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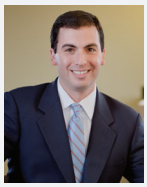
Announcements

Josh Gilbert Promoted to Partner



Josh will co-manage the Deposit Access practice and coordinate our Mobile Payments and Innovation activities. He joined First Annapolis in 2005 after earning his MBA from the Darden Graduate School of Business at the University of Virginia.

Hugh Gallagher Joins First Annapolis

As a Principal in the Deposit Access Practice, Hugh will focus on Mobile and Emerging Payments, Payments Strategy, as well as supporting other lines of business and client relationships. Hugh's industry experience includes 25 years in payments and financial services with executive roles at First Manhattan Consulting Group, SunTrust Banks, Edgar, Dunn & Company, and eFunds.

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Changing Core Beliefs in Merchant Acquiring: A Conversation with Guy Harris, President of North America, Elavon

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Changing Core Beliefs in Merchant Acquiring: A Conversation with Guy Harris, President of North America, Elavon

By Scott Calliham

Recently we had the opportunity to speak with Guy Harris, President of North America at Elavon, about Elavon's general approach with its customers. In this Q&A format, we cover topics such as how the industry has evolved in its approach to customers and how Elavon is changing its business practices to become more customer-centric.

As President of North America at Elavon, Guy Harris has direct responsibility for the leadership of Elavon in North America, where he oversees strategy, profit and loss and growth.

Prior to taking on his current role, Guy served as Executive Vice President and Managing Director for Elavon's Western, Central and Southern European regions. In this role, Guy successfully grew revenue by 15 percent, per annum, through the employment of a value-based, customer-focused approach.

Before joining Elavon, Guy was Vice President of Global Sales for Misys, a leading global supplier of IT solutions to the banking industry. He also served as Sales Director at CR2, a leading multichannel, global, banking software provider, where he played a key role in increasing sales by 35% compound growth per annum, and as Managing Director at Banctec, a business process outsourcing company. Guy holds an Ordinary National Diploma in Business Studies from Kingston College.

What are some of the beliefs you see in the market, and how are you trying to change these opinions?

I believe the acquiring market has managed to craft a language it uses to express and explain its market, but we've lost touch with our customers along the way. For instance, we've renamed the customer a "merchant." So for instance, if you are a coffee house, you don't see yourself as a "merchant" because you run your coffee shop. However, the industry categorizes these businesses as "merchants," and they each have a "MID" and a "TID" – irrelevant and very non-customer-like terminology for any business.

That terminology is indicative of the way the industry treats customers holistically – more as numbers rather than people. What I saw in Europe, and I see in the U.S., is an acquiring business that may not necessarily come across as customer-centric. One way we're changing that at Elavon is by rethinking our approach and the customer experience. For example, formerly, if we needed to re-price a customer, a pretty stern letter was distributed blaming a third party for the re-pricing event. Now, we're being transparent and thoughtful and showing our customers the value they receive from choosing us. It's an approach not unlike my cable TV company in the U.K.: they write to me every year with a lovely, glossy thing with pictures of the programs, and say, "Great to have you as a customer. This year we've introduced six new channels, twenty-two new films, the sports, rugby, etc." And at the bottom it says, "Your monthly fee has gone up by £2." So as a customer, I get to that point, and I say, "Oh yeah, okay, it's gone up by £2, but look what I've got."

Yet another opportunity where we can provide a better experience is managing how we communicate on the topic of fraud monitoring. The first policy in an instance when fraud is indicated is usually to suspend settlement for the transaction, but there are many inconsistencies with managing customer communications about the suspension. What we really should do is tell our customers "Look, sorry, you need to understand this is what happened, we just needed to check with you, we apologize." Simple steps like these will help us. At Elavon, we're taking these steps and many more to put our customers first. We're not calling business owners "merchants;" we're calling them "customers," and our approach is to listen to their needs and provide solutions that help them grow. It's new for us, but we realize customers have choices and we want them to choose us.

What other core misperceptions do you believe exist in the market today?

I believe acquiring is a value-based proposition, not a commodity. But to a certain extent, our industry has allowed it to become too commoditized. We'll say, "How much are you paying… whatever it is and so-and-so?" I go back to if I'm a customer and I own a coffee shop, I care about how much I pay for something in the sense of whether it's disproportionate for the service I get. However, I'm not obsessed with needing to get it down to a 0.5% to acquire a service. What I'm most interested in actually starts when you first meet the sales person and if the sales person is focused on selling what the customer experience is about. There are certain fundamental questions related to the customer experience that often are not commodities, such as:

- "Is my money paid on time?"
- "Is the acquirer able to understand what my business is and what I am doing?"
- "Am I dealing with a company that's friendly and helpful?"
- "Are they easy to do business with?"
- "Can I get a hold of them when I have an issue?"
- "Are my statements clear so I know what I'm paying every month?"

These may seem like commodities in today's world, but at Elavon, we consider these value-based services. Furthermore, it is often not about pricing, although there are certainly exceptions to this.

Even though pricing per se does not play a heavy factor in many customers' decisions to change providers, is there an aspect of your core beliefs that impact how you go to market related to pricing?

This philosophy and approach impact every part of the business, including the approach to pricing. RFPs are an example of this. In the past, nine times out of ten, we responded to an RFP with having hardly ever met or done any real, what I call, discovery work about the customer's pain point. We'll get some direction on where the price should be, put a price in, and then go back to the company and say, "Here's the price!" We will not respond to RFPs now unless we understand exactly what would make the customer change, other than what price they would seem to accept. We have a very clear strategy now that we only respond if we're genuinely engaged with a customer.

On the smaller customers, it's really about managing their expectations. If I'm a customer and an acquirer tells me it is going to cost me $80, and it's now costing me $120 a month, then I feel as though they've lost my trust. And so if we say it's going to be approximately a certain amount, and it isn't, you still lose that trust with the customer. I think acquiring, based on pricing smaller customers, has a way of trying not to be as precise as it needs to be. There are a lot of reasons for this, whether it is chargeback fees, downgrades, or others. If we are able to do anything that takes complexity away and allows the customer to be able to sign something and feel comfortable, that goes hand in hand with having a great customer experience. Additionally, if you set off on the right foot with a customer, then I think the likelihood of keeping that customer increases over a period of time. This is where, in positive ways, Square and the disrupters have brought a real focus to the industry that is

forcing acquirers like us to think about how they engage and interact with their customers as well as new customers.

What other legacy industry perceptions are you trying to overcome?

I think many acquirers suffer from far too high attrition and we all believe there is not much to solve for in this challenge. We spend more time winning customers than we do keeping those customers. To counteract this long-term trend, Elavon has a leadership team that includes someone that focuses on the customer experience and whose job is to manage our customers.

When we look at our customer base, we are truly tackling the questions of who are the ones likely to leave and what should we put in place to stop it. Before, we would wait until the customer was leaving. We had what's called a BRU-Business Retention Unit. The unit was very reactive. I believe in reaching out to our customers on a regular basis, talking to them. I've heard from many in the industry that this is an unsound policy- there are a lot of people that say, "Don't wake the customers up, if they're transacting, leave them alone." I don't believe in that approach. So we're putting in place a team of customer account managers that will look after all our customers. So every single one of our customers will have a contact at Elavon - every single one.

So looking after our customers, keeping every single customer longer, making it easier for them to do business with us, are all things that will drive growth within our business as opposed to just chasing after loads and loads of customers. Although we cannot ignore new sales and it will remain a very important part of the business, we need to be better than that. I think this change in philosophy is just the start, and it's making Elavon relevant, exciting, and helping us grow in the marketplace. I think we have been seen by some as a sleeping giant—a large organization with capability that it hasn't executed on. We are changing dramatically, we have largely a new management team, and we are going to be very relevant in the market for a very long time to come.

Interview completed by Scott Calliham, Principal, specializing in Merchant Acquiring, scott.calliham@firstannapolis.com.

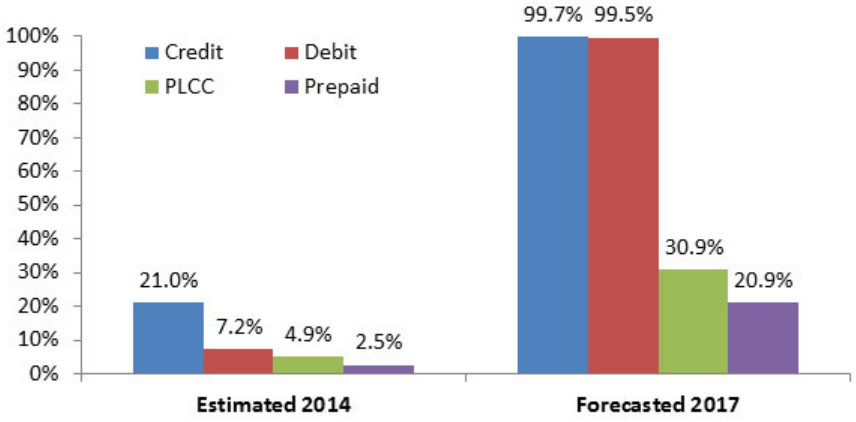
U.S. EMV Update: Portfolio Conversions

By Casey Merolla

As the October 2015 liability shift deadline quickly approaches, issuers are feeling heightened pressure to migrate card portfolios to EMV. Over the past six months, the industry has reacted to highly-publicized data breaches at major merchants as well as received much needed clarity around debit routing with the recent resolution of the Durbin-related litigation and announcement of cross-licensing agreements among several debit networks for use of a common application identifier (AID).

Given the uncertainty that surrounded debit for much of 2013, many issuers focused almost exclusively on credit portfolio conversion strategies, and are therefore far along with credit-specific plans. Most large credit issuers have completed certification and testing with their processing partners, and many are issuing chip cards as part of the existing re-issuance cycles for credit cards. The recent developments on the debit side have allowed issuers to expand their focus to debit portfolios, and many are pursuing similar strategies to credit. While credit conversions will outpace debit, First Annapolis estimates that by 2017, all credit and debit cards issued will be EMV-compliant (see Figure 1).

Figure 1: Projected U.S. EMV Penetration of Total Cards in Force



Source: First Annapolis Consulting research and analysis.

The strategy of relying on re-issuance cycles is expected to be the norm for issuers across the industry. Few issuers to date have opted to pursue mass re-issuance, though First Annapolis expects to see a wave of larger FIs mass re-issue card portfolios in late 2014 and early 2015. Private label cards will likely convert at a much slower pace, and be highly merchant dependent. Target, for example, has announced that its RED card will be (and is being) re-issued as EMV, while Neiman Marcus has expressed a willingness to explore EMV, but has yet to make a commitment. Given the limited utility of private label credit cards, the urgency to convert is less immediate and will be driven by merchants' greater EMV and POS strategies.

Prepaid card conversion will be highly dependent on segment (e.g., general purpose reloadable, government, gift etc.). First Annapolis predicts that temporary cards, particularly gift cards, will not be issued with EMV capabilities due to the cost and short life cycle of the cards. Government, payroll, and employee benefits cards will likely follow a similar conversion trajectory to debit, driven largely by government and consumer concerns around payment security. Lastly, direct deposit-enabled general purpose reloadable cards will likely convert to EMV, though presumably at a slower pace than debit. Issuers and program managers are unlikely to issue temporary cards with EMV capabilities, but will provide the cardholder with an EMV card once the account is personalized and enabled with recurring deposits.

The combination of merchant data breaches and resolution of the Leon/Durbin decision has created significant momentum for the industry's move to EMV. Most issuers are focused on deploying EMV as quickly as possible, and conversion efforts are in full swing.

For more information, please contact Casey Merolla, Senior Manager, casey.merolla@firstannapolis.com, member of Deposit Access Practice, specializing in Debit and Prepaid.

Headwinds to Credit Card Receivables Growth Beginning to Subside

By James Watts

Industry credit card receivables grew by 2.8% on a quarter-over-quarter basis and 2.9% on a year-over-year basis in the second quarter of 2014. This level of receivables growth marks the largest year-over-year increase since the fourth quarter of 2008. Year-over-year growth was nearly universal as five issuers, Citi, American Express, Discover, Wells Fargo, and US Bank, posted increases in receivables of more than 4.0%.

"As we look at our underlying consumers, they have increased their spending. We can see in our data that the retail volumes on debit and credit cards were up 4% from last year's second quarter but more importantly up 8% from the first quarter of this year showing increased momentum in spending among our card customers." - Brian Moynihan, President and CEO, Bank of America

In addition to an increase in consumer spending, the nation's largest issuers attributed growth to three key areas:

1. **Strong New Account Growth:**
   - Chase opened 2.1 million credit card accounts (up 40% year-over-year)
   - Citi attributed some of its growth to the new account performance of the AAdvantage Executive card
   - Wells Fargo's new account growth was up 4% year-over-year
   - Discover experienced "double digit" new account growth year-over-year
   - The number of new consumer credit card accounts generated at Bank of America grew by nearly 18% year-over-year

   "Core growth is now outpacing one-offs [a one-time event such as a portfolio acquisition] and we acquired over 2 million new accounts in the quarter, up 40% year-on-year." - Jamie Dimon, Chairman and CEO, JPMorganChase

2. **New Product Enhancement and Rewards:** Wells Fargo continues to highlight the success of its Propel products, releasing several impressive statistics as part of its 2014 Investor Day (e.g., Propel 365 pilot data indicates a 53% increase in average spend per active and a 13 – 32% increase in spend related to bonus categories versus Wells' existing credit card portfolio[1]). Discover recently launched Discover it Chrome, a product that offers 2% back on gas and restaurants.

   "Our growth rate has been above the industry average reflecting new account growth, product enhancement and increased usage among our existing customers." - John Stumpf, Chairman, President and Chief Executive Officer, Wells Fargo

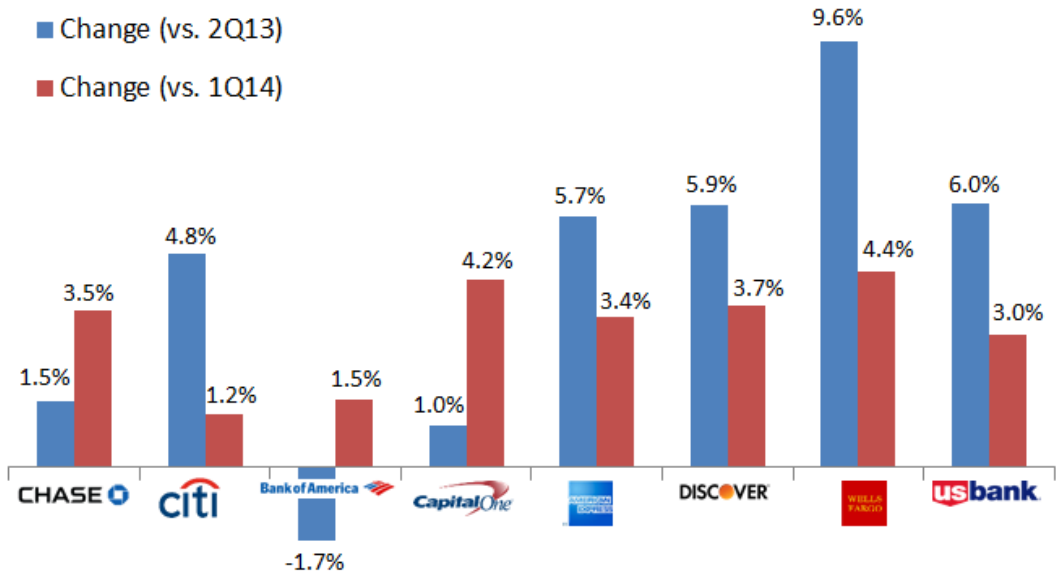
3. **Other Tactics:** The nation's largest credit card lenders continue to test balance transfer offers and credit line increases. For example, Bank of America launched its Better Balance Rewards card, which promotes a 0% balance transfer offer and rewards revolvers who responsibly manage a balance, and Capital One has been experimenting with credit line increases over the past couple of years.

According to the Fed's most recent quarterly survey of bank's senior loan officers, a large percentage of banks expect higher growth (or lower contraction) during 2014 and the (slight) majority of respondents expect that growth in credit card receivables will reach precession levels by 2016. Despite high aspirations for increased cardholder loans over the next several years, commentary was cautious and it is clear that banks plan to continue to take a prudent approach to growth.

[1] Existing Credit Portfolio excludes College and Secured Cards.

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

Figure 1: Changes in Ending A/R Year-Over-Year and Quarter-Over-Quarter – 2Q 2014



Source: Issuer Quarterly Filings.

A Look at Merchant Acquiring's M&A Activity Among Small Companies

By Scott DeHaven

In the first quarter of 2014, First Annapolis conducted a survey of over 150 smaller acquiring related companies (those with less than $20 million in annual EBITDA) along a variety of vertical niches, product offerings, and/or geographic locations. Through the outreach effort, First Annapolis identified several consistent themes in the acquiring industry's M&A environment. See Figure 1 for observations and analysis by First Annapolis.

In short, smaller companies, especially those truly possessing a differentiated service or product, are being aggressively pursued and companies looking to make a strategic purchase in the near term may need to be prepared to pay a premium.

For more information, please contact Scott DeHaven, Consultant, specializing in Merchant Acquiring, scott.dehaven@firstannapolis.com.

Figure 1: First Annapolis' Observations of the Acquiring Industry's Small Company M&A Environment

Observation	Commentary
Large Payments Companies are Aggressively Pursuing Small Payments Companies	• ~20% of the companies that First Annapolis surveyed expressed an interest in selling and many had recently received several purchase inquiries • Buying interest is predominately coming from larger organizations that are hungry for innovative solutions and products
High Valuation Expectations	• Smaller payments companies have high valuation expectations • Most organizations believe they have solved for a "special sauce" and that future growth expectations and/or technology warrant a premium valuation
Smaller Companies More Interested in Selling	• The smallest organizations (EBITDA <$1 million) have the greatest interest in selling
More Sophisticated Companies Not Willing to Sole-Source a Transaction	• The more sophisticated organizations that are interested in selling believe the market is filled with willing buyers and enlist the support of advisors to create competitive sales processes
True Differentiation that Provides a Competitive Advantage is Rare	• A majority of companies interested in a sale understandably market themselves as differentiated and expected to be compensated for their uniqueness • However, in many instances, the organizations we encountered were not truly differentiated in a meaningful way (e.g., providing mPOS solutions is no longer a significant differentiator)

Source: First Annapolis Consulting research and analysis as of March, 2014.

Mobile Wallets and Consumer Positioning

By Jeff Crawford

Over the past several years, consumers have had the opportunity to try a number of different so-called, digital and mobile wallets resulting in varying degrees of actual uptake and usage. These wallets offer a range functionality including storing payment credentials, to enabling retail point of sale (POS) transactions, to allowing access to loyalty cards and offers, and supporting mass transit ridership. While there is no common definition of what a wallet is or what it does for a consumer, most providers have come to settle on a few key selling points.

First Annapolis recently examined the value propositions from several leading wallets by observing the customer messaging and documenting the common elements (see Figure 1).

The wallet providers backing these offerings are a disparate lot, ranging from the largest wireless phone network operators (backing Isis) to the leading payment networks (Visa's Checkout and MasterCard's MasterPass). The offerings themselves range from developmental (MCX) to 3rd and 4th generation offerings (Google Wallet, PayPal, and Level Up). Despite this diversity, all providers share a common message around convenience and security, with some convergence around faster checkout and saving money with offers. From here, we examine two questions:

1. How well does the promised consumer value proposition match up with the actual service offering?
2. Does the consumer value proposition align with what consumers want in a digital / mobile wallet?

Looking at the first point, the central value proposition most wallets focus on is convenience, security, and offering coupons/deals. Regarding convenience, wallets generally allow users to store cards in one location for use at the POS or remotely and to store or get access to digital receipts. However, actually using wallets at the physical POS generally requires more steps than using physical cards, and some wallets have a restriction on card types that can stored. For security, wallets make a better case with PIN protection for access to the wallet and remote wallet disablement, but otherwise wallets generally rely on existing card issuer security. Finally, while several wallets allow users to digitally store offer and loyalty account credentials, consumers have limited redemption options (i.e., the service has not reached mass adoption with merchants).

We examined two recent consumer-facing surveys that looked at ranking services and features on mobile devices to examine how well wallets address consumer preferences.[1] The following items ranked highest: stopping fraudulent purchases, digitizing paper items, instantly viewing transactions, and organizing smartphones. These findings indicate that customers do value security and convenience, but account access and organizational elements rank higher than other wallet provider value proposition elements such as offers or P2P payments.

So what should wallet providers do? The payment networks and players like PayPal, not surprisingly, are focused on meeting current consumer expectations, i.e., enabling easier and more convenient payments. Visa has recently rebranded and refocused its offering, shifting from V.Me to Visa Checkout. The new offering focuses exclusively on the remote channel (PC, tablet and mobile), enabling users to store any payment card and expedite payment at participating retailers by entering a username and password. PayPal, arguably the digital wallet with the highest consumer adoption level, has a similar offering and is expanding to bolstering in-app purchasing (e.g., opting to pay with PayPal using Uber). This focus on enabling payments first via the remote channel rather than offering a complete end-to-end solution including POS payments, offers, transit, etc. may resonate better with consumers who are increasingly looking to this channel to make purchases. Delivering a simple and easy remote payment offering advances the digital wallet value proposition, likely expanding consumer adoption. This service will be helpful in laying the groundwork for future utility expansion, including mobile payment at physical POS.

[1] TSYS 2013 Consumer Payment Choice Study, "Survey Question: Please rank your interest in the following services if they were available on the mobile phone that you carry" and Vibe 2013 Mobile Survey, "Survey Question: Which mobile phone feature would benefit you the most?"

For more information please contact Jeff Crawford, Manager, jeff.crawford@firstannapolis.com, member of Deposit Access Practice, specializing in Debit and Prepaid and Mobile/Alternative Payments.

Figure 1: Digital Wallet Consumer Value Proposition

Value Proposition Element	Wallet Adoption	Messaging Examples
Convenience	Google wallet, VISA Checkout, PayPass, isis, PayPal, MCX Merchant Customer Exchange, LevelUp	▪ Google Wallet: "Carry less, save more" ▪ Isis: "Pay with your phone" ▪ Level Up: "Engineered for ease" ▪ PayPal: "Choose how to pay"
Security	Google wallet, VISA Checkout, PayPass, isis, PayPal, MCX Merchant Customer Exchange, LevelUp	▪ Google Wallet: "Stay safe when you shop" ▪ Isis: "Safer than your existing wallet" ▪ Level Up: "Engineered for security"
Faster Checkout	Google wallet, PayPass, VISA Checkout, PayPal	▪ Google Wallet: "Speed through online checkout" ▪ Visa Checkout: "The easier way to pay online, from the company you know and trust."
Save Money with Offers	Google wallet, isis, LevelUp	▪ Isis: "Savings...always with you" $1 back on Serve purchases; $10 referrals ▪ Level Up: "Engineered for rewards"
Enable Easy P2P Payments	Google wallet, PayPal	▪ Google Wallet: "Send Money. Spend Instantly." ▪ PayPal: "Send money to a friend for free"

Source: First Annapolis Consulting research and analysis.

The Changing Retailer Financial Services Landscape in Europe

By Maria Popova and Claire Nooij

The retailer financial services market in Europe has undergone several key changes in the past few years due to the turbulent economic environment. First, nearly all major retailers have outsourced their financial services. Second, forthcoming reductions in interchange will prompt changes in product structures. Third, non-traditional providers are growing as traditional issuers have pulled back from the market.

Trend 1: Outsourcing trend nearly complete

European retailers began outsourcing their credit businesses in the mid-2000's, and today the trend has nearly played out. One of the last major holdouts, Spanish retailer El Corte Ingles, sold 51% of its consumer finance business to Santander in October 2013. The remaining significant exceptions include large U.K. retailers Tesco, Kingfisher, Argos, and quasi-retailer/brand Virgin, and continental European retailers IKEA (Sweden), and Auchan (France). The U.K. has to some extent run counter to the trend: British supermarket chain Sainsbury's bought out its financial services JV partner Lloyds Banking Groups in January 2014, and several retailers in the U.K are expanding into core banking services (e.g., Tesco with current accounts, Virgin with actual branches, and Marks & Spencer with premium and zero fee current accounts via their JV with HSBC).

Trend 2: Product structures are changing

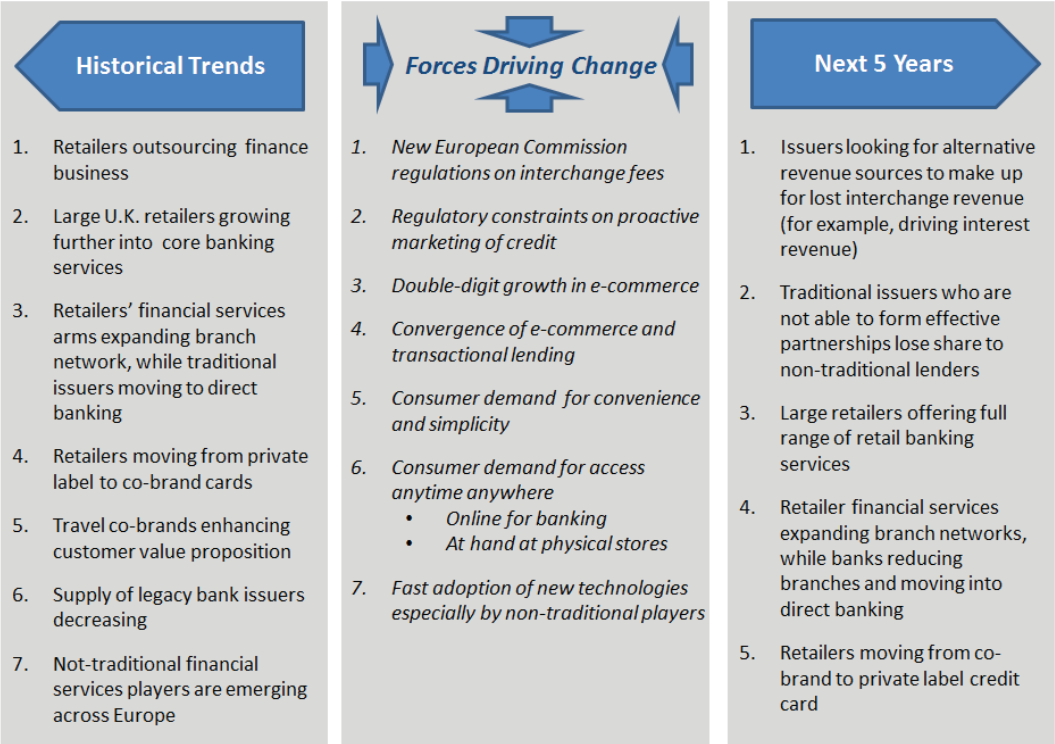
European retailers moved more quickly from private label credit cards to co-brand cards than their U.S. counterparts, starting in the early 2000's (e.g., most large U.K. department stores and Cetelem's Aurore network). However, as has occurred in the U.S., we expect increased interest in private label cards in Europe due to significant declines in interchange rates proposed by the European Commission. For example, in the U.K. credit card interchange will decline from just under 1.0% to 0.3%. Although there were many co-

brand programs in Europe, in some markets, especially in smaller ones, many programs were unsuccessful. With pending interchange reductions further decreasing the co-brand business case, we expect that private label cards will become more attractive for retailers due to their lower operating costs and ability to go deeper in the risk spectrum and increase approval rates.

Additionally, general purpose credit card issuers and acquirers will drive installment functionality at the POS to make up for lost revenue, which will compete with retailer card programs. POS installments are widespread in Turkey and Southern Europe, and are being examined in other markets and by card schemes.

However, our recent examination of retailer cards revealed no major changes to date. Travel co-brand programs have made several changes to further differentiate their products, including Turkish Airlines eliminating annual fees (Turkey is outside of EU interchange regulation), Melia Hotel Group increasing its earn rate, and NH Hotels revamping its entire program and tiering structure.

Figure 1: Retailer Financial Services in Europe: Trends and Outlook



Source: First Annapolis Consulting research and analysis.

Trend 3: The issuer landscape is evolving

The supply of issuers has decreased significantly during the financial crisis (e.g., in the U.K., both GE Money and then its successor Santander exited the market). European banks struggle to meet return hurdles in the consumer credit business. Constrained by stringent regulation that forces lenders to be conservative in their lending practices, makes it challenging to make money on fees, and effectively prohibits proactive marketing of credit. Additionally, there are still no issuers that can provide a truly pan-European solution for multinational retailers, although BNPPF and Santander, have broad geographic footprints. Therefore major retailers are challenged to find partners willing and able to issue on a multinational or even on a domestic basis.

New non-traditional players are filling in these gaps, particularly in the Nordics, Benelux, the Germanic markets, and the U.K. To name a few examples, transactional lender Klarna is rapidly expanding across continental Europe and has recently announced plans to enter the U.K., transactional lender After Pay is active in the Netherlands, Billpay provides invoicing and transactional finance services in Germany, and payday lender Wonga is active in the U.K. Key differentiators for these newer players include ease of use in the e-commerce environment, effectively softer regulatory constraints (as the new lenders do not fall under the same definitions as banks), and more aggressive and sophisticated underwriting and risk management.

Most of these new players are focused on e-commerce, which is growing at 10% - 35% per year (depending on the region) as compared to zero/low growth in the face-to-face channel in Western Europe. Traditional issuers, and to some extent retailers, risk losing out on the significant growth opportunity due to the convergence of e-commerce and transactional lending. However, these e-commerce players face significant operational challenges making the leap to a face-to-face environment, but in the end probably no real need to move to the physical world.

Implications for retailers and issuers

The retailer financial services market is changing significantly, and over the next 5 years it is likely to take a new shape.

Retailers with well-established financial services, especially in the U.K., are likely to offer a broader spectrum of retail financial services, while others will probably focus on partnerships with both traditional and non-traditional lenders to drive core sales. While legacy banks will increasingly move towards banking via direct channels, many large retailers are well placed to capitalize on their geographic footprint and frequency of visit to offer in person sales and service. Although e-commerce is growing rapidly, the physical POS is still likely to stay the key point of contact with customers for such merchant categories as supermarkets and departments stores, giving ample opportunity for them to sell financial services.

Interchange reductions will result in the restricting or closure of many co-brands, and retailers will find it more feasible to turn to private label and/or instant financing services, such as POS installments. Non-traditional lenders will capture significant share via transactional lending in the e-commerce and mobile environments.

While certainly these trends present challenges to existing retailer finance market, they also present a variety of new interesting partnership opportunities for retailers with banks and non-traditional lenders for in-store financial services and new types of lending in the physical, e-commerce and mobile environments.

For more information, please contact Maria Popova Associate, maria.popova@firstannapolis.com, or Claire Nooij, Analyst, claire.nooij@firstannapolis.com. Both specialize in Credit Card Issuing.

Tracking Amazon's Payment-Related Moves

By Grant Saunders

Over the past few years, Amazon has made a series of payment-related investments that have positioned the company to further diversify its payment solutions. Recently, the e-commerce giant has begun to show tangible signs of its developments, both in its traditional online channel as well as in mobile and point-of-sale. Amazon is in a unique position to further expand its payments capabilities. The company has reported to have over 230 million active consumer accounts, compared to PayPal's 143 million, as well as a trove of consumer spending data derived from its online retail business.

Login and Pay with Amazon: In October 2013, Amazon launched 'Login and Pay with Amazon,' a service that enables consumers to pay with their payment credentials stored in their Amazon wallets, streaming the checkout process on third party websites and directly competing with PayPal, among other checkout services.

Subscription Payment Management: Amazon introduced a subscription based or recurring payments service in June 2014. Similar to 'Login and Pay with Amazon,' the service allows businesses to tap into Amazon's vast customer base to help reduce friction in the payments process on third party websites.

Smartphone Launch: In June 2014, Amazon unveiled Fire, a smartphone designed by the company. The phone contains features such as an advanced image recognition technology called Firefly, which can be used to identify, and thereafter purchase, items scanned by the phone.

Amazon Wallet Launch: Amazon quietly released a beta version of its mobile wallet this past July. While the current version of the app, which was released on the Google Play store and comes pre-installed on the Amazon Fire, only supports gift and loyalty cards and not credit or debit cards, according to TechCrunch additional features may be in development, such as a solution for person-to-person payments.

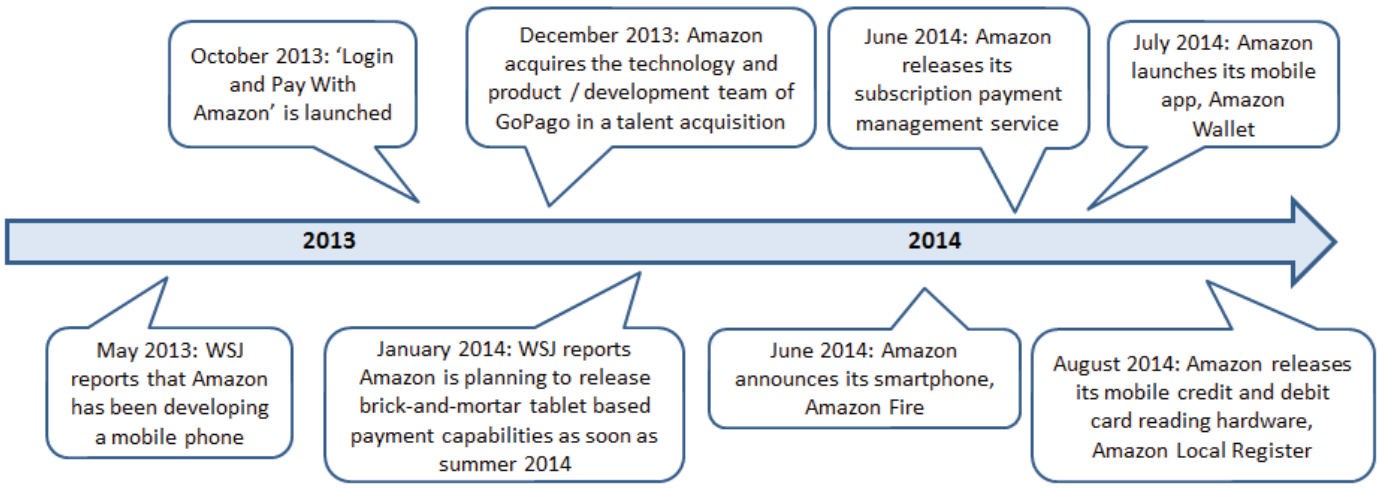
Point of Sale Developments: Corroborating with reports released earlier this year by The Wall Street Journal and with internal Staples documents leaked in July, Amazon recently released a mobile credit card reading device, dubbed Amazon Local Register. Similar to Square and PayPal Here, the device can be connected to mobile and tablet devices to accept debit and credit card payments. Amazon is offering a promotional rate and a subsequent flat rate fee per swiped transaction of 2.50%, lower than both Square's and PayPal Here's fee per swiped transaction of 2.75% and 2.70% respectively.[1] The release of the hardware follows Amazon's acquisition this past December of the cloud based commerce company GoPago, which provided point-of-sale software and hardware that allow consumers to order and complete retail transactions all on their smart phones. It appears that the current version of the hardware cannot accept payments from Amazon's Mobile Wallet, but rather solely accepts swiped credit and debit cards.

The recent developments illustrate Amazon's appetite to leverage its payment capabilities outside of the company's on-line retail channel. While Amazon has been quiet about its payments strategy, given its recent activity it appears that the company is positioning itself to address an evolving set of merchant and consumer needs. Of course, Amazon joins a long list of non-traditional players that have made moves or have ambitions in the payments space given the convergence of retail channels and the reach of entities such as PayPal, Apple, Starbucks, Google, Facebook, Twitter, Square and the like.

[1] Fees shown are the standard publicized rates for swiped debit or credit cards. Manually entered transactions generally demand a higher fee and merchants may negotiate different rates. Amazon's promotional rate of 1.75 percent is offered until October 31st and is valid until January 1st, 2016. Fees for Square, PayPal Here, and Amazon are taken from their respective websites.

For more information, please contact Grant Saunders, Analyst, specializing in Credit Card Issuing, grant.saunders@firstannapolis.com.

Figure 1: Amazon's Payment Developments Timeline



Source: The Wall Street Journal, TechCrunch, Reuters, eBay 10-K, and Amazon Press Releases.

Different Approaches for Renewing Vendor Agreements

By Myron Schwarcz and Ryan Allen

Relationships between issuers and their respective card brands, processors, and other service providers tend to be highly complex. This complexity is in part due to the nature of the services being performed and to the high cost of transitioning providers, which together create lengthy relationships with extensive integrations. As such, the agreements governing the relationship between service providers and issuers are complicated and challenging to negotiate. Many issuers seek to extend agreements reaching maturity at existing terms or default to automatic renewal provisions, rather than going through a rigorous renegotiation process.

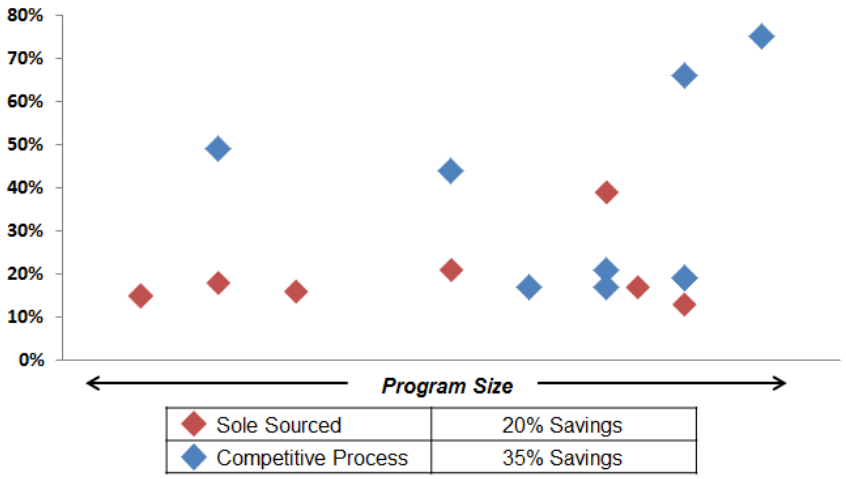
However, there are trade-offs associated with such an approach. In general, the costs for card brand and processing services decline over time, while service provider performance obligations tend to increase. The expiration of vendor contracts provides opportunities for issuers to assess current relationship dynamics and target enhanced value in subsequent terms. However, the process employed (e.g., competitive or sole sourced) can materially affect the issuer's ability to achieve its desired outcome. First Annapolis, through its experience working with many issuers over 20+ years, has identified key factors to consider when determining whether to pursue direct negotiations with a single provider or execute a competitive bid process with multiple providers, including:

- state of the relationship;
- current proximity to desired business terms and pricing levels;
- strategic and risk factors;
- compliance obligations; and
- internal guidelines, timelines, and resource availability/constraints.

Issuers that are reviewing incumbent vendor relationships should evaluate these factors in parallel. To facilitate a comprehensive evaluation, it is essential that all key issues and their respective importance to the overall business strategy be identified early in the process. When evaluating an incumbent provider, issuers should consider the state of the relationship and major pain points. If the relationship has soured due to poor performance, service quality, functionality gaps, and the like, it is likely in the issuer's best interest to evaluate alternative providers. Soliciting competing proposals not only provides issuers the ability to evaluate market features, functionality, and pricing against their current relationships, but it can signal that considerable changes are required for the incumbent provider to maintain the business. If issuers employ this tactic, it is important to manage the incumbent effectively by clearly, and frequently, communicating its objectives throughout the process, regardless of the outcome. Moving forward with a competitive process does not necessarily mean that an issuer will ultimately migrate the business. Our recent experience has found that in 75% of competitive situations, the issuer remains with its incumbent provider.

This competitive dynamic creates the necessary leverage for issuers to optimize value regardless of the appetite for changing providers. Additionally, issuers are better equipped to address functional, financial, and performance issues related to the incumbent provider after understanding what other service providers are willing to offer. Our issuer clients that have sourced vendor relationships through competitive selection processes have generated higher levels of financial savings relative to those that have sole sourced negotiations. The data in Figure 1 highlight the financial aspect of this dynamic. Insofar as myriad factors influence pricing for such services, the competitive process alone does not explain these observations, but the relationship is clear.

Figure 1: Competitive vs. Sole Sourced Process Savings



Source: First Annapolis Consulting research and analysis.

A competitive process is not always the best option in situations where issuers, having evaluated incumbent relationships, have not identified material opportunities for improvement in business terms, pricing, or service performance. The timelines, resource commitment, and costs required to execute a competitive process are considerable. These processes often require months of work, dedication of critical staff to support the evaluation, and the assistance of outside advisors and attorneys. In addition, the process itself may stall negotiations that could have otherwise begun at the same time, thereby delaying potential benefits of a renewal agreement. As such the potential benefits of conducting a competitive process may not always justify the costs. To effectively run a competitive process, an issuer must begin about 18 months in advance of agreement expiration to allow time to evaluate and select a vendor, negotiate an agreement, and potentially perform a conversion. Though, timing flexibility may exist depending on the nature of the rights and obligations of issuer and vendor in the agreement governing the existing relationship.

While achieving optimal contractual and financial results is often paramount, it is also necessary to consider the strategic and risk factors inherent in the decision making process. If an issuer has multiple strategic relationships with a vendor, it may be necessary to consider the implications of maintaining that relationship versus implementing a competitive process and selecting a competitor. There can also be implications in agreements that have financial contingencies based on the enterprise value of relationships that, if broken, could severely impair affiliate business units.

In summary, many factors will determine the process by which card issuers select and negotiate with service providers. It will be important to balance the need for improvement in business and economic terms with the timing, resource requirements, and potential impact to incumbent relationships.

For more information, please contact Myron Schwarcz, Senior Manager, myron.schwarcz@firstannapolis.com; or Ryan Allen, Senior Analyst, ryan.allen@firstannapolis.com. Both are members of the Deposit Access Practice, specializing in Strategic Sourcing.

Payments Industry Stock Price Tracker

By Collin Bauer

First Annapolis monitors monthly and annual movement in stock prices and market capitalization for companies across the payments value chain. Observations for July 2014 are reflected in Figure 1. Last month, the payments sectors that First Annapolis tracks experienced mixed gross results; however, all sectors either equaled or outperformed the overall market's 2% decline in July.

Summary:

The issuing sector matched overall market trends and posted declines of 2% in aggregate in July. Nearly all issuers tracked posted negative results in July except for Citi and WEX, which experienced gains of 2% and 1%, respectively. FleetCor's overall stock performance has surpassed others in the sector since January with its double-digit year-to-date gains of 12%. The issuing sector, as a whole, has posted declines of 3% in 2014 on a YTD basis.

The processor / acquirer sector experienced overall gains of 1% in July, driven largely off positive results from Heartland (+15%), and 2% gains from the two largest players in the sector, FIS and Fiserv. Heartland's stock increase was partially due to its announced acquisition of TouchNet Information Systems, expected to close in Q3 2014. Global Payments, despite YTD gains of 7%, posted declines of 5% in July and trailed the overall market. While individual performance has varied significantly, the processor / acquirer sector as a whole has experienced gains of 2% in 2014.

MasterCard and Visa experienced gains of 2% and 1%, respectively, in July. The network sector as a whole has posted declines of 7% YTD in 2014 and trails the overall market's 4% gain.

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

Figure 1: Monthly Stock Price Tracker

Companies	July 31, 2014	Month Δ	YTD Δ	Market Cap ($Billions)
Issuers				
JPMorgan Chase	$56.48	-1%	-3%	$303.51
Bank of America	$14.98	-3%	-4%	$161.24
Citi	$48.10	2%	-8%	$147.66
American Express	$86.47	-9%	-4%	$91.82
U.S. Bank	$41.33	-5%	2%	$75.78
Capital One	$79.49	-4%	4%	$45.21
Discover	$60.12	-3%	7%	$28.33
FleetCor	$130.87	-1%	12%	$10.87
WEX	$106.44	1%	7%	$4.19
Weighted Average	-	*-2%*	*-3%*	-
Acquirers / Processors				
FIS	$56.10	2%	5%	$16.14
Fiserv	$61.44	2%	4%	$15.69
TSYS	$31.96	2%	-4%	$5.91
Global Payments	$69.27	-5%	7%	$4.71
Vantiv	$32.96	-2%	1%	$4.54
Heartland	$47.51	15%	-5%	$1.68
Weighted Average	-	*1%*	*2%*	-
Networks				
Visa	$211.81	1%	-5%	$133.17
MasterCard	$74.98	2%	-10%	$87.17
Weighted Average	-	*1%*	*-7%*	-
Market Index				
S&P 500	$1,925.15	-2%	4%	-

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

