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Announcements

Scott Frisby Joins First Annapolis

Scott has joined the firm's European office as a Manager, focusing on the Card Issuing and Retailer Services practice areas. Scott brings 13 years of experience in product, marketing, and strategy with Visa Europe.

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A Quick Take on Apple Pay

On September 9, Apple fired the proverbial shot heard around the payments world with its announcement of Apple Pay, a payment service that is integrated into the new iPhones that enables both contactless point-of-sale and in-app payments. The fanfare surrounding the launch of the larger phones was not unfounded as Apple has reported selling more than 10 million iPhone... More

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In a move that is sure to make waves in the corporate travel industry, Concur Technologies, Inc., an expense and travel management software developer, has agreed to sell itself to... More

The Evolution of Online Checking

In the wake of the Durbin Amendment and Regulation E of the Electronic Funds Transfer Act, many banks were pleasantly surprised that the debit interchange cap and regulation of overdraft... More

Untapped Opportunities in European Small Business Cards

Small business cards have long been under-penetrated in Europe, but based on the outcome of pending interchange regulation, issuers could find themselves eager to accelerate issuance of small... More

Q2 2014 U.S. Fleet Card Issuer Performance Snapshot

As the only two fleet card issuers currently publicly owned, FleetCor and WEX financials provide a lens into fleet card performance. As seen in Figure 1, First Annapolis tracks various... More

Exploring Investment and Industry Analyst Reports for Trends in the Merchant Acquiring Space

In a recent effort, First Annapolis examined equity analyst reports and industry commentary articles to understand the thinking about key industry themes in the analyst community. The reports either... More

Q2 2014 U.S. Credit Card Issuer Performance Snapshot

Credit card receivables in the U.S. 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. As a modest sign of... More

First Impressions on Industry Innovation at FinovateFall 2014

First Annapolis attended the FinovateFall conference in New York City in late September. Over 70 companies, startups and enterprises alike, got seven minutes on stage to show off their latest... More

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A Quick Take on Apple Pay

By Jeff Crawford and Matt Zalubowski

On September 9, Apple fired the proverbial shot heard around the payments world with its announcement of Apple Pay, a payment service that is integrated into the new iPhones that enables both contactless point-of-sale and in-app payments. The fanfare surrounding the launch of the larger phones was not unfounded as Apple has reported selling more than 10 million iPhone 6 and iPhone 6 Plus devices, a new launch weekend record.

Apple Pay is set to launch in October and it is integrated into the iOS operating system and managed through Apple's existing Passbook app. Despite differentiating itself by offering added levels of security, through the use of tokenization and biometric authentication, Apple Pay was built to work within the existing payments infrastructure. Furthermore, Apple Pay is not a new payment scheme and transaction level data will remain with issuers and merchants, not Apple.

We continue to believe that payments innovation must benefit all constituents. On the surface Apple Pay appears to deliver on this tenet. Rather than disrupt the market, Apple utilized its market influence to drive an unprecedented level of industry cooperation. Customer adoption will ultimately determine whether Apple Pay is a success, as the digital wallet and payments space has been difficult to penetrate, even with significant investment, time-in-market and broad feature-rich propositions. Apple too has significant challenges ahead, including onboarding more and larger merchants as well as convincing customers that Apple Pay is actually a better way to pay, but Apple is as well positioned to succeed as any other mobile payment initiative in the market today.

For more information, please contact Jeff Crawford, Manager, jeff.crawford@firstannapolis.com, member of Deposit Access Practice, specializing in Debit and Prepaid; or Matt Zalubowski, Manager, matt.zalubowski@firstannapolis.com, specializing in Credit Card Issuing.

Apple Pay / Apple Watch

iPhone 6
6 Plus

iOS 8

Apple Pay: What We Know

Scope and Timing	Apple's Motivation and Value Proposition	Payments Accounts	Completing Transactions	Data and Security
▪ In-Store payments ▪ Streamlined online payments ▪ Available on iPhone 6, 6 Plus, and Apple Watch (early 2015) ▪ US-Only ▪ Available in October	▪ Replace physical wallet: "Your wallet. Without the wallet." ▪ Payments will be faster, more secure, and private ▪ Apple share of U.S. smartphone market >40% ▪ ~5-10% NFC terminal enablement (U.S.)	▪ Add: from iTunes account or take a picture of a card ▪ Store: token stored on secure element (no card # on device) ▪ Use: Passbook app is user interface; general purpose credit and debit cards	▪ In-Store: Contactless NFC-based physical payments with Touch ID authentication ▪ In-App: Integrated via the Apple Pay API with Touch ID authentication	▪ Data stays with merchant and bank (not Apple) ▪ Merchants process tokens, not the card # ▪ Payments service can be remotely disabled

Announced Participants:

Networks		VISA, MasterCard, American Express
Banks / Issuers		American Express, Bank of America, Capital One, CHASE, citi, WELLS FARGO
	Coming Soon	BARCLAYS, NAVY FEDERAL Credit Union, PNC, USAA, usbank
Merchants	In-Store	BABIES R US, bloomingdales, Disney STORE, DUANE reade, macy's, petco, STAPLES, SUBWAY, Toys R US, unleashed!, Walgreens, Walt Disney Parks and Resorts, WHOLE FOODS MARKET
	In-App	GROUPON, Instacart, MLB.com, OpenTable, Panera BREAD, SEPHORA, STARBUCKS, TARGET, TICKETS.COM, UBER

Apple Pay: Many Open Questions

Loyalty and Offers:	Will Apple allow third-party integration? Will these be included in the next release?
Integration:	What is required of merchants ?
Technology:	How is the Apple Watch integrated? Will Apple use other mobile payment technology (e.g., iBeacons)?
Liability:	What party or parties are responsible for fraud?
Other Partners:	Are there other partners involved? Will MCX merchants be involved? What about regional networks? How will debit work for issuers with unaffiliated networks not owned by V/MA?

Initial Perspectives

Apple, not surprisingly, has focused more on the basic customer experience and features of the Apple Pay service, mentioning that they believe this will be the key differentiator in their mobile payment initiative (e.g., they have included an "Apple Pay Human Interface Guidelines" document as part of app developer information).

While there are many important questions to be answered, Apple certainly has ability to drive more attention and adoption for mobile payments. Apple Pay is a very significant event for the payments industry and could be the long awaited launch point for broad mobile payment adoption.

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A Merchant Acquiring Perspective on Apple Pay

By Brooke Ybarra

In general, we do not think Apple Pay, in its current iteration, is that impactful to acquirers. Apple has made a concerted effort to "play nice" and fit within the existing payments ecosystem, which for the most part protects acquirers' current role. The real news, at least for acquirers, is the payment network tokenization standard (see Figure 1) that Apple Pay will use, and of course, we can envision extensions and iterations to the announced version of Apple Pay that could make it more of a competitive threat in the future.

This is the first in a series of articles exploring Apple Pay's impact on payment acceptance. This article provides preliminary observations of Apple Pay's impact on acquirers based on what we know today. Future articles will reassess these observations as Apple Pay is actually launched in the market and explore the potential impact of future Apple Pay iterations and related technologies through a series of 'what if' scenarios.

So, what do we know today, and why does it matter to acquirers?

1. The introduction of Apple Pay shouldn't steal volume from acquirers. Transactions using Apple Pay (both in store and in app) will leverage the merchants' existing acquirer and processor. The only exception to this would be if a merchant chooses to switch acquirers because their acquirer cannot support Apple Pay (either because it cannot support NFC-based transactions or the payment network tokenization standard).

2. Apple appears to be maintaining its aggregator payment model for digital/virtual goods and services, called In-App Purchase. With In-App Purchase, Apple acts as a merchant aggregator, processing transactions through its own payment processor and keeping 30% of the transaction revenue. In-App Purchase is different from using Apple Pay in an app. The former applies to digital/virtual goods and services only, while the latter applies to physical goods. If Apple relaxes its stance on In-App Purchase and allows developers to use Apple Pay for digital/virtual goods and services, acquirers could benefit because transaction volume that currently flows through Apple and its acquirer would be up for grabs.

3. Acquirers may be able to leverage the enthusiasm and interest Apple Pay has generated to cross-sell contactless EMV terminals in their merchant base. For acquirers that do not currently support or offer an NFC terminal, they may see increased merchant demand for such an offering.

4. Apple Pay transactions should be more secure than traditional swiped transactions in the physical environment and more secure than keyed transactions in the app environment. Acquirers may realize benefits from the security features through reduced fraud and chargeback rates.

5. Acquirers don't need to support Apple Pay, so much as they need to support the payment network tokenization standard. From an acquirer's perspective, Apple Pay itself is not much different from other digital wallets, but its use of the payment network tokenization standard implies some technical hurdles. Payment network tokens are supposed to look and feel like personal account numbers (PAN), even leveraging the same BIN identifiers to enable routing using existing operations. Even so, acquirers will probably need to do some development work in order to support the tokens, for example, ensuring they can send and receive new, additional data fields. Acquirers also need to be able to support NFC transactions.

6. Apple is not charging acquirers a fee related to Apple Pay transactions, however, MasterCard is charging a 'digital enablement' fee for its token service. The fee will take effect on January 5th and is 1 bps of cardholder not present volume. It is unclear if this fee will apply to in store Apple Pay transactions, where a payment network token is used but the cardholder is present (and card present interchange rates apply). So far, Visa and American Express have not announced tokenization fees for acquirers, but they may follow suit. MasterCard and Visa are charging tokenization-related fees to issuers, including a monthly management fee and a token provisioning fee.

7. Finally, payment network tokenization is a substitute for acquirer-level tokenization in mobile transactions. Many acquirers offer tokenization services to merchants, and the use of payment network tokens renders the acquirers' service duplicative and difficult to use in the Apple Pay environment. Acquirer-level tokens should still have applicability in the physical and e-commerce worlds, though, and perhaps there is a new revenue opportunity for acquirers to identify and match payment network tokens with acquirer-level tokens, providing merchants with a more complete view of their customers' spending habits.

For more information, please contact Brooke Ybarra, Manager, specializing in Merchant Acquiring, brooke.ybarra@firstannapolis.com.

Figure 1: Payment Network Tokenization

Apple Pay will employ a payment network tokenization standard that prevents the full personal account number (PAN) from being stored on the phone or shared with the merchant.

EMVCo is responsible for the tokenization standard, which was developed and is being implemented by Visa, MasterCard, and American Express.

Because Apple Pay will be one of the first implementations of the card networks' token services, it is difficult to separate the impact of Apple Pay from the token standard. That said, it is important to understand that payment network tokens will have applications beyond Apple Pay.

In transactions that use a payment network token, the acquirer will receive the token from the merchant and route it to the appropriate payment network. The token will look and act like the PAN it represents, enabling the acquirer to correctly route the token without knowing the actual PAN. The payment network will decrypt the token and pass it and the PAN to the issuer for authorization. When the authorization message is passed back to the merchant, the payment network may return the token and PAN to the acquirer, at the acquirer's option, to facilitate the acquirer's back office activities. Even if the acquirer receives the token and the PAN, it will only pass the token and the authorization message back to the merchant.

Source: First Annapolis Consulting research and analysis.

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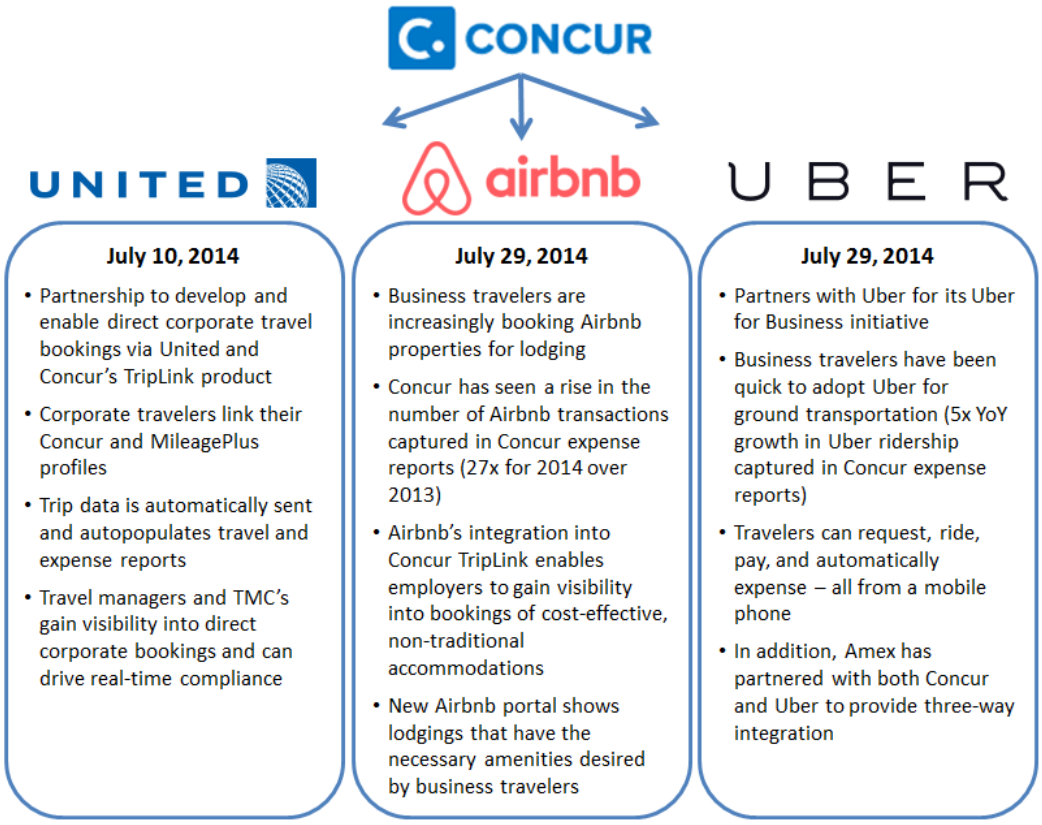
SAP Acquires Travel Management Software Leader Concur

By Alex Kays

In a move that is sure to make waves in the corporate travel industry, Concur Technologies, Inc., an expense and travel management software developer, has agreed to sell itself to SAP AG for $129 a share, or about $7.36 billion (enterprise value of $8.3 billion). At a premium of 19.7%, the transaction extends SAP's streak of recent cloud-based software-as-a-service acquisitions and puts the world's largest enterprise software company squarely at the forefront of consolidating a globalized business solutions network.

Concur, which helps organizations manage their T&E programs with detailed business travel and expense software, is not currently profitable on an annual basis, but is expected to report sales that have doubled to nearly $700 million since fiscal 2011. It also enjoys various travel and technology partnerships with companies such as American Express and, more recently, United, Airbnb, and Uber (see Figure 1). Concur currently has 23,000 clients and 25 million users in 150 countries, according to Business Insider, with clients ranging from mid-size to Fortune 500 companies, as well as universities and the government.

Figure 1: Recent Travel-Related Partnerships by Concur



Source: First Annapolis Consulting web research as of September 2014.

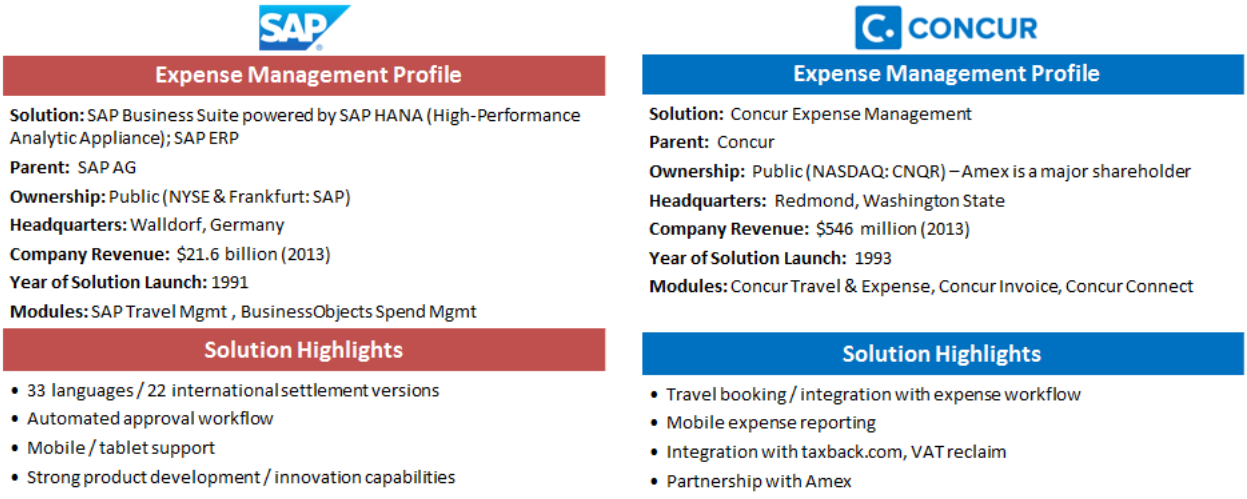
SAP seeks to immediately augment its SaaS and cloud computing offerings with the move. Estimates say the combined company will have 50 million users in the cloud following the deal. To further illustrate the opportunity for scale, the majority of SAP customers do not use Concur, and only around 30 percent of Concur customers use SAP. With other recent travel-related acquisitions including Ariba in 2012 and Fieldglass earlier this year, SAP is seeking to fill any perceived gaps among its expense management lines of business while cementing its intention to consolidate the cloud (see Figure 2).

News of the potential sale was first reported on September 2. Concur had also reportedly approached Oracle Corp. and Microsoft Corp. early on when exploring opportunities.

Source: Bloomberg, Forbes, Business Insider, Concur website.

For more information concerning the transaction and implications for business travel payments and services, please contact Alex Kays, Senior Analyst, specializing in Commercial Payments, alex.kays@firstannapolis.com.

Figure 2: Current Expense Management Capabilities



Source: First Annapolis Consulting web research and market observations.

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The Evolution of Online Checking

By Mike Kovalchick and Frank Verhaegen

In the wake of the Durbin Amendment and Regulation E of the Electronic Funds Transfer Act, many banks were pleasantly surprised that the debit interchange cap and regulation of overdraft fees did not entirely eliminate profitability from debit and checking products. In continued efforts to maximize the profitability of these offerings, banks confirmed that customer behaviors enabled through online and mobile banking provide greater returns, and are actively pursuing the segment. "Self-service" customers – customers who solely use online and mobile banking and forgo more traditional and expensive customer service channels such as branch tellers and call centers – are identified as particularly profitable customers relative to their counterparts. To encourage customers to adopt self-service behaviors, some banks have created or augmented "self-service checking account" offerings that steer users to online and mobile and either do not provide or charge a fee for usage of more expensive customer service channels. Unlike legacy "free checking" accounts with limited features, the self-service checking accounts are truly fee-free and offer enhanced benefits.

To further encourage adoption of the products, many self-service checking accounts offer some form of interest on deposits or even a transactional rewards program. The goal of these programs is to augment customer loyalty to the brand and product, thereby increasing transactional usage of the product, which in turn results

Figure 1: Illustrative 'Self-Serve' vs. 'Traditional' Checking Account Offerings

	Illustrative 'Self-Serve' Checking Account	Illustrative 'Traditional' Checking Account
Fees		
Monthly Fee	Free	$5 - $10
Out-of-Network ATM Fees	Free	$2 - $3
Overdraft Fee	N/A	$35
Features		
Interest Rate	0.50% - 1.05%	N/A
Bill Pay	✓	✓ (fee may apply)
Deposit at ATM	✓ (on a limited basis)	✓
Remote Deposit Capture (RDC)	✓	✓
Financial Management Tools	✓ (on a limited basis)	✓
P2P	✓	✓
Illustrative Annual Customer DDA Cost		
Monthly Fees	$ -	($90)
Out-of-Network ATM Fees	$ -	($60)
Overdraft Fees	$ -	($55)
Interest Benefit	$30[1]	$ -
TOTAL	**+$30**	**($205)**

[1] Assumes national consumer average checking balance of $3,800.

Source: Bank websites, First Annapolis Consulting analysis.

Figure 2: Illustrative 'Self-Serve' Checking Account Features

	Feature	ally	Ally Connect	Bluebird	Bank of Internet USA	Capital One 360	Discover[1]	EverBank	GO bank	Virtual Wallet	fb direct
Capabilities	Bill Pay	✓	✓	✓	✓		✓	✓	✓	✓	✓
	Deposit at ATM					✓				✓	
	Remote Deposit Capture	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
	Financial Mgmt. Tools				✓				✓	✓	
	P2P	✓		✓[2]	✓	✓			✓	✓	✓
Fee-Free	ATM Fees Waived/ ATM Fee Rebates	✓	✓	✓	✓	✓	✓	✓	✓	✓	✓
	No Overdraft Fees			✓	✓	✓			✓		
Incentives	Interest Rate % (Varies; 0.50% to 1.05%)	✓	✓		✓	✓		✓		✓[3]	
	Rewards for Transactional Activity		✓		✓		✓			✓	✓
	Sign-On Bonus					✓		✓		✓	✓
Other	Automatic Overdraft Coverage					✓[4]					
	Enhanced Benefits[5]			✓							

[1] Discover Cashback Checking is expected to be available to the general public regardless of a Discover credit card relationship during 2014.

[2] Amex Bluebird users can utilize P2P payments to other Amex Bluebird users but not external accounts.

[3] PNC Virtual Wallet is created with a linked savings account that earns interest.

[4] Capital One 360's Automatic Overdraft Coverage serves essentially as a line of credit for all checking account customers.

[5] "Enhanced Benefits" refers to concierge service, purchase protection, ID theft assistance, roadside assistance, and other ancillary member benefits.

Source: Bank websites, First Annapolis Consulting analysis.

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in incremental profitability for the bank. Rewards vary widely by product: the Discover Cashback checking account, currently offered only to Discover credit cardholders,[1] generates 10¢ per debit, ATM, or bill pay transaction; the UFB Direct Airlines Rewards account earns points based on debit spend redeemable for airline miles; the Capital One 360 checking account offers a signup bonus of $50 with three debit card purchases within 45 days of account opening; the PNC Virtual Wallet account increases the interest rate on the linked savings account with more than six debit purchases monthly; in addition, numerous self-service checking accounts offer a modicum of interest on the core checking account as their primary incentive. All of these promotions help sway customers towards procuring a self-service checking account; however these incentive structures bifurcate self-service checking account customers into two strategic value plays for banks. The first encourages debit and other transactional activity, capitalizing primarily on interchange revenue. The second stimulates balance growth, generating attractive net interest margin given their lower-cost delivery. Regardless of strategy, the low-cost associated with self-service checking accounts ensures that profit margins are maximized.

The shortcoming of self-service checking accounts, as the name may suggest, is a potential lack of customer service associated with the offering. In fact, many of the banks associated with self-service accounts have little or no physical branch presence. The accounts are marketed towards users that are less reliant on traditional customer service channels in the first place; such targeting helps ensure that account costs are low, enabling banks to offer more compelling value propositions on the account.

The increasing prevalence of self-service checking accounts is a definitive win for all stakeholders involved. Through the product's growth, self-service account issuers are either increasing per account profitability by converting existing customers to online accounts or winning market share from shrinking (both in physical size as well as number) brick and mortar banks. From the customer's perspective, the enticing features, benefits, and overall value accompanying self-service checking accounts are attractive enough to lure many consumers to migrate their balances. Banks offering traditional checking accounts will likely need to re-evaluate their product strategy to compete against these new account offerings.

[1] Discover Cashback Checking is expected to be available to the general public regardless of a Discover credit card relationship during 2014.

For more information, please contact Mike Kovalchick, Director of Implementation Services, mike.kovalchick@firstannapolis.com; or Frank Verhaegen, Associate, frank.verhaegen @firstannapolis.com. Both are members of the Deposit Access Practice, specializing in Debit and Prepaid.

Untapped Opportunities in European Small Business Cards

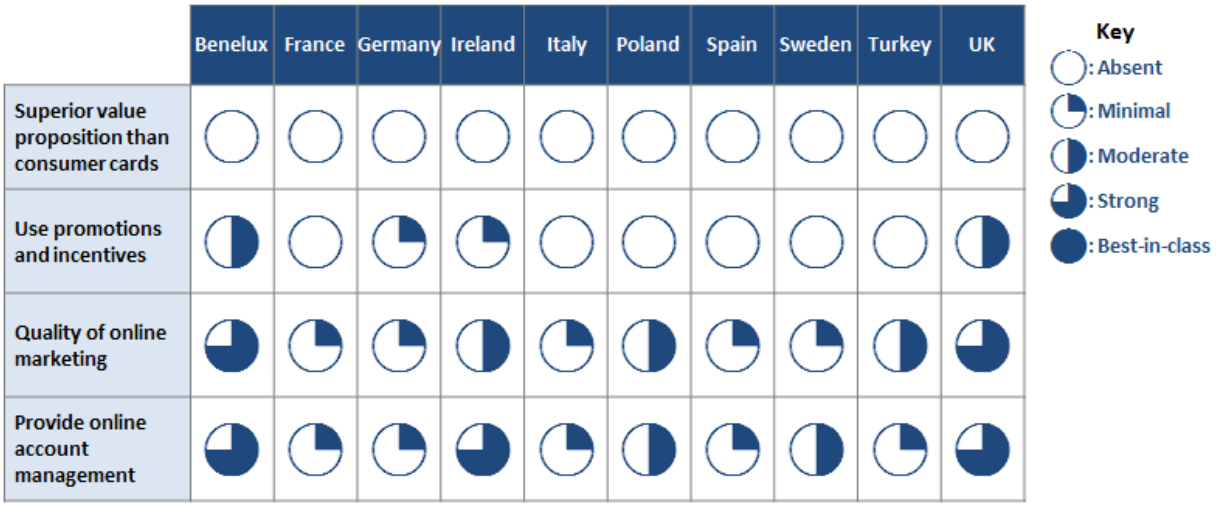
By Allan Reynolds

Small business cards have long been under-penetrated in Europe, but based on the outcome of pending interchange regulation, issuers could find themselves eager to accelerate issuance of small business cards in pursuit of a €1.5 billion revenue opportunity (see Figure 2 for opportunity sizing). European interchange regulation could drastically shift the rationale for issuing small business cards if commercial cards (which are inclusive of small business, corporate T&E, and purchasing cards) ultimately are excluded from the regulated interchange caps applied to consumer cards. Corporate T&E cards are fairly well established in Europe but credit card issuers have largely decided to forgo small business card issuance. Based on our research, most European issuers simply market consumer cards to small business owners and do not market specialized small business products. Regardless of the outcome on interchange regulation, small business lending remains generally under-penetrated, particularly in the aftermath of the financial crisis (a recent ECB survey found that among the 25% of SMEs that applied for a bank loan, 11% were rejected and 10% received less credit than requested). Small business cards could become an effective interchange hedge as well as a means to penetrate the small business lending opportunity.

First Annapolis recently evaluated the business card offerings of issuers across major European markets and our findings confirmed that the small business card opportunity is vastly under-penetrated. Based on 43 issuers across markets, First Annapolis found that:

1. Few issuers market small business cards via online channels

Figure 1: Online Promotion of Small Business Cards by European Issuers



Source: Analysis of business credit card products of 43 issuers selected from top 3-5 issuers in each market performed by First Annapolis Consulting.

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2. Even when there is a product, promotion and new account incentives are virtually non-existent
3. Small business cards do not have superior value propositions in comparison with equivalent consumer cards (despite having higher interchange)
4. Most issuers lack a sufficient online management tool, which is an important requirement for small business owners

Small businesses in Europe overwhelmingly use consumer cards. Our estimates suggest that 5-10% of all active consumer credit cards in Europe are held by small business owners/proprietors which could be better suited using a small business card. Put differently, in the U.S. where small business cards are more prevalent, best-in-class small business card issuers can achieve a product penetration of 30% of the bank's total small business base; in Europe, most banks are below 10%.

The interchange upside from converting small businesses from consumer cards to commercial cards is huge. We estimate the total revenue upside for issuers in Europe to be €1.5 billion annually. This is based on 1.0% interchange upside on incremental spend of €150 billion. The accessibility of this €1.5 billion opportunity is in the hands of regulators, with mixed messages arising from political circles on the inclusion of commercial cards in the regulated interchange rate cap. The most recent version of the bill (adopted by the European Parliament on 3 April 2014) included commercial cards under the cap, but market chatter suggests that there is still a chance that commercial cards will ultimately be excluded.

In the case that commercial cards are excluded from the cap, issuers would be well-served to invest in the development of a small business credit card product and to actively market this product, both into their own consumer card base and broadly into the marketplace. Issuers must of course deal with the challenges that accompany small business card issuance (many of which have contributed to the current state of under-penetration).

Being quick and nimble to underwrite and issue business cards in an increasingly internet-based and real-time distribution environment remains the key challenge. Best-in-class issuers have developed streamlined approaches which lean heavily on consumer practices while also controlling for the extra risks and requirements that accompany a business account. Best-practice marketing and underwriting tactics include:

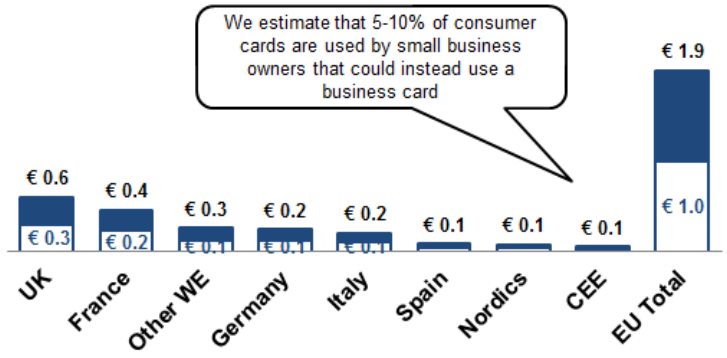
- Create an easy, short-form application
- Utilize pre-approval for bank customers and instant decisioning for new applicants
- Provide digital documents and signatures
- Underwrite the business principals and use personal guarantees
- Include inactive cards in all business package offers
- Upsell a superior value-proposition on business cards

For those banks challenged to invest and to build small business issuing capabilities, there is the option to use an agent bank partnership with a scaled and experienced small business card issuer. Such agent bank arrangements are common for corporate T&E cards. Under an agent bank model, the agent bank is responsible solely for card marketing, while the issuing partner handles the remaining processes, which include underwriting, issuance, pricing, customer support, and customer billing. Particularly as a means to enter the market quickly and to learn the product before self-issuing, the agent bank model can be a good fit for banks lacking the operational expertise in-house.

Small business cards are a significantly underpenetrated opportunity for issuers in Europe, and are prime candidates for investment and focus given potential €1.5 billion revenue opportunity if commercial cards are excluded from the EU interchange regulation. Alternatively, if commercial cards are included in the regulation, the opportunity is less clear given the challenges of operating a small business card product and the fact that interest revenue alone struggles to support the product's business case.

For more information, please contact Allan Reynolds, Associate, allan.reynolds@firstannapolis.com, specializing in Credit Card Issuing in Europe.

Figure 2: Estimated Business Credit Card Interchange Revenue Conversion Opportunity in Europe[1] (In € Billion)



[1] The analysis assumes that 5% (white above) to 10% (blue above) of issuer's consumer card volumes migrate to commercial cards.

Source: First Annapolis Consulting analysis and estimates.

Figure 3: Small Business Card Challenges

Challenge	Solution
• More rigorous KYC and AML checks	• Vet prospects before soliciting to avoid high decline rate
• Higher limits create greater credit risk	• Develop best-in-class risk scorecards / analytics • Tighten criteria for auto approvals; route most applications to manual decisioning process
• Higher burden of servicing and higher processing costs	• Consider outsourcing customer support to a third-party provider • Keep the product simple • Negotiate aggressively with processing vendor
• More product portfolio complexity; one more product for the branch to manage	• Rationalize the consumer products; focus on a healthy mix of consumer and business card products

Source: First Annapolis Consulting observations.

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Q2 2014 U.S. Fleet Card Issuer Performance Snapshot

By Brian Rutland

As the only two fleet card issuers currently publicly owned, FleetCor and WEX financials provide a lens into fleet card performance. As seen in Figure 1, First Annapolis tracks various metrics to analyze the performance of their fleet card programs.

FleetCor: FleetCor's North American business experienced solid growth in Q2 2014, primarily driven by organic growth due to increases in both purchase volume and revenue per transaction. FleetCor's 2013 acquisition of NexTraq, a GPS fleet management solution provider, also contributed to its growth as NexTraq provides higher per revenue transaction products. The impact of all of FleetCor's 2013 acquisitions contributed approximately $9 million in additional revenue in the three months ended June 30, 2014 over the comparable 2013 period. While some of FleetCor's operating expenses increased (e.g., merchant commissions, processing costs), they were offset by revenues increasing at a faster rate.

In August, 2014, FleetCor signed a definitive agreement to acquire Comdata Inc. from Ceridian LLC for $3.45 billion. The deal is expected to be completed in Q4 2014 and will expand FleetCor's North American fuel card business into the Over-the-Road fleet market and the virtual payments space.

WEX: WEX's fleet payment solutions business line grew 11.3% from Q2 2013. Growth was driven primarily through organic growth in the domestic fleet business, an increase in WEX Telematics Unit Service revenue, and higher minimum late fees charged to customers. WEX operating expenses increased 14% from Q2 2013, primarily driven by a $3.5 million increase in service fees. This increase was a result of acquisition related expenses incurred during the second quarter of 2014, expenses associated with the startup of WEX's European commercial fuel card program, and fees related to the increase in the number of WEX Telematics units being serviced. Even with the increase in expenses, WEX operating income increased as revenue grew at a higher rate.

For more information, please contact Brian Rutland, Senior Analyst, specializing in Commercial Payments, brian.rutland@firstannapolis.com.

Fleet Card Issuer Performance Q2 2014

	Fleet Revenue			Fleet Operating Income			Transactions			Charge-Offs (% of Receivables)[3]			Operating Margin			Performance per Transaction					
																Revenue			Operating Income		
Issuer	($ mil) 2Q14	Δ (v. 2Q13)	Δ (v. 1Q14)	($ mil) 2Q14	Δ (v. 2Q13)	Δ (v. 1Q14)	(mil) 2Q14	Δ (v. 2Q13)	Δ (v. 1Q14)	2Q14	Δ (v. 2Q13)	Δ (v. 1Q14)	2Q14	Δ (v. 2Q13)	Δ (v. 1Q14)	2Q14	Δ (v. 2Q13)	Δ (v. 1Q14)	2Q14	Δ (v. 2Q13)	Δ (v. 1Q14)
FleetCor[1]	$138.9	16.2%	9.9%	$68.3	13.7%	21.6%	42.7	3.6%	5.7%	2.0%	30.2%	-10.6%	49.2%	-2.2%	10.6%	$3.25	12.1%	4.0%	$1.60	9.7%	15.0%
WEX[2]	$145.8	11.3%	7.7%	$57.1	6.9%	22.4%	98.6	5.6%	6.5%	1.7%	17.7%	4.2%	39.2%	-3.9%	13.6%	$1.48	5.4%	1.1%	$0.58	1.3%	14.9%
Sum/Wtd Avg	$284.7	↑ 13.6%	↑ 8.7%	$125.5	↑ 10.5%	↑ 21.9%	141.3	↑ 5.0%	↑ 6.2%	1.9%	↑ 24.2%	↓ -4.4%	44.2%	↓ -3.0%	↑ 11.9%	$2.37	↑ 9.9%	↑ 3.1%	$1.09	↑ 7.3%	↑ 15.0%

[1] FleetCor revenues are for the North America segment only.
[2] WEX revenues are for the Fleet Payment Solutions segment only.
[3] Charge-Off values are annualized, and represent the entire business. FleetCor charge-offs include international business. FleetCor charge-off calculation is Write-Offs / the sum of Gross Domestic AR, Gross Domestic Securitized AR, and Gross Foreign AR. WEX charge-off calculation is Charge-Offs / AR.

Note: some growth rates may slightly differ from rates seen in the public filings due to rounding.

Source: FleetCor and WEX public filings.

Exploring Investment and Industry Analyst Reports for Trends in the Merchant Acquiring Space

By Nick Kaw

In a recent effort, First Annapolis examined equity analyst reports and industry commentary articles to understand the thinking about key industry themes in the analyst community. The reports either analyzed specific acquirers or evaluated the merchant acquiring space or larger payments industry in general. Drawing from a base of over 30 discrete reports from Credit Suisse, JPMorgan, and other analysts dating from late 2013 through mid-2014, we reached several key conclusions regarding the broader market's opinions on the industry.

First, we examined the analysts' takeaway opinions on acquirers and categorized these conclusions on a spectrum weighing the comparative focus on growth and margin. As shown in Figure 1, analysts were focused on growth and tended to make their recommendations based on the strengths or weaknesses of an acquirer's growth, as opposed to the merits of its margins.

Analysts are almost unanimously bullish on the independent software vendor ("ISV") and value-added reseller ("VAR") sales channels. Many combine that view with an explicitly bearish stance on the more traditional, feet-on-the-street distribution strategies employed by conventional ISOs. JPMorgan analysts cited the integrated payments solutions space as "one of the faster growing channels in payments and [being] generally characterized by stickier, less price sensitive merchants," a finding with which analysts at Credit Suisse agreed.

Interestingly, analysts are linking the topic of EMV to this integrated payments strategy with the hypothesis that the EMV migration will benefit acquirers that partner with software developers. Credit Suisse analysts predict that "EMV will drive a gradual multi-year POS upgrade cycle that will cause merchants to re-evaluate their current terminal and processor relationships. We believe merchants, especially in the SMB space, will migrate to 'smart terminals' that seamlessly integrate payment solutions with various software applications in order to run different aspects of their businesses. This shift will drive merchants toward iPOS [integrated point-of-sale] solutions, and away from 'dumb' terminals that only facilitate payments." In light of such trends, Credit Suisse prefers "acquirers such as [Vantiv] that are more aggressively moving into the SMB space." Similarly, JPMorgan believes that "SMB adoption of iPOS will trend towards that of large merchants (1000+ store chains), where

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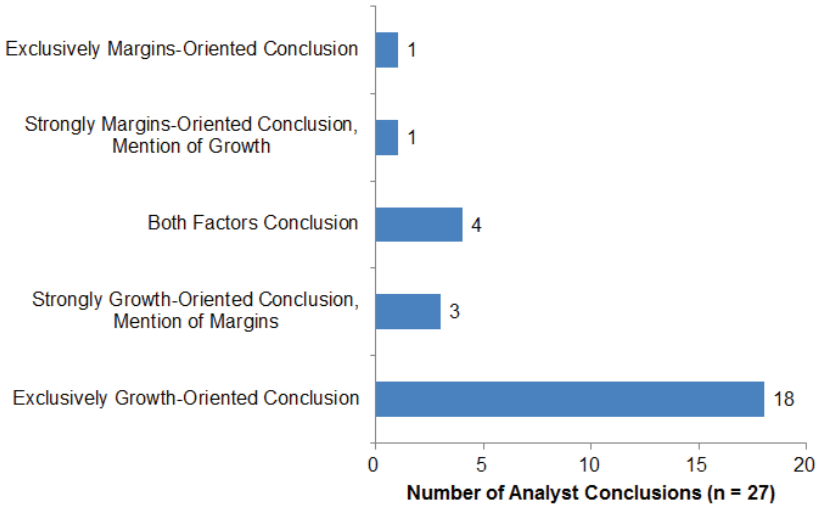
iPOS represents over 90% of installed POS devices, a trend that favors Mercury and other integrated payment processors."

Analysts also noted other themes in their reports on a lesser basis, such as the "increasing demand for more omni-channel solutions" (Credit Suisse) and concerns over regulation. However, the reports did not indicate any substantial concern about any specific upcoming regulation. Instead, the analysts mostly issued warnings about regulation being an investment risk in the abstract.

For more information, please contact Nick Kaw, Senior Analyst, nick.kaw@firstannapolis.com, specializing in Merchant Acquiring.

Figure 1: Analyst Conclusions – Growth vs. Margin



Note: Not all reports included an opinion on an acquirer, while other reports included opinions for multiple.

Source: First Annapolis Consulting analysis of reports from Credit Suisse, JPMorgan, and Digital Transactions.

Q2 2014 U.S. Credit Card Issuer Performance Snapshot

By James Watts

Credit card receivables in the U.S. 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. As a modest sign of progress, 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%. The punch on U.S industry performance is that loss rates remain benign, purchase volume is healthy, and profitability is strong. There is cautious optimism in the first sign of receivables growth in quite some time.

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

	Receivables			Purchase Volume			Net Loss Rate			After-Tax ROA		
Issuer	($B) 2Q14	Change (vs. 2Q13)	Change (vs. 1Q14)	($B) 2Q14	Change (vs. 2Q13)	Change (vs. 1Q14)	2Q14	Change (vs. 2Q13)	Change (vs. 1Q14)	2Q14	Change (vs. 2Q13)	Change (vs. 1Q14)
Chase[1]	$126.1	1.5%	3.5%	$118.0	12.2%	12.9%	2.88%	-43 bps	-5 bps	2.29%	-127 bps	-80 bps
Citigroup[2]	$110.4	4.8%	1.2%	$64.3	6.8%	14.2%	3.81%	-59 bps	-4 bps	3.63%	46 bps	2 bps
Bank of America[3]	$89.0	-1.7%	1.5%	$53.6	3.2%	9.7%	3.11%	-99 bps	-14 bps	3.04%	46 bps	7 bps
Capital One[4]	$71.2	1.0%	4.2%	$52.7	11.4%	19.3%	3.52%	-76 bps	-49 bps	3.50%	-15 bps	9 bps
American Express[5]	$57.7	5.7%	3.4%	$136.5	8.7%	9.8%	1.60%	-40 bps	-10 bps	3.94%	-5 bps	-62 bps
Discover[6]	$52.7	5.9%	3.7%	$29.3	6.4%	14.2%	2.33%	-1 bps	1 bps	3.65%	-31 bps	-7 bps
Wells Fargo[7]	$27.2	9.6%	4.4%	$15.4	21.0%	15.9%	3.20%	-70 bps	-37 bps			
U.S. Bank[8]	$17.6	6.0%	3.0%	$29.6	9.0%	9.9%	3.92%	-31 bps	-4 bps	4.62%	-2 bps	69 bps
Sum/Wtd Avg[9]	$552.0	↑ 2.9%	↑ 2.8%	$499.3	↑ 9.1%	↑ 12.5%	3.00%	↓ -59 bps	↓ -14 bps	3.29%	↓ -11 bps	↓ -19 bps

[1] Includes income from acquiring business and private label receivables and volume.
[2] Earnings restated in 1Q 2014, 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 include "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.
[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. 1Q 12 figure an estimate based on an average turn of 2.0x.
[8] After Tax ROA reflects Payment Services line of business income and average loans. Earnings restated in 1Q 2014, historical figures adjusted to conform to new reporting methodology.
[9] After Tax ROA excludes Wells Fargo. Credit specific income not reported. Reflects any previous quarter restatements and includes addition of U.S. Bank.

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First Impressions on Industry Innovation at FinovateFall 2014

By Ben Brown

First Annapolis attended the FinovateFall conference in New York City in late September. Over 70 companies, startups and enterprises alike, got seven minutes each to show off their latest and greatest innovation on stage to over 1,500 attendees. There is dramatic innovation appearing in payments and the broader fintech space and Finovate is a great place to see it come to life.

Among the 71 presentations, several themes were clear to us:

1. **Personal financial management**: while PFM services like Yodlee and Mint.com have been around for almost a decade, a wave of companies like MX and Geezeo are focused on making it easy for banks to build PFM into their digital customer proposition. At the same time, new entrants like Moven are designing their core proposition around good UI and powerful PFM.
2. **Identity authentication**: the arrival of chip-and-PIN, Touch ID, and endless data security incidents seem to have have triggered intense interest in advanced authentication, especially related to biometrics and contextual awareness.
3. **Open integration**: a number of companies demonstrated solutions to enable partnership-centric finance, from Yodlee's APInnovation API suite to BCSG's white-label market for small business apps to Backbase Marketplace, which lets FIs enable a range of widgets from third-party vendors in their digital interface.
4. **Lending**: a handful of alternative lenders and lending technology providers presented at Finovate. The alternative lending models ran the gamut from personal loans by Kabbage to online retail finance by PayItSimple to invoice factoring by BlueVine and trade financing by Behalf. A range of alternative scoring and underwriting solutions also appeared to help existing lenders innovate.

There is a lot of innovation and interest in these areas. Some innovations have disruptive potential, but many solutions at Finovate were designed to help legacy payments and financial companies offer new functionality and better user experience to their customers.

Seven companies were voted Best of Show by the Finovate audience. None are pure payments players, but as Best of Show each deserves a brief mention here:

AnchorID	**AnchorID** is a new federated identity solution that lets users login to websites and apps using one universal username (and no password). Users can enable whatever level of security they desire from mobile device fingerprinting to PIN codes to biometrics or a combination of factors.
blooom	**blooom** provides simplified 401k advice designed for the average consumer. People can sign up in five minutes, see the quality of their retirement savings boiled down to a single metric, and allow blooom to automatically manage their 401k without having to move their accounts.
CrowdFlower	**CrowdFlower** provides a data enrichment platform to help data scientists, analysts, and engineers collect, clean, and label data to make it useful. CrowdFlower distributes microtasks to millions of people online to bring the human factor to data analysis.
LOYAL3 Investing For All	**Loyal3** makes IPOs accessible to the general public and reduces the cost of direct stock investment. Participating companies work with Loyal3 to subsidize investment costs and make it easier for their customers to own their stock to build deep customer-owner relationships.
MX	**MX** (formerly MoneyDesktop) offers banking technology to power omni-channel customer interfaces and back-end data handling. MX introduced a couple new products, including its new digital banking solution Helios, which runs a single native code base cross-platform.
NICE	**NICE Systems** demonstrated its Real-Time Authentication solution, which uses voice biometrics to securely authenticate customers in real time with no customer effort.
toopher	**Toopher** enables strong, fast, invisible two-factor authentication using the location awareness of your mobile device to automate authentication for logins and other critical actions.

For more information, please contact Ben Brown, Senior Consultant, specializing in Credit Card Issuing and Payments Innovation, ben.brown@firstannapolis.com.

Founded in 1991, First Annapolis is a specialized advisory firm focused on electronic payments. Our market coverage is international in scope with a primary focus on North America, Latin America, and Europe. First Annapolis is headquartered in the Baltimore / Washington, D.C. corridor and Europe is served through our office in Amsterdam. In total, we have over 70 professionals across our practice areas giving us one of the largest and strongest advisory teams focused exclusively on electronic payments.

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