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## Payments Industry Stock Price Tracker

Figure 1 is the Payments Industry Stock Price Tracker for August 2013. The chart measures stock prices and market caps, as well as movement over the last month, and year-to-date. After a strong July, the companies... More

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** returning to First Annapolis post MBA*

# Virtual Commercial Card Accounts: Providing Further Ease and Control for B2B Purchasing in the U.S.

By Frank Martien and Daniel O'Neill

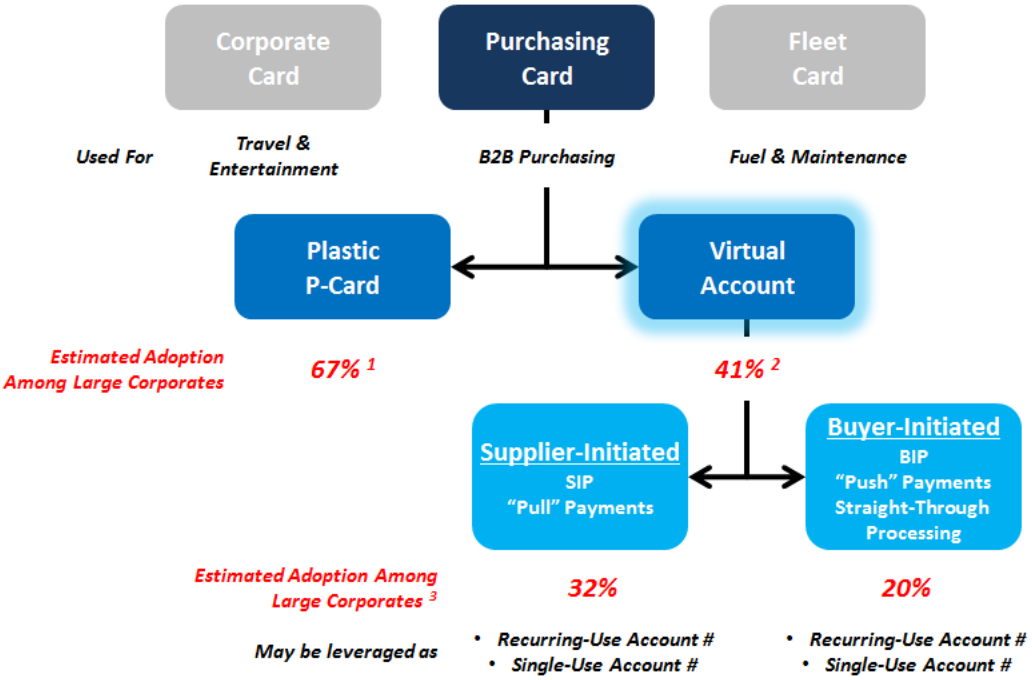
When one contrasts commercial cards with other forms of business-to-business payment such as check, electronic transfer (ACH in the U.S.), and wire, two of the most important benefits that cards bring to a buying organization are a) the ease with which cards can be used and b) the control and security which cards afford. Sometimes, and increasingly in the U.S. and other global markets, the best way to make commercial cards easy and secure is to not use a card at all.

So-called virtual or cardless accounts have existed in various forms for a long time. One typical product construct is a Central Travel Account (CTA) number, with which a buying organization pays for the expenses of multiple business travelers. The account number is "lodged" at a travel agency and used for air, hotel, and other expenses upon the request of authorized individuals. Another common arrangement in the B2B space is to assign a "ghost card" to a supplier with which an organization frequently does business. When the buyer makes a purchase, the supplier may either swipe a dedicated plastic card at a physical terminal, or simply input the ghost account number into a virtual terminal. For both CTAs and ghost cards, the virtual nature of the account allows for greater ease of use (multiple buying individuals can leverage the same payment device) as well as enhanced control (removes the plastic card, thus reducing the risk of misuse or fraud).

CTAs and ghost cards are fairly mature products, but recent years have witnessed a movement toward a more advanced type of virtual account. This account is integrated with a buying organization's Accounts Payable system, and therefore managed alongside other payment methods such as check. Integrating cards and card data with A/P allows for consolidation of all payment activity, which helps to provide a holistic picture of the organization's A/P position. Line-item detail from suppliers who pass Level III data provides the A/P department with enough information to reconcile purchases to invoices, even when multiple invoices are paid at once. This all renders the payment process easier, the first pillar of commercial card use.

Additionally, many virtual accounts are dynamically funded. In other words, instead of an open credit line (which can be quite large for some B2B organizations), the limit is defaulted to zero. When a purchase is made, a transaction is authorized and the credit limit is raised, but only for that particular purchase amount, within a designated date range, and to a specific supplier. This can all be completed from the buyer's A/P system (often accessed through an online portal provided by the card issuer) without the need for a plastic card that risks loss, theft, and misuse. Setting

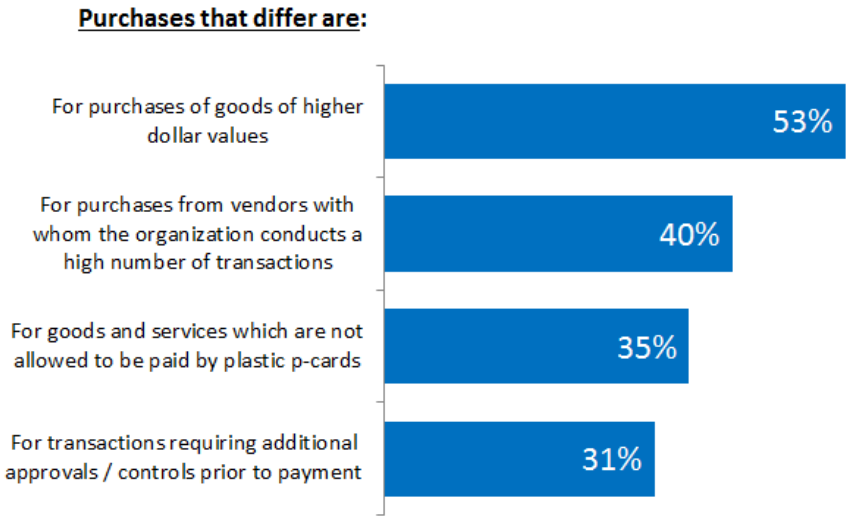
**Figure 1: Purchasing Card Adoption by Type**




Source: [1] PayStream Advisors "The value of Purchasing Cards" (Q4 2012); sum of categories "Currently Use" (64%) and "Deploying" (3%). [2] NAPCP / First Annapolis Consulting 2013 Supplier Acceptance Survey (n=103).

Note: [3] Inclusive of the 11% of respondents to the NAPCP / First Annapolis Consulting 2013 Supplier Acceptance Survey (n=103) who reported using both SIP and BIP solutions.

**Figure 2: How EAP Purchases Differ from Plastic Card Purchases**




Note: The terms "virtual accounts" and "EAP" are synonymous as used by First Annapolis Consulting and RPMG, respectively.

Source: 2012 RPMG Electronic Accounts Payable Benchmark Survey Results; n=4,375 survey respondents.

these parameters around a card transaction greatly contributes to the ability to control purchasing activity, which of course is the second pillar of commercial card use.

A/P integration and dynamic funding are at the core of the virtual account value proposition; and these benefits are available through several product variants. As shown in Figure 1, a virtual account can be either Supplier-Initiated (SIP) or Buyer-Initiated (BIP). A SIP model is similar to the above description of a ghost card; the supplier virtually "swipes" or initiates the transaction. Under a BIP model, the buyer "pushes" the payment to the supplier at will and the supplier receives the funds without taking any action or receiving an account number. This method can be easier and more secure for both parties, given the absence of an account number exchange.

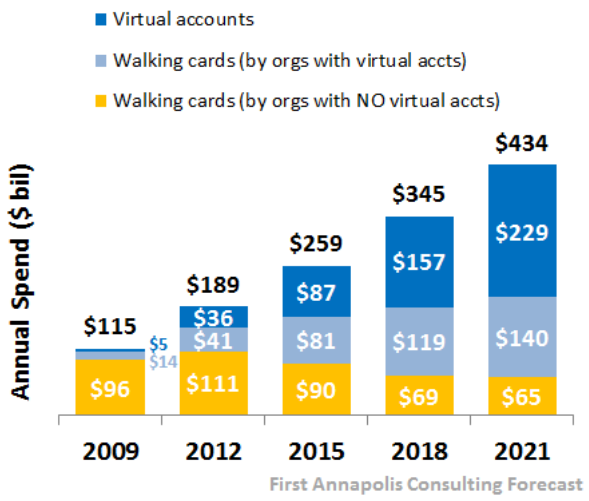
As an additional layer of protection, both SIP and BIP accounts will often allow the generation of single-use account numbers; that is, account numbers that are used once and then disappear. A single-use account number is by definition dynamically funded and provides enhanced control over how much a supplier is paid, and when. Choice of virtual account type or types used (SIP vs. BIP; recurring vs. single-use) will depend on a buying organization's internal processes and preferences, as well the buyer's relationship with individual suppliers.

Whether supplier- or buyer-initiated, A/P integration and dynamic funding have made buyers more comfortable with putting larger and invoice-based purchases on commercial cards. The continued shift away from paper checks has certainly benefitted purchasing card-related solutions, especially since buyers have easier and more secure options with virtual accounts. As shown in Figure 2, many organizations leverage virtual accounts to make purchases that could be unsuitable for plastic commercial cards. Though acceptance fees are a common supplier objection to acceptance (especially for high value card payments), the emergence of large ticket interchange rates can greatly reduce the discount rate paid by a supplier.

The plastic purchasing card will not go away anytime soon, and in fact still has room to grow, as evidenced by the 67% penetration rate of large corporates estimated in Figure 1. However, much of the growth in B2B purchasing card spend will likely be driven by virtual accounts for the foreseeable future, as shown in Figure 3. Commercial cards have always provided simplicity and control for buying organizations; and the robust capabilities of virtual cards further enhance that value proposition and allow for market growth.

*For more information, please contact Frank Martien, Partner, frank.martien@firstannapolis.com or Daniel O'Neill, Associate, daniel.oneill@firstannapolis.com. Both specialize in Commercial Cards.*

**Figure 3: U.S. Purchasing Card Spend**




Source: NAPCP / First Annapolis Consulting 2013 Supplier Acceptance Survey (n=103); 2012 RPMG Electronic Accounts Payable Benchmark Survey Results; n=4,375 survey respondents.; First Annapolis Consulting good faith industry observations; Visa, MasterCard, and Amex annual reports, SEC filings, and investor presentations; The Nilson Report.

## Q2 2013: U.S. Credit Card Issuer Performance Snapshot

**By James Watts**

The trends for the second quarter of 2013 are consistent with the first quarter of the year. The nation's largest credit card issuers reported strong profits despite relatively stagnant quarter-over-quarter asset growth. Purchase volume showed close to a 10% increase on both a year-over-year and quarter-over-quarter basis. However, most issuers remain cautious from both a credit quality and regulatory perspective as it relates to targeting lower ends of the risk spectrum.

1. **Receivables Are Relatively Flat:** Quarterly loan growth was once again flat, while receivables decreased by 2.2% on a year-over-year basis. Capital One reported the largest decline in receivables, but it is primarily attributable to the accounting treatment associated with the pending sale of the Best Buy portfolio to Citi. Consistent with the first quarter of 2013, American Express, Discover, and Wells Fargo all posted quarter-over-quarter and year-over-year loan increases, while the nation's largest issuers – Chase, Citi, Bank of America, and Capital One – all experienced year-over-year decreases.
2. **Attractive Returns Continue:** Issuer returns as measured by ROA increased by 89 basis points on a year-over-year basis and declined only slightly on a quarterly basis. If Capital One was excluded from our analysis (due to one-time expenses related to the HSBC acquisition in Q2 2012), industry returns would have increased by 27 basis points year-over-year. While receivables and revenue growth challenges are widespread, the card industry continues to benefit from a benign credit quality environment and low funding costs. With the Federal Reserve signaling possible "tapering" actions on monetary policy, continued soft demand for credit card loans will become more problematic.
3. **Continued Growth in Purchase Volume:** Purchase volume increased by 9.9% on a year-over-year basis and 10.3% quarter-over-quarter. Purchase volume increases were ubiquitous for all of the issuers in our peer group. Industry purchase volumes are now at parity inflation adjusted pre-recession levels.
4. **Loss Rates Plateau:** Loss rates decreased by 11 basis points quarter-over-quarter and, consistent with prior recent prior quarters, 85 basis points year-over-year. The protracted improvement in loss rates is being driven by issuer targeting and underwriting strategies and the fact that household balance sheets have improved dramatically since the height of the recession with household debt to income ratios now at their lowest point in over three decades.

*For more information, please contact James Watts, Senior Consultant specializing in Credit Card Issuing, james.watts@firstannapolis.com.*

| | Receivables | | | Purchase Volume | | | Net Loss Rate | | | After-Tax ROA | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Issuer** | **($B) 2Q13** | Change (vs. 2Q12)[10] | Change (vs. 1Q13) | **($B) 2Q13** | Change (vs. 2Q12)[10] | Change (vs. 1Q13) | **2Q13** | Change (vs. 2Q12)[10] | Change (vs. 1Q13) | **2Q13** | Change (vs. 2Q12)[9] | Change (vs. 1Q13) |
| **Chase[1]** | $124.3 | -0.3% | 2.0% | $105.2 | 9.6% | 11.1% | 3.31% | -104 bps | -24 bps | 3.56% | 81 bps | -5 bps |
| **Citigroup[2]** | $105.3 | -3.7% | 0.7% | $60.2 | 23.1% | 12.5% | 4.40% | -96 bps | -11 bps | 3.26% | 17 bps | -6 bps |
| **Bank of America[3]** | $90.5 | -4.0% | 0.5% | $51.9 | 6.3% | 11.4% | 4.10% | -117 bps | -9 bps | 2.57% | -5 bps | -33 bps |
| **Capital One[4]** | $70.5 | -12.8% | -8.9% | $47.3 | 13.1% | 13.0% | 4.28% | 142 bps | -15 bps | 3.65% | 512 bps | 20 bps |
| **American Express[5]** | $54.6 | 4.0% | 1.9% | $125.6 | 8.3% | 7.6% | 2.00% | -20 bps | 0 bps | 3.99% | -1 bps | -36 bps |
| **Discover[6]** | $49.8 | 4.8% | 2.3% | $27.6 | 4.5% | 10.8% | 2.34% | -38 bps | -2 bps | 3.94% | 72 bps | -15 bps |
| **Wells Fargo[7]** | $24.8 | 9.3% | 2.9% | $12.7 | 9.0% | 9.0% | 3.90% | -47 bps | -6 bps | | | |
| **U.S. Bank[8]** | $16.6 | -1.5% | 2.6% | $27.1 | 1.9% | 8.9% | 4.23% | 13 bps | 30 bps | 5.40% | 7 bps | 98 bps |
| **Sum/Wtd Avg[9]** | $536.5 | ↓ -2.2% | no change 0.0% | $457.7 | ↑ 9.9% | ↑ 10.3% | 3.61% | ↓ -85 bps | ↓ -11 bps | 3.52% | ↑ 87 bps | ↓ -9 bps |

Source: Issuer quarterly reports and First Annapolis analysis.

Note:

[1] Includes income from acquiring business and private label receivables and volume. Restated from previous quarter which included income from auto and student lending.

[2] Earnings restated in 1Q 2013, historical figures adjusted to conform to new reporting methodology. Purchase volume includes cash advances.

[3] Receivables, purchase volume, and net loss rates are for U.S. consumer cards. After-tax ROA restated to reflect "Consumer Lending" only; which now includes *Dealer Financial Services*. Period amounts have been reclassified to conform to current period presentation.

[4] U.S. card business, small business, installment loans only. Purchase volume excludes cash advances. 2Q12 Results include the impact of May 1, 2012 closing of HSBC transaction resulting in approx $28.2 billion in receivables at closing.

[5] Receivables and charge-offs are for U.S. Cardmember Lending business only. Purchase volume is for U.S. Card Services segment, consumer and small business. Average earning assets is defined as all cardmember receivables (charge) and loans (revolving credit).

[6] Includes U.S. domestic receivables and purchase volumes only. Restated: ROA reflective of Direct Banking segment (80+% credit card) and implied U.S. Cards tax rate of ~40%. ROA denominator estimated from total loans ended totals.

[7] Wells Fargo began reporting purchase volume in 4Q 2013.

[8] After Tax ROA reflects Payment Services line of business income and average loans.

[9] After Tax ROA excludes Wells Fargo as credit specific income not reported. Reflects any previous quarter restatements and includes addition of U.S. Bank.

## Bitcoin's Tough Road Ahead

**By Jeff Crawford and Patrick Carroll**

The last few months have been a roller coaster ride for the Bitcoin community. On one hand, investors such as the Winklevoss twins of Facebook fame have promoted the legitimacy of the product by seeking regulatory approval for Bitcoin-based ETFs on public markets. On the other hand, state and federal regulators are cracking down on the digital currency due to its potential to facilitate money laundering and other illicit activities.

For those unaware, Bitcoin is an alternative digital currency that is not backed by a central bank or government. New Bitcoins are gradually introduced into the market by a process called "mining" where individuals use computer software to solve complex algorithms to earn newly minted Bitcoins. The currency can then be purchased and traded via online marketplaces. Once obtained, Bitcoins can be spent via a limited number of online merchants or marketplaces that accept them for payment. The currency has thus far been unregulated, and transactions between individuals are anonymous. These factors, in addition to a few instances of hacking on the exchanges where they are traded, have led to extreme price volatility.

Of all the hurdles Bitcoin faces, the recent regulatory attention is the most significant. Since its inception in 2009, Bitcoin has become a magnet for illicit online trade and money laundering due to its anonymity and the ease with which a user can convert Bitcoin to and from U.S. Dollars. In May, the U.S. Treasury Department determined that money transmitter rules that govern many payment services in the U.S. also apply to Bitcoin exchanges. States have also begun to investigate whether money transmitter licenses ought to be required for Bitcoin exchanges to operate within the state.

These findings will likely have the effect of slowing and potentially reversing Bitcoin's adoption trajectory to date. Due to its decentralized status, it is difficult to see how Bitcoin will be able to quickly and adequately address these regulatory concerns. The effect of which may be to further relegate the currency to a questionable status with use limited to illegal activities.

For the foreseeable future, the industry centered on Bitcoin must focus on satisfying these regulatory concerns. Regulatory concerns will likely keep the utility of owning Bitcoins in question, thereby encouraging further price volatility and limited merchant adoption.

*For more information, please contact Jeff Crawford, Senior Consultant, jeff.crawford@firstannapolis.com or Patrick Carroll, Senior Analyst, patrick.carroll@firstannapolis.com. Both specialize in Mobile Commerce.*

## From the Field: Sourcing Best Practices for Credit Card Issuers

**By Scott Reaser**

First Annapolis enjoys a unique position in the market, advising many of the largest credit card issuers, community financial institutions and retailers on strategic sourcing initiatives. These engagements have yielded rich insights that can guide credit card issuers as they assess current and future card processing and servicing relationships.

The current market environment requires card issuers of all sizes to optimize available program delivery (i.e., in-house and/or third party providers) and participation economics. Issuers should use all tools at their disposal to execute on their respective sourcing strategies and initiatives.

*For more information, please contact Scott Reaser, Principal specializing in Strategic Sourcing and Deposit Access, scott.reaser@firstannapolis.com.*

| Background | Best Practices / Market Observations |
|---|---|
| Client: Top 20 U.S. Bank<br>Scope: Credit Card Processing & Portfolio Servicing<br>*Our Role: Vendor Selection Support* | • Competitive selection processes continue to drive better overall results than simple renewals or direct negotiation processes.<br>• While it is expedient to pursue a direct or renewal negotiation, the market for credit card processing and servicing services remains highly competitive to the advantage of issuers large and small.<br>• Competition and vendor economies of scale have driven declines in core processing fees over the past several years; however, more recently we have observed competition driving considerable savings in adjacent areas, such as optional processing services (e.g., adaptive control, fraud detection, cardholder website, etc.) and select portfolio servicing functions. |
| Client: Retailer<br>Scope: PLCC Card Processing<br>*Our Role: Vendor Selection & Contract Negotiations Support* | • There remains a strong business case to outsource processing and related services to industry specialists.<br>• Costs, loss of control, risk, and conversion disruption can be arguments to remain in-house, but the revenue growth opportunity provided via advanced capabilities, strategic factors (e.g., vendor expertise, speed to market, innovation, etc.) and regulatory/risk considerations often offset these factors, leading to outsourcing decisions.<br>• Likewise, outsourcing (with a properly structured deal) can shield the issuer from unexpected costs associated with regulatory actions (e.g., CARD Act) and making forward investments in a range of solutions to meet new product needs, such as EMV or mobile payments. |
| Client: European Bank<br>Scope: Credit & Debit Card Processing<br>*Our Role: Proposal Evaluation & Vendor Decision Support* | • Credit card issuers should leverage pricing templates or other structured bid forms to facilitate "apples-to-apples" comparison of card processor financial proposals.<br>• Card processing pricing is inherently complex and highly dependent on system usage, product assumptions, scope of services, and other factors. Without structure on the front-end, it is very difficult for card issuers to effectively analyze and compare financial proposals on the back-end and optimize process value.<br>• Pricing templates can be an efficient and effective tool to determine gaps or disconnects in proposals, identify hidden or at-risk cost elements (due to misaligned usage or other vendor assumptions) and compare pricing elements or categories on an "apples-to-apples" basis.<br>• A pricing template process was conducted after our client evaluated competing proposals. The process determined, among others, one processor's proposed fees were underestimated by 19% (due to disconnects in work effort, usage, and services required by the card issuer), while 30% of another processor's proposed fees were at risk for material increase should the issuer's usage rates be much greater than the processor estimated. The process led to a comprehensive comparison of proposals and a basis to drive real savings via a competitive selection process. |
| Client: Regional U.S. Bank<br>Scope: Credit Card Processing<br>*Our Role: Implementation Support Services* | • Planning and discipline are and will continue to be the key drivers of successful and timely conversions.<br>• Implementations/conversions are highly complex and require proper coordination among stakeholders: business owners, operations, IT departments, card processors, payment networks, and others.<br>• The most successful processes are those that effectively define and agree on business requirements, establish protocols for decision making and issue resolution, identify time sensitive items (e.g., card procurement), and manage to agreed-upon timelines.<br>• While difficult in practice, limiting the number of business requirements changes (e.g., pricing, card features, plastic design, servicing model, etc.) throughout the duration of an implementation/conversion is critical to meeting project timelines. Last minute changes can impact procurement (e.g., cards, T&C's, etc.), may require system, operational and/or processor/network changes, necessitate testing, and may delay project timelines. |

Source: First Annapolis Consulting research and analysis.

## The Starbucks Card by the Numbers

By John Grund and Allison Brenner

Why would a payments consulting firm write about Starbucks and more importantly, why should you care? Let the numbers tell part of the story:

- In 2012, customers prepaid for over $2.9 billion worth of future purchases using the Starbucks Card, the company's stored value product and loyalty platform. This figure includes both activations and reloads, physical and digital. The first three quarters of 2013 are already totaling nearly $2.9 billion
- The Starbucks Card now accounts for 30% of all US transactions further demonstrating customer engagement with the brand and the company's payment product
- The Starbucks mobile app, tied to the Starbucks Card, now accounts for 10% of all US transactions
- Nearly 25% of US transactions are associated with My Starbucks Rewards, the company's loyalty program/platform which requires the registration of a Starbucks Card

The story does not end there. Around the globe, adoption of the company's payment and loyalty offerings is equally impressive. Cards are loaded in 24 countries. China already has 2.5 million My Starbucks Rewards members without a mobile payment platform or eGifting. Penetration on the card product exceeds 35% of total tender in China. Penetration in Singapore and Thailand are also approaching 30% of transactions. Granted, Starbucks has a unique business model with its frequency of shop driving receptivity to a more convenient payment method and its loyalty program. However, it would be a cop-out if other businesses conclude that there is no applicability of the Starbucks model to their own. Every retailer, airline, hotel, and restaurant has loyal shoppers, flyers, and guests. Chances are that many loyal customers are also shared with Starbucks. With mobile agendas taking shape, you would be hard pressed to find stronger engagement and adoption than that achieved by Starbucks. It is not because the Starbucks mobile app is trendy or customers have left their purses and wallets at home. Rather, it is because Starbucks has found the sweet spot of convenience, value, and engagement that a mobile experience, done right, can deliver. The numbers don't lie and others should take note.

Sources: Starbucks Investor Relations, Starbucks 2013 Quarterly Earnings Calls.

*For more information, please contact John Grund, Partner, john.grund@firstannapolis.com; or Allison Brenner, Analyst, allison.brenner@firstannapolis.com. Both specialize in Credit Card Issuing.*

## Payments Industry Stock Price Tracker

By Collin Bauer

Figure 1 is the Payments Industry Stock Price Tracker for August 2013. The chart measures stock prices and market caps, as well as movement over the last month, and year-to-date. After a strong July, the companies First Annapolis monitors across the payments value chain experienced mixed results in August, but in aggregate are exceeding the broader market's 14% gain YTD.

In summary:

The issuing sector underperformed the overall market in August, posting declines of 6% in aggregate. Despite declines from all issuers except FleetCor, analysts largely remain bullish on these banks. FleetCor's 15% gain in August was driven by its favorable second quarter earnings release. FleetCor's stock is up 92% YTD and its price target from analysts currently sits as high as $120.

The processor / acquirer sector posted overall gains of 1%. Global Payments experienced one of the biggest jumps in this sector and its 3% gain in August accounts for the majority of its 5% YTD increase. The other five companies tracked in this sector are exceeding the total market's 14% gain YTD.

In aggregate, MasterCard and Visa posted declines of 1% in August, but are still up 19% YTD. MasterCard gained positive momentum at the end of July after outperforming most analysts' second quarter expectations, but its stock price has slowly declined over the month. Developments surrounding debit "swipe" fees, following a judge's rejection of the Federal Reserve-imposed regulations at end of July, is top of mind for investors and the networks.

*For more information, please contact Collin Bauer, Senior Analyst specializing in Credit Card Issuing, collin.bauer@firstannapolis.com.*

**Figure 1: Monthly Average Stock Price Tracker**

| Companies | Aug. 30, 2013 | Month Δ | YTD Δ | Current Market Cap ($Billions) |
|---|---|---|---|---|
| **Issuers** | | | | |
| American Express | $71.91 | -3% | 26% | $78.83 |
| Bank of America | $14.12 | -3% | 22% | $152.93 |
| Capital One | $64.55 | -6% | 12% | $37.34 |
| JPMorgan Chase | $50.53 | -9% | 16% | $192.50 |
| Citi | $48.33 | -7% | 22% | $149.89 |
| Discover | $47.25 | -4% | 23% | $23.06 |
| FleetCor | $103.11 | 15% | 92% | $8.61 |
| U.S. Bank | $36.13 | -3% | 14% | $66.15 |
| WEX | $80.03 | -8% | 6% | $3.07 |
| Weighted Average | - | *-6%* | *20%* | - |
| **Acquirers / Processors** | | | | |
| FIS | $44.46 | 3% | 28% | $13.00 |
| Fiserv | $96.27 | 0% | 22% | $12.54 |
| Global Payments | $47.65 | 3% | 5% | $3.60 |
| Heartland | $36.95 | -1% | 26% | $1.36 |
| TSYS | $27.67 | 1% | 30% | $5.24 |
| Vantiv | $26.41 | 1% | 29% | $3.61 |
| Weighted Average | - | *1%* | *24%* | - |
| **Networks** | | | | |
| MasterCard | $606.08 | -1% | 24% | $73.43 |
| Visa | $174.42 | -1% | 16% | $113.11 |
| Weighted Average | - | -1% | *19%* | - |
| **Market Index** | | | | |
| S&P 500 | $1,632.97 | -3% | 14% | - |

Note: Weighted Averages are based on current market caps.
Source: Yahoo Finance, First Annapolis Consulting research and analysis.