How Mastercard and Visa Are Beating the Tech Giants at Their Own Game

By Tae Kim  Updated May 29, 2019 5:00 a.m. ET

It was 2013 and the talk of Silicon Valley was about the “mobile wallet” and how Apple and other tech giants were about to muscle into the financial industry’s turf with digital payments.

“I think it’s just getting started,” Tim Cook, the Apple CEO, told analysts at the time, leaving Wall Street thinking of a major disruption.

But when Apple Pay arrived 18 months later, there was no sign of a revolution. Rather than start from scratch, Apple decided to partner with Visa (ticker: V), Mastercard (MA), and American Express (AXP). The new payment feature built into iPhones was just one more way to make payments at cash registers and websites via the existing payment networks. Disruption gave way to incremental change.

Apple executives still showered Apple Pay with characteristic praise; iPhone
users could now “start making payments with the touch of a finger.” Yet the rollout confirmed the real powers behind digital payments: Visa and Mastercard.

**From the Archives: The End of Cash?**

Rather than being cut out of the equation—as investors had feared—the existing payment networks were being endorsed by the country’s most powerful tech company. “Early adopters in the space have learned the hard way,” Visa’s head of innovation told *Barron’s* at the time. “Payments are just hard.”

Visa and Mastercard rallied nearly 20% in the three months after the Apple Pay announcement. And they have essentially been rising ever since. The stocks, while pricey by traditional price/earnings metrics, show no signs of slowing down.

**Visa's network is used** at 54 million merchant locations and includes 3.3 billion cards, issued by some 15,900 financial institutions. In total, $11.2 trillion worth of payments traveled over Visa’s global network last year. Mastercard’s reach is slightly smaller.

Despite countless efforts from tech companies, just one payment start-up—PayPal Holdings (PYPL)—has managed to achieve any kind of similar scale, and it succeeded by focusing on the periphery of Visa and Mastercard’s world. PayPal has become Visa and Mastercard’s counterpart in e-commerce. It is accepted by 22 million merchants and used by 277 million users.

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**AL KELLY – VISA CHAIRMAN, CEO**

“Cash Inc. is, in fact, our biggest competitor. And we’re working to displace cash every day.”

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Together, the three companies look virtually unassailable. Lisa Ellis, payments analyst at MoffettNathanson, has taken to calling the group MVP, in the spirit of the FAANG moniker for tech giants Facebook, Amazon.com, Apple, Netflix, and Google-parent Alphabet.
MVP—part tech and part finance—has crushed the FAANGs in terms of stock performance. The MVP group is up 154% over the past three years, compared with 127% for the FAANGs and 38% for the S&P 500 index.

“When Apple Pay came along and they decided to use existing rails, that was a pretty good early proof point” for the model, says James Tierney, chief investment officer of concentrated U.S. growth at AllianceBernstein, which has owned Mastercard stock since 2008.

The established payments companies “enjoy enormous benefits of scale that we view as hard to replicate,” says Edward Wojciechowski, portfolio co-manager of the Oakmark Equity and Income fund, whose firm is a longtime holder of Visa and Mastercard stock.

Meanwhile, Ellis says that Apple, Google, and Facebook have drawn the line when it comes to the nitty-gritty details of transactions. “They end up deciding they will facilitate payments over their platforms, but they don’t actually want to get into the messy business of doing payments.”

MVP Stocks
Mastercard, Visa, and PayPal’s stocks are each up at least 100% over the past three years.

Ellis says the payment companies ultimately benefit from the network effect of linking merchants, consumers, and banks. That network is defended by a moat of regulation, security, and fraud protection that no tech company wants to deal with. Network effect is an economic concept that explains how a product becomes more valuable as more people use it.

The scale means even a rich disruptor can’t find a way into Visa’s and Mastercard’s business.
“Because they are already at scale and they are on the same technology curve as Big Tech, there is no way to ever underprice them,” Morgan Stanley analyst James Faucette says.

Visa and Mastercard take an average of just 15 basis points, or 0.15%, per card transaction, he estimates. Merchants take 98% of the total card purchases, and most of the balance, or roughly 1.5%, goes to the bank that issues the card. The card networks’ low take rate decreases the incentive to displace Visa and Mastercard. The small fee works for them only because of the enormous volumes that flow through the networks.

Cryptocurrencies have also not gained traction in consumer payments because of relatively slow transaction times and the lack of recourse for fraud or stolen funds. MoffettNathanson estimates that a payments system based on Bitcoin can handle only about seven transactions per second versus Visa’s more than 65,000 transactions. And then there’s the extreme price volatility of digital currencies.

The Numbers
The companies carry premium valuations, but they also have impressive growth prospects.

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<th>Recent price</th>
<th>3-Yr Total Return</th>
<th>Market value (B)</th>
<th>Forward P/E</th>
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<td>$129</td>
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E=Estimate
Sources: Bloomberg; FactSet

“There is no reason for the man on the street to use cryptocurrency for [store payments],” says Paul Lucas, IBM’s chief technology officer of payments. “It is a crazy fluctuating currency,” which repels merchant acceptance, he says.

PayPal’s chief financial officer, John Rainey, tells Barron’s that when the company allowed stores to accept Bitcoin a few years ago, it never got traction because of the price volatility.

The card networks are the connective tissue in a sticky system that merchants, banks, and consumers are all incentivized to keep.
The cards are effectively a lead-generation network for profitable loans and related fees. (Banks derive just 20% of their credit-card revenue from card transaction themselves, according to MoffettNathanson.) For consumers, the cards come with strong incentives of money back and other rewards. Deutsche Bank estimates that cards generate about $120 billion worth of “rewards” for card users annually.

And the business models are profit machines: Visa and Mastercard generated $10.7 billion and $5.9 billion in net income, respectively, last year, while PayPal made $2.1 billion. Analysts still predict annual earnings growth of 15% to 20% for the next three to five years. Visa and Mastercard each have a small dividend yield of about 0.5%.

Vs. Big Tech

The MVP stocks have outperformed the popular basket of tech giants known as FAANG (Facebook, Amazon.com, Apple, Netflix, and Google).

Not all credit-card networks benefit from the same scale, though. Ellis of MoffettNathanson notes that American Express lacks a debit business, which is one reason for its lagging position among mass-market consumers. In 2018, Visa and Mastercard had 57% and 30% respective shares of the global card purchase volume, excluding the Chinese market, versus 8% and 1% for American Express and Discover, according to MoffettNathanson estimates.

“AmEx has faded over time largely because they are essentially a niche model,” Ellis says. “They really just serve affluent U.S. consumer credit customers and business customers.”

An American Express spokeswoman disagreed with the niche assessment, saying that the company added more than three million new cards in the last quarter and 1.6 million additional acceptance locations last year.
AmEx has long been treated differently by investors, though. The company has traded at half the forward P/E ratio of Visa and Mastercard over the past five years. Discover has traded at an even lower multiple than AmEx in recent years.

PayPal’s business resembles Visa and Mastercard in that it benefits from tremendous scale. Most of its customers use PayPal because it makes online transactions faster and more convenient.

“It is one thing to have a really cool app or payment method that consumers like, but if it is not accepted by merchants, it’s of little value for those consumers,” says Rainey, the PayPal CFO. “That’s where scale and a two-sided platform really make a difference in this business.”

PayPal has become an essential arms merchant for retailers trying to compete online against Amazon.com (AMZN). PayPal’s digital wallet carries across the internet, so customers don’t need to re-enter payment and address information with every order. That reduces the friction that often causes consumers to abandon their shopping carts.

Nearly 80% of the top 500 internet retailers use PayPal’s Checkout button, seven times more than Amazon Pay, its closest competitor, at 11%, according to Ellis. Checkout accounts for about 70% of PayPal’s payment volume and 85% of its revenue, according to her estimates.

Like the card companies, PayPal says that its networks secure payments and help fight fraud.

“A big part of PayPal’s brand is the trust and security of our transactions,” Rainey says. “We process 27 million transactions a day that give us a ton of data to learn about riskiness and fraud....That’s where we cut our teeth in this business.”

Valuation and Outlook

With the disruption threat largely in the rearview mirror, the power of Mastercard, Visa, and PayPal is no longer a secret. The stocks trade at premium valuations to the market and to their own recent history. The good news is that the companies’ growth justifies the high multiples.

Visa trades at forward P/E of 27 versus its five-year average of 25, while Mastercard trades at 31 times compared with a five-year average of 26. PayPal fetches 34 times versus its 28 times average. The S&P 500 has a
forward P/E of 17.

The payment companies, however, have unique attributes that help them stand out from the broad market. They have grown earnings at a compounded high-teens rate for the past five years.

“In my view, at the end of day, stock performance is driven by earnings performance,” says Ellis of MoffettNathanson. “The earnings performance of the payment companies, the MVPS—Mastercard, Visa, PayPal—[can] do over 20% earnings growth every year. That level of consistent, durable earnings growth is extremely difficult to beat in another sector.”

AllianceBernstein’s Tierney says that if Mastercard can grow its earnings at a high-teens rate for the next few years, the stock is much more compelling than the rest of the market.

“If it holds the multiple, you’re getting a 15%-plus return, plus there is a dividend,” he says. “That’s very attractive in a world that probably produces 5% to 7% [annual] earnings growth over the next three to five years.”

The Growth Opportunity

The strongest driver of growth for Visa and Mastercard continues to be the move toward electronic payments, away from cash and checks. Some 43% of global consumer purchases were made on cards last year, up from 28% in 2010. It is rising roughly two percentage points each year, according to MoffettNathanson.

The firm predicts double-digit annual global purchase volume growth for five to 10 more years with digital-payment penetration rising to 56% by 2023.

Visa CEO Al Kelly tells Barron’s, “Cash in many countries is the dominant way people pay. Cash Inc. is, in fact, our biggest competitor. And we’re working to displace cash every day.”
The Nilson Report, a leading payments trade journal, estimates that the global purchase volume of credit, debit, and prepaid cards will rise to $78.5 trillion by 2027 from $23 trillion in 2017.

It isn’t just cash replacement. The two major card networks are just starting to benefit from two new drivers: business to business, or B2B, payments and contactless technology.

Mastercard estimates that $120 trillion flows through the B2B market, but many of those transactions are still billed the old-fashioned way and get paid via check. Mastercard hopes to streamline the whole process, much as it has for consumers, where checks are a now a trivial part of in-store payment.

McKinsey partner Philip Bruno says the card networks’ commercial payment revenue will grow faster than consumer payments going forward.

Historically, B2B “has been heavily paper-based with longer payment terms,” Mastercard’s chief financial officer, Sachin Mehra, said in an emailed statement. “We see the potential to deliver the payment across account-to-account and card-payment solutions, while providing additional support in managing vendor relationships through greater insights and fraud management.”

Visa’s Kelly is excited about the B2B opportunity, too. While he didn’t disclose the company’s current B2B payment volume, he says the level can easily rise by 10 times over the next decade.

“If I use the baseball analogy, we’re probably no more than in the second inning as it relates to the B2B opportunity around the world,” Kelly says.

AllianceBernstein’s Tierney sees a future when Mastercard will facilitate mortgage, rent, and tuition payments. If Visa and Mastercard get their
traditional 15 basis-point cut, that would be a significant boon to business.

That’s the financial opportunity. But Visa and Mastercard have also proved their technology bona fides over the years. Their rollout of contactless payments, or “tap to pay,” is the kind of advance that consumers usually expect from Silicon Valley. The contactless cards use near-field communication, or NFC, technology. Instead of swiping or inserting a credit card, NFC allows users to just tap the card on top of a payment terminal. The process can shave seconds off transaction times.

“We’ve seen enormous increases in adoption in the past 18 months,” Kelly says. “I expect by year end in the U.S., we’ll have at least 100 million cards enabled with the ability to be used in a tap-and-pay situation.”

Visa says that outside the U.S., tap to pay is already nearly half of the company’s in-person transactions, thanks to the speed and convenience of the payment method.

Costco rolled out tap to pay last August and CFO Richard Galanti recently told Barron’s that the company is ecstatic about the results so far.

“For the customer—in our case, the member—and us, it’s better because it’s faster. From a safety standpoint, it’s encrypted and more secure,” Galanti said. “We’re very happy. There really haven’t been any issues with it. It does cut meaningful seconds off the transaction.”

Tap to pay is just the latest factor driving the adoption of electronic payments. The easier that card transactions become, the more they make cash seem inconvenient and unnecessary.

For PayPal, the opportunity is less about displacing cash and more about the long transition to e-commerce, which is still in its infancy. EMarketer estimates that global online sales outside of China will grow by 12% annually through 2022, from $1.4 trillion last year. The firm says e-commerce is just 8% of the total global retail market, excluding China.

Tech giants continue to talk about their own efforts in payments, but investors may have finally learned to tune out the news, recognizing the staying power of Mastercard, Visa, and PayPal.

Earlier this month, The Wall Street Journal reported that Facebook is planning to launch a new payments system based on cryptocurrency, potentially giving merchants a fee reduction on card-processing fees.
The stock market shrugged. Mastercard, Visa, and PayPal shares all rose the following day.

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