

Cheque mate

Alan Kohler October 5, 2017



EML Payments (ASX: EML) offers innovative payment card technology solutions

They manage more than 850 card programs across 13 countries

EML Payments Limited has had a fantastic run over the past five years and on all accounts, is going to continue to grow from here because it's just gone into the US last year, and had a huge burst of growth in America through an acquisition there. Today they announced an [agreement](#) with InfoSync for B2B virtual payments, and their share price went up almost 6%!

The point about America and the point about the interview with its CEO Tom Cregan is that there's still about \$26 trillion dollars' worth of transactions in the US carried out by cheque.

They're still writing cheques in the US to the value of trillions of dollars and what EML does is replaces the cheques with electronic payments. Instead of waiting for cheques to clear, businesses get the money straight away whilst EML takes a clip of 125 basis points on the money.

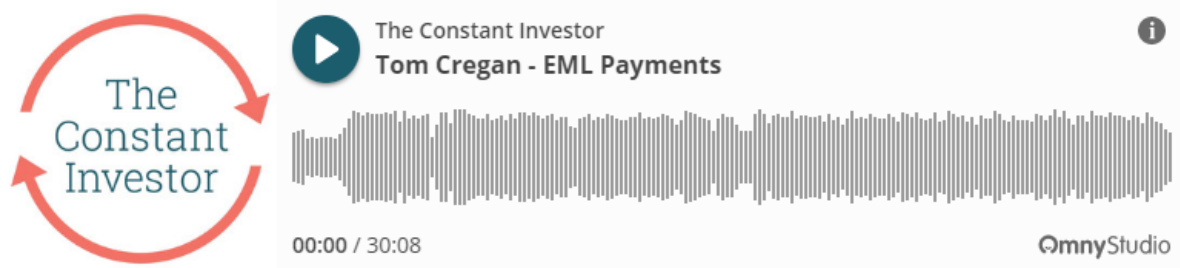
The market that they're going for is \$3 trillion dollars' worth, they're up to a couple billion I think and have clearly got a lot of growth ahead.

It's been a good stock over the past five years and I would say just looking at what's going on in America and their business there, that there's a fair bit of

growth left. Tom Cregan owns about 20% of the company, he's been there for five years himself and he's had a beautiful run with his own wealth, that's for sure.

He's quite interesting on the subject of their position both in Europe, as it happens, and in America.

Here's Tom Cregan, the CEO of EML Payments.



Tom, I have a bit of trouble getting my head around how your business works, could you explain it?

Yeah, it's very simple really. I mean, we're a payments processor so we run payment platforms in Australia, Europe and North America. So, every dollar of volume that's been processed over the platform has a corresponding revenue and EBITDA component to it. So, it's very linear. I mean, we processed \$4.4b last year of payments across the platform at about 130 basis points conversion, so it translated to \$58m in revenues and that's really the model. So, you've got lots of different applications and industry verticals, but in all cases you'll have volume running through it and you're deriving revenue and earnings.

So, you're a sort of financial toll road?

You could say that, yeah. I mean, the revenue components are made up of different elements, from fees that our customers pay us. We're a B2B provider, so our service is provided to governments or corporate entities, and so our revenue is comprised of different elements from fees to interchange which is what we would earn through the payment network of Visa and MasterCard, through to interest on the float, through to FX, through to a whole raft of different things... But all combined, that adds up to about 130 basis points at the revenue line.

But I imagine there's a range of different clips that you're taking?

Yeah, well it depends on what country – we're in 14 countries now so it does vary. One of the major ones is interchange. Which is when customers with our cards are using them to buy goods and services or withdraw money from ATMs, there's an

interchange fee that we earn there through the payment network. There are fees that we charge our customers in the gaming industry to provide the service to their customers. We earn interest on the float that we're sitting on which was north of \$300 million dollars at the full year. There's FX income if cards are used – if an Australian uses their card offshore obviously there's an FX fee. So, there's several different revenue items that can vary by product, but they're blending to 130.

So, I'm just trying to get a sense of the various things that you're doing. Do you compete with Visa and MasterCard or do you work with them?

We work with them. So, they're absolutely an enabler of companies like ourselves.

So, what do you do for them that they can't do already? Why can't they do what you do?

Well I guess they're purely a network, so they're not a card issuer like we are, they don't issue cards in people's hands.

I thought they did?

No, they don't. I mean, MasterCard and Visa's customers are banks, right, and card issuers. So, if the banks that are issuing you your card – so, if you're a National Australia Bank customer you'll get a card with Visa on it but that's being issued to you by National Australia Bank, not by Visa. So, Visa and MasterCard and Discover in the US, other companies like that, are the network. So, really they're the rails – that's the industry terminology – for when a card is used and a card is processed, what network is it running on? Is it running on the Visa or MasterCard network?

So, Visa and MasterCard are not card issuers like ourselves and they're not program managers. So, they don't manage individual programs, they're not managing customer service, they're not managing marketing, they're not managing all those things. That's all being done by their customer which is companies like us and banks and other payment providers.

So, who do you compete with and what are the barriers to entry?

Well, in prepaid, in the part of the ecosystem that we're in it's actually not that competitive. There are lots of kind of industry participants and there are companies like us that exist in the US, they tend to be as we are but they also tend to be fairly sector-specific. So, they tend to have developed payment technology to support solutions in certain industry verticals and they monetise those verticals and they build a business in that way and it's no different to us. But then, if you look at the verticals that people are in, you might find one competitor, two maximum.

So, if I give you our Aussie examples, for example, we're partnering with the online gaming companies, we've got all five of those in the Aussie market and

they're contracted 'til 2020-2021. We've got McMillan Shakespeare and the other people in the salary packaging industry that we launched in July. So, if a company like ourselves is offshore and they think that they've got similar technology, they think they've got a vision, they really want to go and attack the Aussie prepaid market. Gaming and salary packaging are not going to be contestable markets for them before the six years. So, what those companies do is they either don't enter the market at all or they look at the market but they'll look at different niches or different verticals that they think are contestable, and that's really how the market evolves.

So, if I look at gaming in Australia there are no other providers of that product. If I look at salary packaging in Australia, the only other issuer of salary packaging cards is Westpac. National Australia Bank and ANZ withdrew. So, we've got one competitor in that market. If I went to Canada and North America and Europe and I looked at the shopping malls which is a big part of our business where I'm effectively buying a gift card to use at a mall but it's restricted to be used within that mall, there could be one or two competitors of any significance that are credible. If I looked at gaming in Europe there's probably one competitor. So, on a sector basis you tend to see one, maybe two competitors, and largely because the agreements that we enter into and our competitors enter into are long term exclusive agreements, which mean that unless you have an operational error those verticals don't become heavily kind of contestable.

So, the big transformation that took place in your business it seems to me was in the US last year, there's been a colossal increase in the amount of your business there. I gather that was from an acquisition. Tell us about what the acquisition was and what your business is like in the US now?

Certainly, the last 12 months of the US was a big part of it. The year prior to that we'd acquired a business in the UK which serviced a number of European markets and the US acquisition services Canada and the US. And the reason for both those deals really is the fact that they're just quantum of the size of Aussie. So, 90% plus of our earnings are now offshore. So, even though the Australian business will double this year, it won't outgrow the growth we're seeing in Europe and North America. And the strategy was similar for both those businesses, which was acquire companies that were gift card issuers, so they're only issuing what we would call a non-reloadable product.

This business was issuing gift cards in shopping malls where we're the provider to the real estate trust, à la the Westfields of the world. Westfield isn't a customer but it's of that ilk. So, those businesses tend to be pretty stable. Again, you've got five year agreements with them all, so they're fairly stable businesses. But they trade on lower multiples because of they're gift cards and so the only way to make more money out of a gift card business is just continue to sell more cards year on year.

The reloadable business is the opposite, it really doesn't matter how many cards you sell, it's more about the volume of payments. So, one individual might have a card, they could use it every month for five years. So, you know, the multiples are higher for those type of companies. So, we acquired both the US and Europe, you know, they were gift card businesses, we took our reloadable technology to them and that's really about just accelerating their earnings. US, we bought last June, we then took our reloadable technology to them in the first half of the fin year.

We launched our first program there in February of this year, the first reloadable program that they have and that program will do over \$1.5 billion Aussie dollars in this coming fin year, which is more than the entire Australian business will do. So, that's why we're focused on North America because it's the largest prepaid market in the world, several hundred million dollars a year running through different programs over there. And so it was a key part of our strategy to be in the biggest markets.

And what's your market share in the US?

Oh, it's fractional. I mean, this year we'll probably do \$4.5 billion dollars in GDV, what we would call debit volume or you could put \$5 million, that'd be right. \$5 million out of about \$800m. So, it's a vast market, we've got a very small share...

So, what's your competitive advantage there?

I think it really comes down to being able to monetise different verticals. I think companies like ourselves would argue that the technology is a differentiator, which I would agree with that. There are regulatory barriers to entry, which I would agree with that as well. But at the end of the day there are clever companies out there. If we've solved all those issues, they can solve those issues as well. The competitive advantage is really identifying an industry or identifying a vertical, adapting your technology to that vertical and then really dominating that industry within a country or globally and that becomes the value of the business. It's the intellectual property in a true sense of understanding how a certain industry works and tailoring the payment solution to that industry and then trying to leverage that on a larger basis.

So, how much of the American business have you converted from non-reloadable to reloadable cards? Has it all been converted and what's the revenue uplift?

The non-reloadables continues to grow. In Canada that grew at 25% year on year and in North America it grew at 6-8% year on year. So, the underlying business we acquired still grows. This year the revenue that will come effectively from business that was other than what we bought, if you think of it that way, so if I took out all the gift card business the revenue uplift is about 40% I would think, this fin year. So, in terms of just organically acquired customers from reloadable.

Right, I see. And so the thing that strikes me about the United States is there's still an awful lot of cheque transactions going on there. I think the Federal Reserve talked about \$26 trillion dollars' of cheques still being used in the US. We're not using cheques in Australia anymore, is that a potential avenue for growth for you there?

Yeah, and in fact we would think that that's probably – outside of gaming in Europe, we call that B2B, virtual payments, which is really just a means whereby a company can pay a supplier with a virtual MasterCard. So, I'll kind of explain how that works, but we think that's our largest growth driver long term. That market is vast. At the same time I've been keen to tell our investors that they should see that monetise and then get confident that that is there rather than me kind of building a lot of vapour into the story.

What do you mean by that?

Well, when we bought the US business it had been investing for two years in the technology to enable it to operate in what we call B2B, which is the replacement of cheques with virtual cards, but it had one customer. Since we've owned the US business it now has 9 or 10 customers, we've got another 9 or 10 that will be contracted during the year.

What sort of customers are we talking about, what sort of people are they?

They're all corporate entities. So, I'll give you an example. So, the Fed Reserve numbers are right but if we just look at business to business cheques, so these are companies paying other companies and it's typically going to be their supplier, paying their supplier with a cheque and 50% of all business to business payments in America are still cheque related and at an SME level, the smaller the business the higher that number. So, yeah, SMEs would have 75% of payment done by cheque. The reason people use cheques is largely historical, inertia and they don't break. So, they work.

Companies wait to get their cheque, they wait to cash it and receive their money and then they pay their suppliers, so it works but it's inefficient because it takes 10 days to get the cheque, it takes 10 days to clear the cheque, you know, that's the problem, it's just the lag in the system. There's 7,700 banks in America, so they don't have BPAY and they don't have real time settlement and they don't have any of the things Aussies or New Zealanders would take for granted in their banking system. What MasterCard and Visa have done in working with companies like ourselves, is to have those companies pay their supplier but do it on a virtual platform, which effectively is a MasterCard that will end up in your email box that's encrypted, you'll click it, it will un-encrypt and the money will clear instantly into your bank account. So, that's the solution. So, what it saves you is 20 days of waiting to be paid and waiting for money to be cleared. But there's a cost to you because if I'm paying you, if your my supplier and I'm now paying you with a virtual MasterCard, you're now the merchant and it's costing you 2.5% to

get paid. So, for the supplier it's really at the end of the day a cash flow factoring decision. Do I want to get paid 20 days sooner or does my business model have 2.5% of flex in it that I can afford to lose 2.5% on the margin in order to get paid 20 days sooner?

And so that's the model in a nutshell. When you look at the customers that we've signed, our most recent one in May is a company that manages payments on behalf of fast food franchisees, in which they're managing their accounting, their managing their books, they're managing all of their payments and they're writing cheques for \$900 million dollars a year worth of cheques. So, we're contracted with them and what we do is we go through that supplier list in full and we look at which suppliers would not have the flex in their business case to be able to pay 2.5% and which ones would. We then go and convert those customers and it's voluntary.

So, you're simply saying, would you like to be paid sooner and if so under these terms? And we get somewhere in the realm of 15-20% of companies saying, 'Yes, we'd prefer that model.' So, that's the model in a nutshell. Now, this year we will do...

Why don't you make it 1% and get 100% of the customers?

Well, it is purely contractual, so the 2.5% is set by Visa and MasterCard and that's the interchange rate that they set as the scheme, and then it's whatever we rebate back to our customer. So, you know, if you think about fast food franchisees, the \$2.50 the interchange that EML earns by paying their suppliers with a virtual card, we rebate half of that back to them. So, EML's making 125 basis points and our customer is making 125. And our customer effectively turns their accounts payable division into a revenue generator.

I thought Visa and MasterCard are harvesting that 2.5% but they're not?

No. So, that's what I mean. They're keeping about 15 basis points out of that and their model is to make 5, 10, 15 basis points on trillions of dollars, but it's companies like EML and others like us that are out there actually doing that work and getting the cheque business converted to cards and that's how they end up, they get a slither on trillions of dollars of volume, which is why they've got such a great business.

So, is there now a bit of a gold rush going on in America of companies like yours trying to replace cheques?

There is. I think, back to what I would say earlier though, some of them are very sector specific. So, there are companies that have looked at healthcare. So, you know when Aussies would go to a health practitioner we've got the HICAPS network that links obviously you with your insurer, and so you go to the dentist, you're automatically getting your insurance rebate. You're only paying the left

over. That doesn't exist in the US at all. So, there are companies that have targeted health as a specific sector, there are companies that have targeted travel as a specific sector. We would tend to target industrials, so they tend to be more logistics companies, they can be telecoms businesses.

So, what's the size of the market you're going for?

Trillions. The statistic is that the market size by 2021 or 2022, I can't quite remember, in the US is forecast at \$3.1 trillion, so it's gigantic. But that's why I was saying to you that we're letting the numbers do the talking because we've gone from one customer to 9 or 10 customers and we'll end this financial year with 20 customers. But it's 20 customers in a matter of years, it should be hundreds. But when you tend to talk to a lot of Australian investors about a market size that's trillions sometimes their eyes can glaze over because they just can't comprehend that kind of number.

So, the 20 customers you'll end up with, how much business is that, how much money is that?

This year we will do \$2.5 billion dollars in virtual payments. So, it's \$2.5 billion out of what will be trillions. So, that's what I mean, it's a fractional business. Now, if we can grow that at the same rate in the next two or three years and we've earned \$10 billion dollars or more then it becomes a very big sizeable part of our business. But I've always preferred as a CEO to let the numbers do the talking rather than kind of spruik the story early on. I think it'll prove to be our most lucrative market over the next 10 years I think, simply because the market is so vast. You're talking to companies that do \$3 billion dollars of cheques. We talked to a large publicly listed telecoms company – this gives you an idea of kind of the inertia there – large publicly listed telecoms business, CEO and Chairman personally signs off every cheque above \$80,000.

So, he personally signs 113,000 cheques a year and just refuses to adopt any other technology other than cheque because he really thinks that's how he keeps a direct line of sight over expenses in the business. So, that would be completely anathema to what a CEO of Australia would do because we've got electronic banking...

That's complete madness!

When we spoke to him we said, 'You do realise that all of these payments are electronic, you would see every one of them, you would get to release every one of them so you don't lose any control.' And his comment was, 'Look, until I'm fired or I die, I'm not changing the way I do business.' So, those attitudes exist in the US and they'll take several years to change, but in the meantime, that's what creates the opportunity for us. Now, of all the suppliers that we talk to, as I said, only about 15-20% want to be paid in that manner and others are quite happy to stay on cheques and they don't want to change their model. And the people who do adopt it are not having their arms twisted.

So, if you think of the one that we announced in February that's in the fast food industry, the suppliers that we're paying there are not Coke, because Coke or Pepsi would have negotiated a fixed national deal and they're not going to have 2.5% of flex in their pricing model to be paid electronically. It's not going to be the guy who provides them chips for the same reason that potatoes are a commodity and you're going to have very thin margins. But it will be the people like the air conditioning repair guy, the electrician, the glazier, the guy fixing a hole in the car park. In the US you've got companies like Square and Stripe and other people who do mobile payments.

So, if your air conditioner goes out at home you call a repair person. He'll come into your house, he'll fix it. He's going to take your credit card payment on the spot, he's not going to give you an invoice and hope you pay in 60 days, right? So, he's taking cards already in his ordinary course of business and we call him and say, 'Look, if you're doing repairs in any one of these fast food restaurants, we're going to pay you on card.' The response is, 'What took you so long? Because I already take cards in my business. I prefer to take cards because I don't need to go and visit a bank, just do it.'

So, that's where there's about a 15-20% conversion rate without any arm twisting whatsoever. It's just making people aware that there's a different model available to them if they want to get paid that way.

It sounds like you've got a decent growth runway ahead of you, Tom.

North America, that'll be the biggest part of our business in a couple of years. We've probably got two or three competitors in that market in the verticals that we're going after. It will be a trillion dollar market opportunity in those years to come, I don't have any doubt about that. The market's only really waking up to it now and it will continue to mature. So, in the US it will be that opportunity and reloadable. In Europe it will largely be reloadable and in Australia as well. If you contrast the US business, that same virtual payments business would have very little future in Australia because it doesn't solve a problem because companies can do bank transfers here and they can do them in real time. We've got a pretty elegant similar system in Australia. So, you know, virtual payments is certainly a US phenomenon because it's probably the country in the world where payments are most inefficient.

I'm going to have to leave it there, Tom, been great talking to you.

Thanks a lot. Cheers.

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