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Financial Services

CAN RETAILERS WIN THE MOBILE PAYMENTS WAR?

WHY CARD ISSUERS SHOULD CARE

PART 1

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This is the first part of a two-part white paper speculating on where mobile POS payments are headed. This part addresses whether open wallets or retailer-specific apps will win over the consumer. Part two will address how retailer-centric mobile payments might impact card issuers.

Prior to October of 2012, there was a frenzy of speculation on how quickly the NFC mobile payments model would displace magstripe cards. NFC would provide a level playing field, allowing all retailers to accept all solutions, and those solutions would most-likely take the form of a mobile wallet that held all a consumer's payment card data – allowing the consumer to leave their physical wallet at home.

Then Apple did the unexpected: the iPhone 5 didn't have NFC. In fact, a senior Apple executive said at the time: "It's not clear that NFC is the solution to any current problem. Since 40-50% of smartphone users opt for Apple, this reduced the market for NFC-based mobile wallets overnight.[1] In frustration, Google is even considering a mag-stripe card to access Google Wallet.

With a time-out from the hype, we can speculate on the pace and form mobile POS payments might actually take and what it all means for banks. Our hypothesis is that mobile POS payments are more likely to end up retailer-centric rather than wallet-centric. It is based on observations on two key retailers: Starbucks and Wal-Mart.

[1] Of course the same speculation is now building about the iPhone 6 release set for late 2013

WHY DOES STARBUCKS WORK?

The Starbucks program has gone from strength to strength, accounting for 10%+ of its POS payments and growing fast. It has spawned imitators at arch-rival Dunkin' Donuts as well as yogurt chains and elsewhere. One recent analysis said the Starbucks program accounts for the vast majority of current mobile POS payments. So why has the Starbucks' model taken off while more "open" models have not? And what does this say for the future of mobile payments?

The Starbucks platform sits on the line between evolutionary and revolutionary. It seamlessly transitioned a magstripe-based loyalty program to a new form factor – the mobile app. This made it easier to assemble a user base. They chose a bar-code technology rather than NFC, because the scanners were already linked into their cash registers and POS systems – this held infrastructure costs down. They only on-boarded one payment credential, not the whole wallet – keeping it simple. The Starbucks demographic is heavy on smartphone users so demand is robust. Finally, Starbucks could achieve rapid ubiquity in its ecosystem -- every store and every terminal accepted the solution within a very short time.[2]

Mobile payments also had a clear business case for Starbucks. They do have a line-speed problem, so faster payments actually matter – and anyone who has stood in those lines knows the vast majority have a smartphone in-hand while they wait. Line speed had been one of the key selling points for NFC in its contactless-cards incarnation. And, by aggregating many small payments into one big one, they saved real payments costs. At this point Starbucks have made no attempt to steer payments to debit or ACH (as PayPal does), but this is clearly another source of potential uplift.

CAN CLOSED BEAT OPEN?

So will the future of mobile payments consist of lots of retailer-specific apps or will "open" wallets like Google Wallet and ISIS take the high ground? Historically, general purpose credit cards like Visa, MasterCard, American Express and Discover gutted the market share of Private Label cards. But is this the right precedent?

One objection to the retailer-specific model is that it would crowd the user's smartphone with too many apps. Every time they enter a store, the consumer needs to hunt down the app for that retailer. Apple Passbook solves that problem: Once you register an app with Passbook, it is called up the moment you enter that retailer's store. So discovery costs are minimized.

A second objection is that consumers won't want their payment credentials spread over many different retailers for security reasons. This is overstated. In eCommerce, consumers register payment credentials at many merchants to take advantage of one-click shopping engines. Card issuers actually encourage us to set up recurring payments at utilities, telecommunications providers, gyms, and elsewhere. So why would retailer apps be riskier? These apps are likely to be hosted by a handful of large processors and merchant acquirers who will go beyond basic PCI compliance. Finally, many of the apps are password protected, providing security that is greater than what is available for plastic cards.

And again, Apple has a solution. In early June they announced a "Keychain" that will store credit card data in the cloud. To keep it secure, it will only sync to "trusted devices," using 256-bit AES encryption. This should allow retailer apps to outsource credit card storage and onboarding to Apple, vastly simplifying app development and reducing the risk of card data breaches. The Clearing House's recently announced Secure Cloud initiative accomplishes a similar goal.

[2] There are exceptions. The author was crushed when he couldn't use the app in a Barnes & Noble Café that prominently displays Starbucks signage, but is not in fact a Starbucks affiliated enterprise

A further objection is that the Starbucks model will only work at merchants with very frequent patronage. QSR[3] merchants like Starbucks and Dunkin' Donuts strive for multiple visits per week. Supermarkets, drug stores, and gas stations also see customers one or more times a week. However, department and specialty stores may only get a few visits a year and might have difficulty getting a customer to download their app for such infrequent patronage. Wouldn't customers prefer to use an "open" wallet at these merchants?

Maybe. It depends on whether the loyalty program offered by the individual merchant is more generous than the "offers" available from open wallets.[4]

LOYALTY VERSUS ADS & OFFERS

The retailer app model tries to make an already loyal customer even more loyal -- by spending more when they visit, or by visiting more often. The open wallets help retailers do the same thing, but by targeting their competitors' customers. So, the question for the consumer will be whether the loyalty offers available on retailer apps will be superior to the dis-loyalty offers available from "open" wallets.

Loyalty programs are critical to the retailer app case. Retailers can get 40%+ of their revenue from the most loyal 20% of their customers. Some of these loyal customers already carry the retailer's Private Label card to get rewards and discounts. But not everyone qualifies for PLCC or wants another card to carry. Big retailers may supplement PLCC with an app approach: It provides a more frequent marketing channel, it knows when the customer enters the store, and it can have a broader uptake among loyal customers than the PLCC card alone. It still knows buying behavior at the SKU level.

Open wallet offers help retailers poach one another's best customers. SKU level data is not available, so targeting can only be at the merchant level. In practice, that will mean micro-targeting your competitors' best customers while they micro-target yours. Merchants hate this. If the ecosystem takes hold, merchants would be engaging in an "offers" race-to-the-bottom that undermines their own margins while paying rents to the wallet providers.

One possibility is that the two models appeal to different audiences. Those inclined to be brand-loyal will stick with the retailer apps while those who are more price-sensitive will migrate to open wallets. Alternatively, consumers may be brand loyal in some categories but price sensitive in others, so they will subscribe to both an open wallet and several retailer apps.

But on the margin, which will offer better deals? In fact, the two models use different data to impact behavior and this will guide value.

WHICH DATA WILL WIN?

Retailer apps know past buying behavior at the SKU level, allowing very targeted offers. Such data also allows retailers to recruit manufacturers to subsidize value. For example, a drug store might know that a customer is fond of a particular shampoo and their last bottle was purchased long-enough ago that they should need a refresh. They can get the shampoo manufacturer to share funding for an offer to prompt the next shampoo purchase, or to buy a companion conditioner. The manufacturer benefits by getting an incremental sale and avoiding disloyal sampling; the retailer benefits by driving the consumer into an incremental visit where they not only stock up on hair products, but may buy other items as well. This narrow kind of targeting can lead to a very rich offer. Of course, the consumer

[3] Quick Service Restaurants, usually fast food

[4] Apps like Uber are yet a different mobile payments model – aggregating many small merchants within a narrow vertical to accept a common payment method. These apps are closer in spirit and function to retailer apps than open wallets

may have stayed loyal without the offer, so some sales will be cannibalistic, but this can be calibrated in a variety of ways using behavioral analytics.

For open wallets, there is no detail on actual purchases, but there is knowledge on how consumers spread their purchases across a group of merchant competitors. For example, the wallet knows how many visits a consumer made to McDonalds, Burger King, Wendy's, etc., how much they spent per visit, and what geography they spent it in. A merchant can then target offers to consolidate patronage. Cardlytics and others already use this model using statement data and statement credits.

This works well in narrow merchant categories like fast food and specialty stores, but less well in general categories like discount stores. The wallet may know someone spent $50 at Wal-Mart, but has no idea what they spent it on. Sears or Target might covet that customer in general, but they can't involve manufacturers and they can't know to focus offers on apparel or garden supplies or home wares. On its own, this information is less valuable than the SKU level insights that the retailer has and will result in less rich offers. Retailer apps have a clear advantage over this class of open wallet.

Google has an advantage over other open wallets through its ability to link spend behavior to search behavior. If someone is researching shoe styles online, one can assume they want to buy shoes. Google can then auction off the right to send a shoe offer to this consumer. This assumes that the consumer hasn't already bought the shoes online. Nevertheless, there is real value in knowing that a customer is both ready to spend on a specific category and has previously frequented specific stores. Such an offer can be narrow (only those ready to buy) and rich (since cannibalization is unlikely).

WILL A THOUSAND APPS BLOOM?

We are unlikely to clog up our smart-phones with hundreds of retailer apps – a dozen maybe, but not many dozens. First of all, only large chain retailers can afford the overheads. Even if processors like Square and Level Up provide loyalty and payments functionality to the army of small retailers, they still must attract consumers. SMEs lack the sophistication to target while avoiding cannibalization and they would find it hard to get manufacturers' subsidies; as a result, their loyalty programs are likely to be less attractive to consumers.

Second, the vast bulk of a particular consumer's discretionary spend will be concentrated in a modest number of categories and merchants. Supermarkets, drug stores, gas stations, discount stores, QSRs, department stores and specialty retailers might afford the overheads and value the insights. Supermarkets and drug stores already have very sophisticated loyalty analytics accessed through bar-coded key-tags, which many of us carry today – moving these to an app is not a stretch. Most other big retailers have a PLCC card with associated frequent buyer benefits. Porting these programs to an app is a logical next move. The great granddaddy of all retailer-specific NFC apps is Mobil SpeedPass which continues to operate nicely to this day.

Even among big retailers there are wide skews in analytics sophistication. A recent Oliver Wyman survey demonstrated that most retailers use fairly unsophisticated promotions strategies. While apps may be the trigger that forces retailers to up their game, this will still take time. And until the apps provide rich offers, there is limited reason for consumers to adopt them. As one example, the Starbucks app helps my family save on the order of 20% on our caffeine habit. Our frozen yogurt of choice just launched a mobile app that give us rewards about every third visit; at present this is just a loyalty app, but payments are on the way.

One more big incentive for retailers to create compelling apps is that any spending kept out of the open wallet deprives competitors of useful insights on their best customers. Open wallets are "blind" to any transaction riding on retailer apps and therefore, competitors can't use that data to target offers to those consumers. If enough large retailers follow this strategy, the open wallets are left to fight it out only over the already disloyal, price-sensitive consumer who is far less valuable – a common knock on Groupon, for example. Of course, if the retailer apps offer more attractive offers, even the price-sensitive consumer would be better off *becoming loyal* than they might by "playing the field" on an open wallet.

WAL-MART IS COMING

Wal-Mart has made a series of announcements that suggest it is indeed pursuing a strategy to develop a fully functional app along the lines we have discussed in this paper. The best known of these announcements is MCX, a consortium led by Wal-Mart and Target to develop a retailer-centric, mobile payments ecosystem. The others were more recent:

- In May, Wal-Mart announced a very functional shopping app. The press release describes dynamic shopping lists and detailed budgeting tools. The app knows when the customer enters the store, shifts from eCommerce mode to POS mode, guides the customer to the aisle with their desired merchandise, and recommends companion products to complement the one purchased. But the relevant feature for this discussion is that it allows the consumer to "View applicable manufacturer coupons for products carried in local Wal-Mart stores." And this is the beta
- In June, Wal-Mart bought a predictive analytics company called Inkiru that will become part of its WalmartLabs division – a unit focused on web and mobile technologies. The announcement suggests that Inkiru's engine will be used to serve up real-time, relevant offers to mobile app users

Wal-Mart is deploying all the pieces to capture loyal customers within its own ecosystem and initiate their payments. Given the sophistication of the technology employed here , only a few other retailers can follow suit immediately; but, the vendor community will no doubt provide smaller retailers similar capabilities on an outsourced basis.

It will be hard for the third-party wallets to match this kind of value to consumers.

CONCLUSION

Large retailers have a big incentive to launch compelling mobile apps linked to loyalty programs and enabling payments. Any retailer without an app and loyalty program unilaterally disarms – they can't see their competitors' data but their competitors can see theirs. Analytically sophisticated retailers will both outperform the open wallets and opt out of the race to the bottom.

There will clearly be an arms race between open wallets and retailer apps where offers are the nexus of competition and competency in data and analytics are the key strategic levers. But funding these offers will remain a challenge, and here is where card issuers may find themselves in the cross-hairs. This will be the subject of Part 2.

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