VIEWPOINT

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2018 Outlook: Merchant Services

The ghosts of merchants past: almost gone, but not forgotten

Over 7,500 brick-and-mortar stores in the United States have closed in 2017. Some malls have shut down entirely. This surpasses the previous high of just over 6,000 store closings, which occurred in 2008 during the Great Recession. Many merchants are down but not out. For 2018, key questions for merchants and their payment providers, including acquirers, card networks, and issuers, will be: Where and how will consumers be making their purchases, and do the patterns and behavior revealed suggest what merchants should do? Answers to these questions can be discerned from the look ahead to 2018 in the following pages.

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Looking Back at 2017 Merchant Services Predictions

Last year's *2017 Outlook: Merchant Services* by Mercator Advisory Group was remarkably prescient, we are happy to say. We predicted merchant acquirers would continue their external hunt for ways to generate growth, and that's what happened. For example, First Data picked up the growing companies Acculynk, CardConnect, and BluePay. In a blockbuster deal, Vantiv bought Worldpay, reducing U.S. legacy merchant acquirers to four players (the new entity will take on the Worldpay name). Also in 2017, card networks made technology acquisitions to bolster their card security resources: Mastercard picked up NuData Security, and Visa acquired Cardinal Commerce. Our skepticism about consumer adoption of the universal payment applications—Android Pay, Apple Pay, and Samsung Pay—was well founded as data show that U.S. shoppers still like their plastic cards. But we foresaw that consumers' need for speed would spur the on-demand economy and the expansion of mobile apps for a variety of services across merchant verticals including ride hailing, fast food, casual dining, and C-stores/gas stations. We will not rest on our laurels, however, so as the curtain comes down on 2017, we present here our vision for 2018. As always, your comments and thoughts are welcome.

Mobile Payments Will Stir Merchants' Holiday Punch

The strategic boost that merchants gain from consumers' mobile shopping and payments will continue in 2018, smartphones having become the expanded sphere of commerce. Satisfying the demand for everything mobile emanates from a wide array of mobile stakeholders including smartphone makers, banks, merchants, and assorted tech developers. Competition has intensified for space on the cellphone screen as well as the digital wallet. 2018 will see continued expansion in the mobile payments landscape driven by consumers' evolving shopping habits.

When Apple, Google's Android, and Samsung all launched universal payment apps, they were thought to be the next new thing to receive wide adoption at point-of-sale (POS) terminals. But consumers have not responded in kind and for good reason. The universal pay apps do not give shoppers enough reasons to use them. Mobile apps need incentives beyond making a payment for consumers to use them. Moreover, POS terminal enablement for mobile remains fragmented and not all store employees are trained in the acceptance of mobile payments. The result has been very low customer usage of Apple Pay, Android Pay, and Samsung Pay, estimated to be less than 8% adoption by smartphone users in the United States in 2017, according to Mercator Advisory Group's annual CustomerMonitor Survey Series as well as other studies. Samsung Pay is taking the most proactive steps with a rewards program, although general awareness still appears to be lacking. Don't expect significant usage increases in 2018 for the universal pays. Far more engaging and popular are the many other mobile payments options from merchants themselves.

Single-merchant mobile payment apps will continue to grab payment market share by taking advantage of the U.S. consumer's increasingly mobile device-centered lifestyle. Mainstream retailers and quick service restaurants (QSRs) will be the vertical markets best positioned in 2018 to increase sales with mobile pay apps. Walmart Pay and Kohl's Pay are standout single-merchant payment apps among mainstream retailers, and their payments

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transaction volume will continue to grow. Ease of use, consistent acceptance at the point of sale, and integration of rewards are keys to mobile pay apps' success. Data analytics continues be a merchant's best friend, and the customer intelligence data provided by in-house payment systems including mobile apps will be beneficial for stores that pay attention to it in 2018.

C-stores and gas stations are jumping on the bandwagon of single-merchant mobile pay apps as the grab-and-go nature of their customers' purchase behavior fits this payment mode as well. These merchants thrive on fast service and frequent customer visits and have many stores in high-traffic locations. Expect to see more loyalty and rewards programs tied in with these mobile apps. Since many of these mobile apps use the ACH payment system, the retailers save on transaction processing fees and can divert those costs to invest in proactive marketing programs. The C-store giants 7-Eleven and Circle K lead the U.S. market, and in 2018 their parent companies will again be looking for acquisitions to gain greater scale and market coverage.

Starbucks will be a telling barometer of the popularity of single-merchant mobile pay apps. Currently, the coffee retailer states that 30% of all payments for purchase at its stores are completed via its mobile app, and that percentage is expected to rise. That metric sets a high but achievable bar for other retailers in the QSR space. Mobile integrated apps must be focused on the customer experience and not just the transaction itself. Starbucks stores sell the café experience, not just the coffee.

Payments Fraud Is Still the Ebenezer Scrooge of the Season

Dampening the revelry of the holiday season, card-not-present (CNP) fraud continues to be a cloud hanging over e-commerce merchants. A revolution in e-commerce fraud detection is occurring with advancing tools, techniques, and strategies to combat CNP fraud. Online merchants still need to incorporate these measures as part of their standard website checkout process.

2018 rings in dynamic and proactive fraud detection and prevention tools that will include machine learning, artificial intelligence, behavioral biometrics, persistent identity, persona linking, mobile device ID, and dynamic risk scoring. These newer techniques strike at the heart of fraudsters' attempts by neutralizing their main tactics. Fraudsters previously could simply change their angle of attack and quickly spoof static fraud defenses. Fraudsters are smart operators and have always adapted quickly in leapfrog fashion to static fraud detection methods involving risk scoring and data mining of purchase transaction details and buyer characteristics. Typically, as soon as a merchant or its security provider becomes wise to a phony transaction, the fraudster simply moves on—by using a different device, address, or card number. Under the old ways of fraud detection, merchants were always fighting the last war and defending against yesterday's attacks. Merchants will have more access to advanced fraud detection in 2018.

Merchants must make a New Year's resolution to vastly improve the security of their data systems and POS terminal locations, especially those that go unattended. The pipeline of stolen records is continuously refilled through data breaches, which occur with alarming frequency. The dark web enables fraudsters to have access to millions of stolen card numbers with little or no effort and at minimal cost. There are even websites that sell anti-fraud detection software to hackers so that they know what type of fraud alert system a merchant is using and how to counteract it. Criminals have access to inexpensive computers and internet connections and are experts in computer software and coding schemes that can easily take advantage of lax security measures.

Entering 2018, in-store (card-present) fraud should continue to decline, primarily due to the transition to EMV chip cards and terminals. According to Visa, at merchants that accept EMV cards, counterfeit card fraud losses decreased 58% in December 2016 compared to December 2015. Another measure gaining favor because of its effectiveness is tokenization, which safeguards payments security by substituting a unique nonsensitive representation of data (a token) for sensitive payment information or card credentials. Tokenization has become standard fare in the universal payment apps Android Pay, Apple Pay, and Samsung Pay. The card networks have fully embraced tokenization as well. Merchant acquirers are also expanding their homegrown security solutions and can act as another layer of defense for merchants. Meanwhile a veritable army of independent software vendors (ISVs) are coming to the rescue of online merchants by introducing highly effective security solutions. Machine learning algorithms are now the advanced solution of choice to ferret out fraudulent CNP purchase attempts.

Consumers Are Getting in the Spirit of Shopping

Digital commerce has added a new dimension to merchants' sales channels, but merchants still need a physical presence to satisfy shoppers who want a choice of shopping either online or in person. The customer experience is still the driving force in both in-store and online shopping. More than ever, 2018 will expand consumer behavioral and shopping preferences that have been evolving. Some applications, like on-demand services, have become mainstream, but others, such as contextual commerce, which uses a smartphone user's location to generate offers from merchants nearby, are still in introductory or pilot stages. Following are some of the ways that consumer behavior is likely to continue to evolve in 2018.

On-demand services will accelerate across merchant verticals. Ride-hailing services Uber and Lyft will generate increased transactions with the mobile pay apps that are the linchpin of their business models. They will introduce expanded cross-selling users offers such as dining, entertainment, and take-out meals on the ride home. Grocery store delivery services will be the fast growth on-demand service in 2018 as most of the national chains are rolling out delivery services. Brick-and-mortar department stores, electronics, and home improvement will see increased business on click and collect, which is their variation of mobile order and pay.

Conversational commerce speaks to a new channel. "Smart home" voice-activated assistants are coming into their own with Amazon's Alexa, Google's Assistant, and Apple's Siri in various stages of machine learning capabilities. These are a new way for consumers to verbally order on-demand services (with the notable exception of ride-hailing in most cases). Restaurant meals and household goods will increasingly be ordered via voice-activated digital assistants. Add Bluetooth-connected cars, which will serve as digital assistants that can assist drivers with car operating services as well as ordering dinner on the way home.

Mobile self-checkout eliminates checkout lines and serves shoppers in a hurry. Mobile self-checkout will not take off rapidly, but it is inevitable. The technology rollout curve is steep and investment is high, and there are operational challenges such as integration with current systems, employee training, and customer education. Mobile self-checkout will take several years to appear in many stores, and it will be large merchants that lead the way beyond today's early availability What is clear is that an evolution is underway in shopping. It began with mobile payment at the point of sale, expanded to mobile order and pay, and looks ahead to mobile self-checkout. Savvy brick-and-mortar merchants now know that retail success today is all about the customer experience. Engage and entertain customers, save them time and money, and they will come. Amazon Go—the concept self-checkout C-store in Seattle—represents the most ambitious and complex attempt at mobile self-checkout. While not yet open to the public, this pilot store could be a testing ground for Whole Foods now that Amazon owns it. Amazon Fresh grocery pickup locations could potentially be expanded to customer self-selection and checkout.

Contextual commerce means being at the right place at the right time. Some on-demand services are ideal for cross-selling, and contextual commerce plays a role. Lyft and Uber riders can be given offers for dining and shopping based on the time of day and the geographic location of their destination. Home and apartment rental bookings can be accompanied by air and trip activities offers. It's no surprise that Expedia and Priceline are playing active roles in this on-demand category.

Expanding delivery services looms as a potential threat to self-checkout. Just when merchants are introducing mobile self-checkout for customer convenience and time savings, along comes an expanding array of home delivery services—almost everything from groceries and restaurant meals to household supplies. So now consumers may not even need to go to stores. Home delivery services could become a popular substitute for in-store shopping, but merchants that emphasize the in-store customer experience will still win the day.

Looking ahead to presenting a compelling assessment of the customer's merchant experience, Mercator Advisory Group will launch its ***Customer Merchant Experience Survey*** in 2018, a U.S.-based consumer survey series that will gauge and provide insight on best-of-breed shopping experiences, preferred buying interfaces, and most desired payments methods in the U.S.

Payment Providers' Elves Busy Making Deals and Delivering Services

2018 will see another active period of mergers and acquisitions for all providers in the payments ecosystem. The last few years have seen consolidation among acquirers, basically shrinking the number of U.S. major providers from eight to four. The main M&A activity in the near future will be to acquire technology expertise and greater market share and coverage. Areas that will attract buyers continue to be e-commerce, security solutions, and specialized tech knowledge in various vertical markets. Gateways especially will be a center of M&A attention for their international e-commerce solutions as well as the increasing level of payment transactions they handle—precisely the core competencies that will make them attractive for acquisition.

Legacy merchant acquirers recognize the threats from competition such as emerging payment facilitators and gateways that specialize in mobile and online business. A more ominous risk lies in the potential for big non-bank players such as Amazon, Apple, Google, and PayPal to muscle further into payments. Winners will be those companies that follow Wayne Gretzky's timeless advice: "Skate to where the puck is going, not where it has been."

Both merchant acquirers and gateways have transitioned away from transaction processing, which has been commoditized, and focused instead on higher-margin services. Anything that helps merchants run their businesses more cost effectively and drives new revenue will be on the menu of provider services. Included are fraud detection, predictive analytics, customer intelligence, and a wide range of business operational management tools, such as tools for accounting support, staff planning, and supply chain management. Providers will try to bundle services for one-stop shopping rather than offering an à la carte menu. Some merchants may still find reassurance and less risk in dealing with multiple payment providers though.

Legacy acquirers, gateways, card issuers, and networks will still benefit from the millions of transactions that might not otherwise have occurred without the on-demand services markets. An added boost for payment processors is that these e-commerce type transactions are card not present, or CNP, which carry higher fees. Certain vertical markets that are growing or have been underserved will draw attention from payments providers that will develop specialized solutions and expertise to better met their needs. These verticals include healthcare, parking, subscription services, delivery and logistics, and events/entertainment.

Mobile POS Will Ring in the New Year and Beyond

Next-generation mobile POS (mPOS) systems will become ubiquitous as Square's Reader and First Data's Clover battle for additional installations and market share. While mobile POS solutions were once targeted solely to micro and small businesses, merchants of all sizes now look at this platform as a must-have payments tool. Large merchants with spacious stores have adopted mPOS, realizing its potential for allowing sales staff to assist customers to check out anywhere in the store.

Busy fast food restaurants and coffee shops discovered that staff could shorten lines of waiting customers by moving up the queue to take orders and payments. Pay-at-table devices and applications, which increase wait-staff productivity and table turnover as well as enhance payment card security, will soon become a familiar feature, especially at casual dining venues.

Cloud-based payments platforms will find their way into more merchant locales. These software-as-a-service (SaaS) solutions can provide data and transmission protection all the way from payment terminal device to payment processor. Because they do not store sensitive payment information at the point of sale, they help protect merchants against the ever-present threat of fraud.

Savvy payment providers are learning that the real value of mPOS is as an entryway to merchants' overall business. Clover and Square deliver added-value business tools and services that go beyond the payments transaction.

Recently, they have become lenders to small businesses by offering cash advances and working capital loans. Payments transactions serve as an excellent basis for business risk assessment and credit decisions, so mPOS providers will expand their lending services and compete with financial institutions for small business loans.

Conclusions and Looking Ahead to 2018

More positives than negatives appear in both near term and long term. Merchant and payment services providers will experience an expansionary year, although unforeseen risks are always lurking in the geopolitical arena in addition to inevitable changes in tax and regulatory requirements.

Favorable economic tailwinds will promote consumer spending. Among these, increasing consumer confidence and decreasing unemployment will drive retail sales. Confidence among small businesses, where most new jobs are created, continues on the rise.

Approaching headwinds may actually be closer than they appear. Rising interest rates and possible inflation would dampen consumer discretionary spending and lead to lower retail sales. Store closings will continue to occur in large numbers, albeit at a declining rate.

Winners will include companies that focus on mobile payment solutions; machine-based fraud detection developers; consumers that now have the largest array of payment options and services in history; e-commerce giant Amazon, with Walmart coming up fast; gateway payment providers that capitalize on cross-border and cross-currency commerce.

Losers will include brick-and-mortar stores that do not adapt to mobile shopping and engage customers with integrated features; legacy payment providers that suffer eroding transaction processing volume due to non-bank firms (like Amazon, PayPal, and ACH-based systems) that make inroads into the payment value chain; on-demand categories that are becoming saturated with too many providers such as restaurant and meal prep delivery firms.

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