1919 INVESTMENT COUNSEL
Complexity to Clarity

Disruptive Innovation Spotlight

August 2020

Each quarter we highlight an investment theme from the Disruptive Innovation Strategy, focusing on the megatrends driving disruption and the companies we believe are best positioned to capitalize. Companies mentioned in this series should not be perceived as specific stock recommendations.

Tectonic Shifts in the Payments Industry

FinTech Poised to Lead

Introduction

In Disruptive Innovation, it is common to frame industry change in terms of an "S" curve, where change happens slowly, then all at once. This is similar to an earthquake, where pressure builds over time and is released through a cataclysmic event. The economic shutdown resulting from the COVID-19 pandemic appears to have had such a seismic, cataclysmic effect on retail and the related payments industry. Temporary store closures have led to a spike in bankruptcies among well-known brick-and-mortar retailers teetering on the edge, while online sales have *surged*. This shift in spending patterns also has led to a shift in *payment methods*, favoring digital wallets and enhanced digital services, over cash and physical credit cards. It's an important distinction because a digital payments platform can expand into loans, insurance, investments, and other services in ways that cash and bank-issued credit cards cannot. In the near-term, this dislocation benefits those companies operating on the fault lines between retail and banking that have high eCommerce exposure. Longer-term, the bankruptcies of well-known retailers point to an acceleration of the creative-destruction process for both retailers and payment processors unable to serve a more digitally-oriented consumer.

Companies in our FinTech theme, including PayPal, Square and PagSeguro Digital, have responded to the crisis by *accelerating* investments in an ecosystem of financial services for both merchants and consumers, a so-called "two-sided" network, while legacy processors continue to focus on short-term profitability through layoffs and consolidation. It is too early to tell what the lasting damage from the pandemic will be to the $100 trillion dollar payments industry, but with PayPal revenues, for the first time, overtaking Visa's[1], Square

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[1] In 2Q20, PayPal reported revenues $5.26B, up 25% YoY, while Visa reported revenues of $4.84B, down 16% YoY. Visa's revenues were heavily impacted by the contraction in credit card spending at the point of sale. The comparison is not like-for-like since Visa primarily operates a payments network, and PayPal offers a more diversified range of higher-margin digital payments services.

considered to be the largest licensed[2] "neobank[3]" in the world, and PagSeguro the leading online payment services company in Brazil, it is clear that these companies are poised to step into a leadership role in whatever comes next.

PayPal (PYPL)

When the so-called "PayPal Mafia", including Elon Musk, Jack Dorsey, Reid Hoffman, and Peter Theil founded the company in the late 1990's, they had two key insights. First, that online sales would need a low-cost, low-friction online payment technology. Second, if they developed such a technology, they could achieve scale by first offering a low-cost peer-to-peer payment service for sites like eBay, and later roll out higher-margin ancillary services to their customer base. At the time, card acceptance was expensive and the technology for processing online sales was beyond the reach of many small merchants. What PayPal offered was a secure, cost-effective way for even the smallest merchants to accept online payments and to consumers, a free account linked to their bank account, which could be used for online purchases.

PayPal has come a long way since the late 1990's, and today is the largest payments processor outside of China, processing a payment volume approaching *one trillion dollars* annually for the 350 million members on its platform. At the peak of the pandemic, when malls were closed and online sales surged, PayPal's revenues grew 25% year-over-year, while legacy payment processors saw their revenues plummet as much as 25%[4]. PayPal was fortunate to be operating at scale when the pandemic hit and was able to seize the opportunity. The important question today is what comes next: Will consumers go back to using cash at the mall, or will the dramatic shift towards eCommerce, digital media and other online activities, such as food delivery, continue? PayPal is betting it will, and is investing accordingly.

Two recent initiatives PayPal is rolling out highlight the strength of its two-sided platform. The first is based on a recent acquisition of Honey, a company that developed a browser-based plug-in for customers to receive alerts for price changes on products on their watch list. PayPal is planning to take Honey to the next level by partnering with its large merchant base to customize offers for PayPal users who have clear purchasing intent. For merchants, these leads are the most valuable, and give PayPal an opportunity to provide a seamless one-button checkout experience as well as a full-featured loyalty program, benefitting merchants, consumers, and PayPal. The second initiative is the introduction of QR codes for payment at CVS stores across the US. QR codes are ubiquitous in Asia, Latin America and other parts of the world, but not the US, where credit cards are more prevalent. The advantages of QR are well known. They provide a direct link between a product one may be considering, and all of the features of a digital wallet, including split payment methods, use of loyalty points, warrantee registration, cash back, installment payments and live chat features to get more information, right from your smartphone. The pandemic led CVS to partner with PayPal to expand its touchless checkout services out of health concerns, but rather than recreate a wireless version of a cash or card transaction, they decided to roll out QR codes with PayPal as the next evolutionary step.

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[2] *In March 2020 the Federal Deposit Insurance Corporation (FDIC) issued Square a banking license.*

[3] *The term "neobank" describes an online bank capable of offering a range of financial services, without physical branches. Sanford Bernstein estimates that Square's Cash App alone is valued at over $25 billion, making it the largest neobank in the world (July 2020).*

[4] *In 2Q20 Paypal's net revenues grew 25% YoY, while Global Payments (GPN) saw net revenue decline of 14%, Fiserv (FISV) adjusted revenue declined 15% and Fidelity National (FIS) saw a 25% decline in its Merchants Solutions business.*

Square (SQ)

When Jack Dorsey founded Square in 2009, the problem he set out to solve was to level the playing field for small merchants by offering advanced point of sales technology that, at the time, was only available to large merchants. Square initially offered low-cost point-of-sale terminals which linked credit card transactions to customer email addresses. It has since introduced support for wireless payments as well as a Square App Marketplace, which offers a range of low-cost small business applications. The insight Square gained from its ecosystem allowed it to expand into other services, including small business lending through Square Capital, which larger banks are often reluctant to offer. Through these efforts, Square exited 2019 with over $116 billion dollars in annualized payment volume, up 25% over the prior year.

In 2013, Square saw an opportunity to introduce a digital wallet, like PayPal's Venmo app, that allowed users to send and receive money through its bank account-linked Cash App. As with PayPal, it too has expanded into other services, including stock trading, bitcoin transactions, and a loyalty program called Boost, which offers discounts on Spotify, Whole Foods and Panera among others. But unlike PayPal, Square focuses on the "underbanked", including the young and those unable or unwilling to pay for a traditional bank account. Square's strategy is simple: provide customers with the free Cash App and, over time, layer on additional banking services to keep them engaged with the ecosystem. Revenue would come through interchange and other fees charged to 3rd parties for access to its Cash App customers. Since the Cash App's introduction, the company has introduced a Square debit card, personal lending, and very recently payroll direct deposit, which has proven to be an important customer retention tool.

When the pandemic hit, Square was one of several FinTech companies tapped to disperse PPP loans to small businesses, and when payments related to the CARES act were issued, many linked them to their Cash App account. But Square was not immune to the slowdown. In-person point of sale volumes declined 15% from the prior year. However, online sales surged by 50% as the company helped its merchants pivot online, resulting in 25% of total payment volume coming from online channels, and one in three new online sellers using Square for the first time. Even more impressive was the rapid uptake of Cash App, where usage *doubled* among its 30 million customer base. Customers with direct deposit linked accounts also began using Cash App for every day spending, leading to nearly triple the revenue for Square compared to customers who only used it for peer-to-peer transfers. At the height of the pandemic, revenues from the Cash App ecosystem grew well over 100% from the prior year, but more importantly, the banking relationships Square has established during this period are likely to endure.

PagSeguro Digital (PAGS)

PagSeguro Digital is a NYSE-listed FinTech company that was spun out of the largest internet portal in Brazil, Universo Online (UOL), which has 113 million unique monthly users, representing 94% of Brazil's internet-enabled population. Its business model is similar to Square in that it provides financial technology and banking services to individuals and small businesses. In a country where nearly 30% of the workforce is paid in cash, and over 90% of businesses are classified as small or micro merchants, the opportunity among Brazil's underbanked population is vast.

PagSeguro first disrupted an entrenched payments duopoly by providing low-cost payment terminals to entrepreneurs and sole proprietors, and generating revenue from additional services such as real-time settlement and working capital loans. More recently, it began disrupting the consumer banking industry by offering free bank accounts, and offering a mobile "meta-app" of ancillary services. In addition to peer-to-peer money transfers and personal credit, users can make doctor appointments, pay traffic tickets, order taxis, pay for gas and accept meal vouchers, all within the PagBank app. The company expects PagBank to represent upwards of 30% of revenues within the next five years as it builds out its two-sided network.

PagSeguro Digital has yet to report midyear results, but exiting the March 2020 quarter, at the earliest stage of the pandemic in Brazil, it had a revenue run rate equivalent to about $1.2 billion US dollars, up 27% YoY. In July 2020, it reported its best month ever of payment device sales, up 80% in June, driven by a surge in omni-channel transactions. This strong performance is counterintuitive to what one might expect from a company exposed to small businesses in an economic downturn. But PagSeguro had proven its ability to grow during the last two recessions in Brazil by focusing on technology to serve a very large addressable market in a digitally-savvy country.

Conclusion

FinTech companies, including PayPal, Square and PagSeguro Digital, have been among the best-performing and most resilient companies throughout the pandemic, while traditional financial services companies have been among the worst-performers in the S&P 500[5]. Without question, the cataclysmic impact of a global pandemic, and subsequent shift in consumer spending patterns has changed the payments landscape. In the short-term, these changes have favored FinTech, but the pressures have been building for nearly twenty years, as spending habits have increasingly shifted from in-person cash and credit card transactions to digital ones. In our view, the successful strategy is not merely to digitize a plastic credit card but to create a platform of symbiotic digital services, as PayPal is doing with Honey and QR Codes, Square is doing with Cash App, and PagSeguro Digital is doing with its PagBank app. It is quite likely we will look back at the pandemic as the catalyst for a tectonic shift in payments and related services.

[5] *Year-to-date through July 31, 2020, PYPL was up 81%, SQ was up 108% and PAGS was up 12%, while the Financial Services sector of the S&P 500 was down 22%, trailing the overall S&P 500 index, which was up 1.2%.*

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20 Years of Experience

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