to make it America's biggest-ever unlisted firm. Stripe is not the only company cashing in on the check-out business, as the digital payments revolution finally takes off in America.

It has been some time coming. Back in 2018 Ant Financial, China's payments giant, raised private funds at a valuation of $150bn. It was common then to hear Chinese executives remark that America, land of the posted cheque and the hand-signed credit-card receipt, was years behind, held back by a cosy club of banks and credit-card firms that were too lazy to innovate.

Now investors have decided the moment has come. Take PayPal, a digital-payments firm that counted Elon Musk and Peter Thiel as early bosses, and which was set up in 1999 to allow users of Palm Pilots, a forebear of smartphones, to "beam" each other money. It was later bought by eBay, an online marketplace, which spun it out in 2015 for $45bn. Today it is worth $280bn, more than Citigroup and Wells Fargo, and is America's 19th-most-valuable company. It is also more valuable than Ant, the global industry's original gorilla, which has fallen out of favour with regulators in China in recent months and been forced to cancel its initial public offering.

Investors' enthusiasm for Western digital-payments companies has been whetted by the pandemic (see chart). PayPal's share price has jumped by 180% in the past 12 months. That of Square, an American rival, has more than quintupled; and that of Adyen, based in Amsterdam, has nearly tripled. The digital boom is luring credit-card colossuses and tech titans, such as Visa and Google, to online payments. Smaller startups, meanwhile, are carving out niches. Yet markets still love the four specialists: PayPal's shares trade at 68 times earnings; Square's, near 510. Why are investors so bullish?



The digital-payments industry is rather like a transport system. "Acquirers" connect the shop's app or website to the payments infrastructure and check key details, including a buyer's identity, probity or available funds, to authorise travel. The money then moves along the customer's chosen type of "rail": credit-card, bank-to-bank or mobile-wallet systems, run by distinct firms. Then come the refreshment trolleys—service providers, like buy-now-pay-later firms, that purport to make the payments journey more pleasant. Everyone takes a cut of the transaction along the way.

Part of the digital firms' ascent reflects the fact that they have achieved scale. PayPal, the biggest of them, combines an online wallet used by 350m consumers with a gateway accepted by 30m merchants. That generates big network effects, which the firm has sought to encourage further by crafting tie-ups with other firms that have many users, like Mercado Libre, a Latin American marketplace; UnionPay, a Chinese credit-card scheme; and Google. The company expects its number of users to double by 2025. Square, which has carved out a niche by targeting independent merchants and consumers underserved by conventional banks, operates a similar model (the chairman of *The Economist*'s parent company is a director of Square).

By contrast Adyen and Stripe, which are pure online acquirers, have no consumer brand. But their tech nous makes it fast and easy for businesses to set up online-payment platforms, which has caused companies to flock to them. (Stripe has long served smaller firms and Adyen big ones, but both are now converging.) They typically integrate a client's website with payment networks within days. Because verifying a customer's identity and probity is hard, especially when transactions are cross-border, about 10-15% of online transactions are usually declined. But the digital firms can reduce rejection rates by four to five percentage points. In return for all this they charge a decent fee: Stripe typically takes a cut of about 2.7-2.9% of the value of each transaction, or 1.9% in Europe. Now that they can spread their technology costs over hundreds of billions of dollars of transfers, the fee they earn on every additional payment is nearly all profit, which they can then reinvest.

Three trends are helping propel the digital firms further. One is the rapid growth of e-commerce, which has been turbo-charged by the pandemic. Online-transactions volumes surged by 19% globally last year as locked-down consumers turned to the internet. And there is further to go: online payments accounted for just 45% of all retail payments tracked by Mastercard, a credit-card giant, in 2020. The second trend is the dash away from cash at bricks-and-mortar shops in favour of digital payments, which covid-19 has probably accelerated by about three to five years.

A final factor comes from increasing market share within online payments. For all of the specialists' might, over half of digital-transaction volumes worldwide are still acquired by the captive, sluggish arms of banks, says Lisa Ellis of MoffettNathanson, a research firm. Since most lack global aspirations and e-commerce expertise, market share is bound to migrate to the online giants.

Such trends boost Visa and Mastercard, the dominant credit-and-debit card networks, too. Yet they run only one type of rail, whereas the four payment champions are mostly agnostic about which channel the money travels on. And the established card firms are also under attack from anti-trust watchdogs who worry that they make it difficult for merchants on their networks to process transactions through other, cheaper, alternatives. On March 19th shares in Visa fell after reports that the Department of Justice was investigating it.

A bigger threat to the fintech quartet, perhaps, could come from giants in adjacent sectors. Big-tech firms are starting to beef up their own payment apps (Apple Cash, for instance, now lets users pay each other by text message). Large retailers like Walmart and Target are building their own acquirers and wallets, through which they could dole out rewards to loyal customers.

In order to pre-empt the threat of competition, the digital-payments firms are expanding their offerings. PayPal has launched buy-now-pay-later, cryptocurrency-trading and credit-card services. On March 8th it said it would buy Curv, a digital-asset-security firm; it bought Honey, a coupon service, last year. It says it wants to become a "super-app" for financial services, and in February told investors it expected to more than double its revenue to $50bn by 2025. Square's peer-to-peer payment business, Cash App, has evolved into a digital bank enabling users to buy bitcoin, trade stocks, receive paycheques and use a debit card. It now has 36m users, up from 7m in late 2017, and brings in 45% of Square's gross profit. Stripe has started offering working capital and accounts to merchants, in partnership with banks.

With digital payments set to continue to surge, the fantastic four have three or four years of clear runway before running head on into each other, predicts Darrin Peller of Wolfe Research, an equity-research firm. By then, however, they will probably have become entirely different firms, each with its own suite of banking or software products. That should give them even more room to roam, as well as access to far bigger revenue pools than that of payments alone. It may have taken a while for digital payments to hit the big time in America and the West. But better late than never.

Vocabulary list
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