Infinicept

GET PAYMENTS GOING YOUR WAY™

Mastering Merchant Pricing:

A Software Provider's Guide to Understanding and Maximizing Your Payments Revenue

As a vertical software company, you're creating solutions for customers with common challenges and opportunities. The more you're able to provide what these businesses need in a single package, the more value you can offer, leading to better customer retention.

Adding payments to that mix has unlocked another benefit. Not only does solving payments challenges for your customers help you retain and grow your customer base, it also delivers a substantial new revenue stream. This has the potential to make your business more profitable and even more valuable to investors.

Embedding payments into software has created an enormous market opportunity. Juniper Research predicts that embedded payments revenue will grow 84% over the next four years, exploding from $32 billion in 2023 to $59 billion in 2027.

But for ISVs, adding payments to your platform is just one piece of the puzzle. To truly take advantage of what payments have to offer, you need to understand how payments revenue works and the levers you can pull to maximize it.

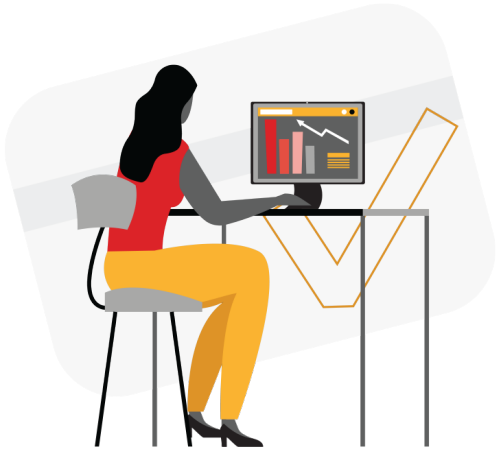
The Economics of Payment Processing

For decades, payments and their associated revenue were the purview of specialized payment processing companies. These companies operated in a world all their own, cloaked in jargon. As the experts in payments, they managed all of the risk and compliance, and they kept all of the revenue.

Over the last decade, however, that landscape has changed dramatically. Vertical software companies became the front line for reaching small and mid-sized businesses.

APIs and other advancements in technology enabled these companies to connect to the payments system, bridging the gap between the legacy payments system and a new audience.

An entire industry has sprung up to provide even more infrastructure, making this process easier and easier. As a result, many software companies are now getting a significant chunk of their revenue directly from payments.



TapGoods, a rental management software, earns over 30% of its revenue from payments. For many software companies, that number may be 50% or more. The 2023 Forbes Fintech 50 list includes a growing number of software companies, from salon management platforms to field services, that are making a significant portion of their revenue from payments

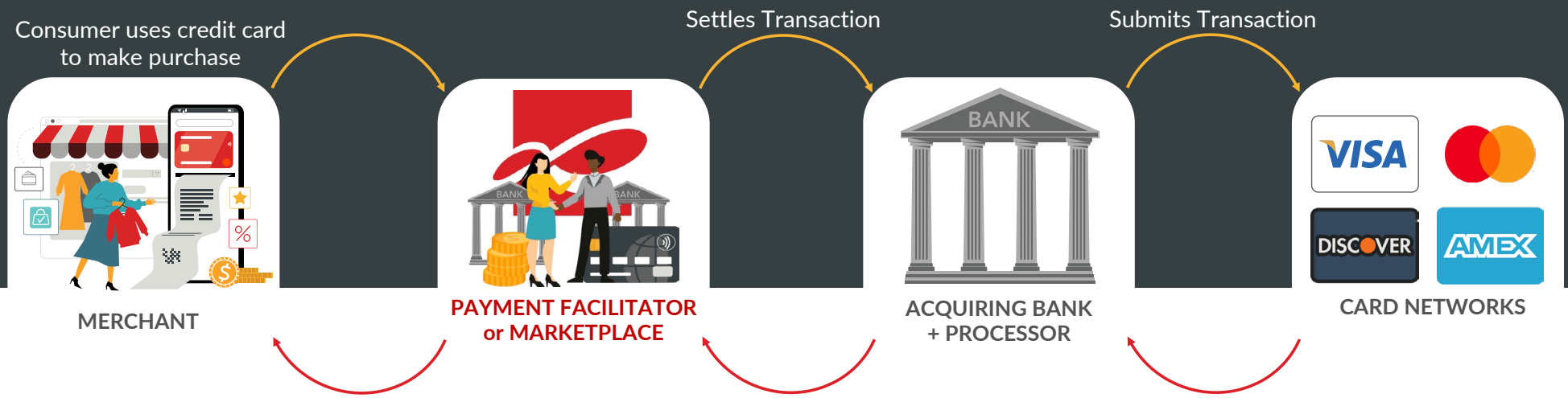
To understand how payments revenue can be so lucrative, let's start by taking a look at where the revenue comes from.

HOW PAYMENTS REVENUE WORKS

The company that sells the payment services to the merchant collects a processing fee for each transaction, typically about 2 to 5% of each transaction. Those fees are then split among the parties involved in providing the payments.

In every payment transaction, there are essentially five roles involved, in addition to the merchant and the consumer:

- **Card networks,** such as Visa, Mastercard, American Express and Discover
- **Issuing banks,** which issue credit and debit cards to consumers
- **Merchant acquirers/Acquiring banks,** which are responsible for funding the merchant or the payments company.
- **Payment processors,** which manage the movement of transaction and settlement data between the card networks and issuing and acquiring banks.
- **Embedded payment providers,** which package up the payment services and sell them to the merchant.



The roles can get confusing because one entity sometimes fulfills more than one of the acquiring/processing roles. Acquiring banks might operate payment processing services, and they might sell directly to merchants themselves.

For example, let's look at J.P. Morgan Chase. Chase is an acquiring bank, it operates as a payment processor, and it sells its payment services to merchants, typically large ones. In this case, Chase is the payment provider, the processor and the acquiring bank rolled into one.

But payment providers also might be other types of companies, like independent sales organizations (ISOs), marketplaces, payment facilitators or software companies.

Drake Software, for example, serves the needs of tax preparers with its tax preparation software and associated services. It also offers DrakePay, which enables its customers to accept payment from their own clients. Drake sells the payment services to its customers and sets the pricing; it serves as the payment provider. But in this case, SVB/First Citizens Bank fulfills the acquiring bank and processor roles.

FEE BREAKDOWN

The fees that merchants pay for processing card transactions can be divided into four components:

1. Interchange. The amount of interchange paid for each transaction is set and controlled by the card networks and paid to the issuing bank.

   Interchange rates are highly variable. Every transaction has its own interchange rate, based on:

   a. The type of merchant
   b. The type of card—debit, credit or rewards, and higher-value cards v. regular consumer cards
   c. How the transaction is processed (card present, card not present, tapped, dipped or keyed in)
   d. The amount of information included in the transaction message

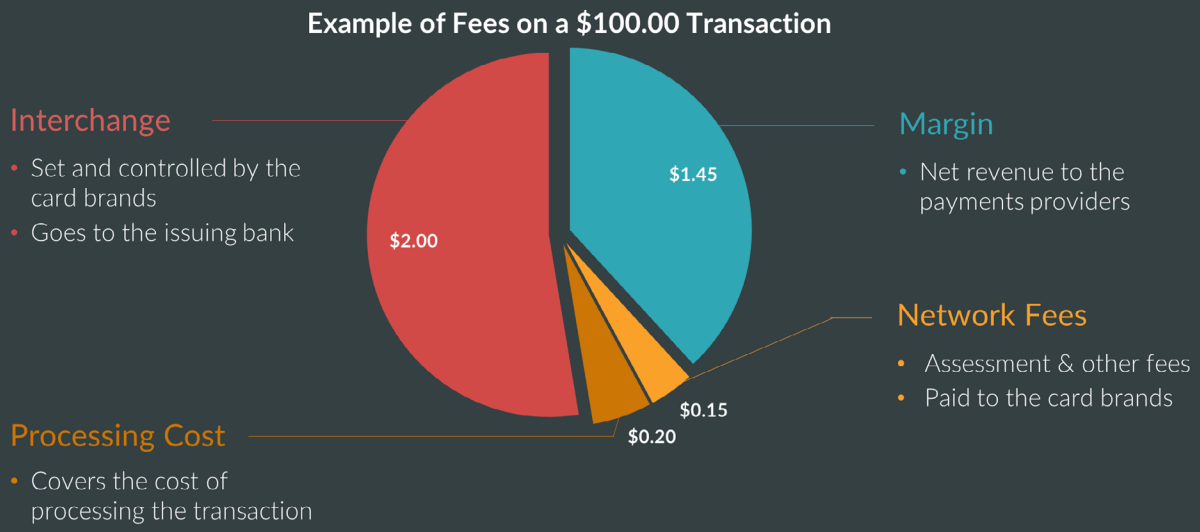
2. Processing cost. This covers the cost of processing the transaction and is paid to the processor and the acquiring bank.

3. Network fees. These assessments and other fees are paid to the card network associated with the transaction.

The first three categories are essentially fixed and set by the companies that receive them. This brings us to the fourth category:

4. Margin. The payment providers receive the remainder of the payment fee. This is where software company revenue comes from. It can be determined in different ways, which we'll cover in the next section.

Components of Payment Processing Fees



How does all this affect your own payments revenue potential?

As you can see from the example above, the amount from each individual transaction that goes to the payments company is small. But it is recurring and, multiplied by thousands of transactions, it becomes significant.

In the long run, the amount of revenue you can make from payments depends on three factors:

- Average transaction value
- Transaction volume
- Pricing model

MAXIMIZING TRANSACTION VOLUME AND VALUE

Understanding the first two factors is relatively straightforward. Because you earn money on every transaction, the more transaction volume you have, the more money you make.

By the same token, higher transaction values will result in higher margin per transaction.

You have little control over average transaction value, because it can depend on the industry you're in. A fast casual restaurant will likely have lower transaction values than a high-end furniture retailer, for example.

But you can affect your transaction volume by marketing and selling your payment product effectively. First, it's important to make sure your payments offering is compelling.

Many software companies decide to offer payments because they're trying to solve problems for their customers. Maybe they're enabling faster payout to maximize cash flow for their customers.

Perhaps they're making it easier for their field service customers to accept payments onsite, rather than invoicing and waiting for payment.

Maybe they want to incorporate pre-set tipping options into their salon management payments, so salon owners can maximize the tips their employees receive.

What are the unique payments problems or opportunities your own customers face, and how does your payments offering solve them? Make sure you're communicating the unique benefits of your payment offering as you would for any other benefit of your product, with ongoing sales and marketing efforts.

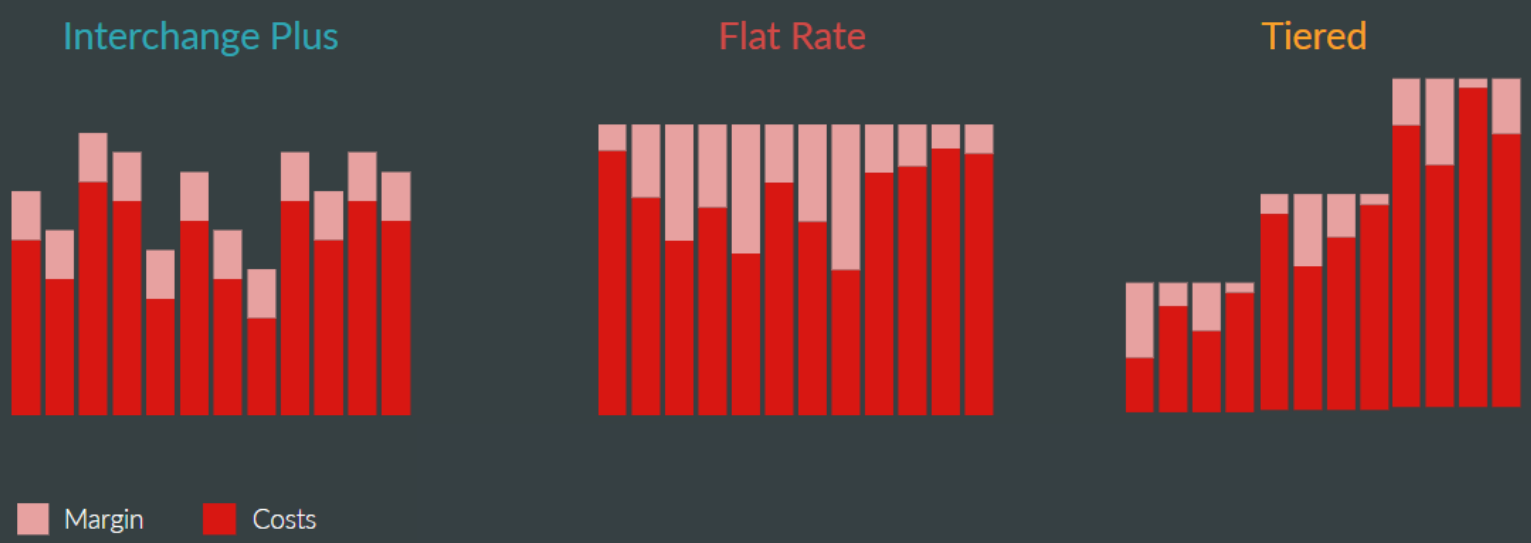
Software companies manage large amounts of customer data, which they can use to develop insight into the needs and barriers those customers face. Savvy providers can also use their customer information to identify the customer segments most likely to benefit from their payments offering—such as those with the highest transaction volumes—and market to them specifically.

The amount of revenue per transaction that you see will also depend on your pricing model. There are three typical models: interchange plus, flat rate and tiered.

Each has pros and cons based on factors such as ease of understanding and reporting, transparency, and impact on the payment provider's margin. We'll detail each of these in this section.

It's important to weigh the advantages and disadvantages of each model against your own business goals and strategy. You want to choose the model that works best for your customer base and enables you to be the most competitive and provide the most value for your customers balanced with your ability to maximize your margin.

Merchant Pricing Models



Interchange Plus

Interchange plus is a straightforward pass-through pricing model in which the payments provider charges a set amount over their costs for each transaction.

Let's take a detailed look at an interchange plus transaction where a customer for Scott's Shakeshack taps to pay with their Visa rewards credit card to settle a $25 bill.

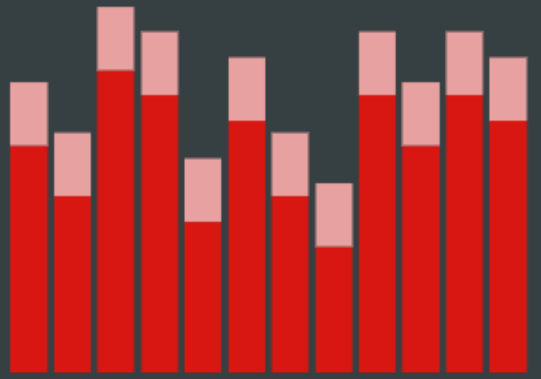
To work through this transaction, we'll use the following interchange and network and processing fee amounts.*

- **Interchange rate** = 2.10%
- **Network & processing fees:**
  - Assessment fee = 0.14%
  - APF fee = $0.0195
  - Processing fee = $0.07

The provider will pass through these fees and add their margin on top to arrive at the total fee they charge for the merchant. For the **margin**, we'll say they're charging:

  - 75 basis points (0.75%) + $0.10 for every transaction.

For this transaction, then, the total transaction fee will be **$0.937**, and **$0.2875** of that will be the payment provider's margin.



Here's a breakdown for how we arrive at that fee:

Total transaction fee = **[interchange fee]**
+ [network & processing fees]
+ [margin]

Next, we'll plug in the formulas to determine each of these amounts for this $25 transaction:

Total transaction fee = [$25.00 x 2.10%]
+ [($25.00 x 0.14%) + $0.0195 + $0.07]
+ [($25 x 0.75%) + $0.10]

= [$0.525]
+ [($0.035) + $0.0195 + $0.07]
+ [($0.1875) + $0.10]

= [$0.525]
+ [$0.1245]
+ [$0.2875]

= **$0.937**

From the merchant's perspective, here's how the effective rate—the percentage of each transaction the merchant ultimately pays in fees—looks across different types of card and transaction types within an interchange plus model.

	Visa Consumer		Visa Rewards		Visa Signature		Visa Debit	
	Card Present	Card Not Present	Card Present	Card Not Present	Card Present	Card Not Present	Card Present	Card Not Present
Total fee	$0.937	$0.962	$0.937	$0.962	$0.937	$0.962	$0.937	$0.962
Effective rate	3.75%	3.85%	3.75%	3.85%	3.75%	3.85%	3.75%	3.85%

Pros of interchange-plus transaction pricing:

- **Highly transparent.** Interchange plus pricing provides complete visibility into the breakdown of transaction fees.
- **Fair.** Merchants are never thought to be overpaying for any transactions. They know exactly how much margin their provider is receiving.

Cons:

- **Difficult to predict,** given the variability of interchange.
- **Complicated reporting,** relative to the other models.

Flat rate

Flat rate pricing is a model in which the payments provider charges the same rate for every transaction. While this means that the margin varies on every transaction, that can become easy to predict with some experience and knowledge of the mix of card and transaction types in the provider's portfolio.

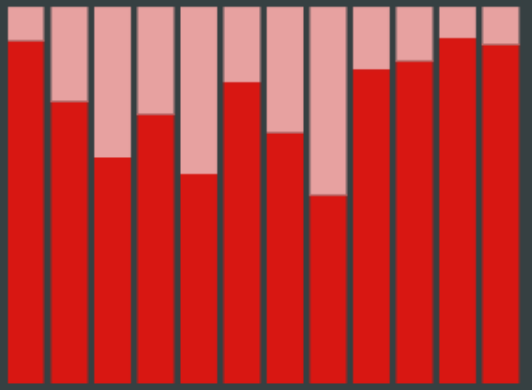
To demonstrate flat rate pricing, we'll take a detailed look at a transaction where a patient with Dave's Dentistry inserts a Mastercard debit chip card to pay a $25 dental visit co-pay.

For this example, we'll use the following interchange and network and processing fee amounts.

- **Interchange rate** = 0.05% + $0.22
- **Network & processing fees:**
  - Assessment fee = 0.1375%
  - NABU fee = $0.0195
  - Processing fee = $0.07

In this case, the provider charges a flat rate of 3.50% + $0.30 for every transaction, which means their margin amount can essentially be different every time.

For our sample transaction, the total transaction fee will be **$1.175**, and **$0.8186** of that will be the payment provider's margin. For flat rate pricing, the fee will be $1.175 for every $25 transaction; it's the margin that's different this time.



Here's a breakdown for how we arrive at the margin for this transaction:

Margin = **[Total transaction fee]**
- [interchange fee]
- [network & processing fees]

Next, we'll plug in the formulas to determine each of these amounts for this $25 transaction:

Margin = [$1.175]
– [($25.00 x 0.05%) + $0.22]
– [($25.00 x 0.1375%) + $0.0195 + $0.07]

= [$1.175]
– [($0.0125) + $0.22]
– [($0.0344) + $0.0195 + $0.07]

= [$1.175]
– [$0.2325]
– [$0.1239]

= $0.8186

From the merchant's perspective, here's how the effective rate—the percentage of each transaction the merchant ultimately pays in fees—looks using the same transaction amount across different types of card and transaction types within a flat rate model.

	Visa Consumer		Visa Rewards		Visa Signature		Visa Debit	
	Card Present	Card Not Present	Card Present	Card Not Present	Card Present	Card Not Present	Card Present	Card Not Present
Total fee	$1.175	$1.175	$1.175	$1.175	$1.175	$1.175	$1.175	$1.175
Effective rate	4.70%	4.70%	4.70%	4.70%	4.70%	4.70%	4.70%	4.70%

Pros of flat rate transaction pricing:

- **Easy to understand** and predictable for merchants.
- **Opportunity to enhance margin.** Using technologies available from card networks or enhancing your data with more information will help reduce transaction cost, leaving more of the fee available for margin.

Cons:

- **May be more expensive for merchants.** Providers using flat rates may have to set those rates on the higher side to guard against having any transactions they're losing money on.
- **Price increases are required to maintain margin** if costs increase. Increasing prices always runs the risk of alienating and losing customers.

Tiered

For tiered pricing, providers might have a few tiers based on the interchange rates of the transactions and card types, with more expensive transactions falling into a higher tier. While there are tier divisions that are generally accepted as fair, this pricing model is sometimes abused when providers obscure the basis of their tier types to take advantage of merchants.

Example 1

First, we'll take a detailed look at a transaction where a customer with Lauren's Landscaping pays a $25 invoice with a Visa consumer credit card, using tap-to-pay.

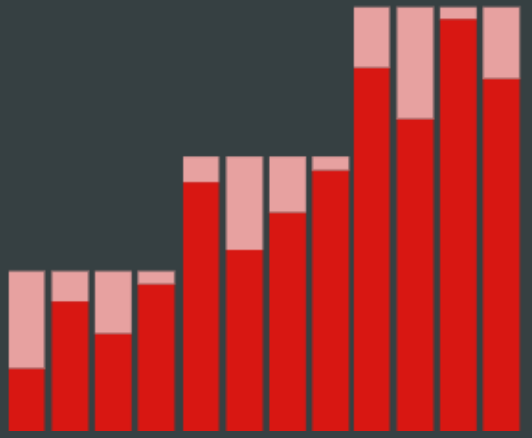
A card-present transaction with a Visa consumer credit card incurs a relatively low transaction rate, so this will fall into the payment provider's qualified (least expensive) tier.

For this example, we'll use the following interchange and network and processing fee amounts.

- **Interchange rate** = 1.51 % + $0.10
- **Network & processing fees**:
    - Assessment fee = 0.14%
    - APF fee = $0.0195
    - Processing fee = $0.07

In this case, the provider charges a qualified rate of 2.50% + $0.30 for every transaction, which means their margin amount can essentially be different every time.

For our sample transaction, the total transaction fee will be $0.925, and $0.323 of that will be the payment provider's margin. For tiered pricing using the qualified rate, the fee will be $0.925 for every $25 transaction; it's the margin that's different.



Here's a breakdown for how we arrive at the margin for this transaction:

Margin = **[Total transaction fee]**
- [interchange fee]
- [network & processing fees]

Next, we'll plug in the formulas to determine each of these amounts for this $25 transaction:

Margin = [($25.00 x 2.50%) + $0.30]
– [($25.00 x 1.51%) + $0.10]
– [($25.00 x 0.14%) + $0.0195 + $0.07]

= [($0.625) + $0.30]
– [($0.3775) + $0.10]
– [($0.035) + $0.0195 + $0.07]

= [$0.925]
– [$0.4775]
– [$0.1245]

= $0.323

Example 2

Next, we'll take a detailed look at a transaction where a customer with the same merchant, Lauren's Landscaping, pays a $25 invoice online with a Visa Signature Preferred credit card.

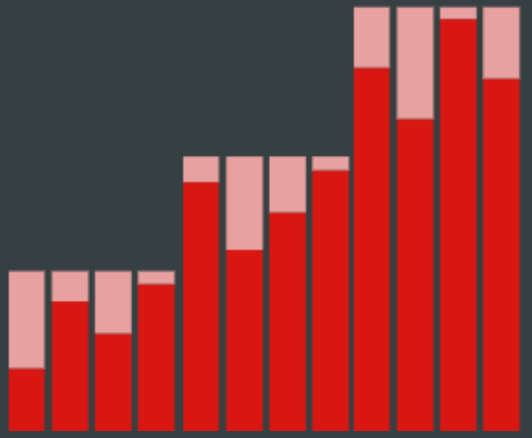
A card-not-present transaction with this type of credit card incurs a much higher interchange rate, so this will fall into the payment provider's non-qualified (most expensive) tier.

For this example, we'll use the following interchange and network and processing fee amounts.

- **Interchange rate** = 2.50% + $0.10
- **Network & processing fees**:
    - Assessment fee = 0.14%
    - APF fee = $0.0195
    - Processing fee = $0.07

In this case, the provider charges a non-qualified rate of 3.90% + $0.30 for every transaction, so their margin amount can essentially be different every time.

For our sample transaction, the total transaction fee will be $1.275, and $0.4255 of that will be the payment provider's margin. For tiered pricing using the non-qualified rate, the fee will be $1.275 for every $25 transaction; it's the margin that's different.



Here's a breakdown for how we arrive at the margin for this transaction:

Margin = **[Total transaction fee]**
- [interchange fee]
- [network & processing fees]

Next, we'll plug in the formulas to determine each of these amounts for this $25 transaction:

Margin = [($25.00 x 3.90%) + $0.30]
– [($25.00 x 2.50%) + $0.10]
– [($25.00 x 0.14%) + $0.0195 + $0.07]

= [($0.975) + $0.30]
– [($0.625) + $0.10]
– [($0.035) + $0.0195 + $0.07]

= [$1.275]
– [$0.725]
– [$0.1245]

= $0.4255

From the merchant's perspective, here's how the effective rate—the percentage of each transaction the merchant ultimately pays in fees—looks using the same transaction amount across different types of card and transaction types within a tiered pricing model.

	Visa Consumer		Visa Rewards		Visa Signature		Visa Debit	
	Card Present	Card Not Present	Card Present	Card Not Present	Card Present	Card Not Present	Card Present	Card Not Present
Total fee	$0.925	$1.275	$1.025	$1.275	$1.275	$1.275	$0.925	$1.025
Effective rate	3.70%	5.10%	4.10%	5.10%	5.10%	5.10%	3.70%	4.10%

Pros of tiered transaction pricing:

- **Easy to understand for merchants,** although providers might need to provide some education about the different tiers and how they're determined.
- **Maximum opportunity to enhance margin** with interchange optimization.

Cons:

- **May be more expensive** for some merchants.
- **Less visibility** into the breakdown of merchant fees, which means that some actors could abuse it to take advantage of merchants.
- **Price increases are required to maintain the same margin** if costs increase, which may cause attrition.

**Note: A detailed discussion about the different interchange rates and network and processing fees charged for different card and transaction types are outside the scope of this paper. The examples given are fairly representative of the given types, and we made some assumptions for the sake of simplicity. It's important to reiterate that you'll be able to get a sense for the fees and rates for the card and transaction types that are most common among your own merchant portfolio.*

Think strategically to get the most from your payments

Embedding payments within your platform makes you more competitive to your customers and prospects. But it also presents you with a separate sustainable and recurring revenue stream that boosts your business fundamentals.

Taking steps to optimize your payments offering with a solid pricing strategy and robust sales and marketing efforts enables you to get the most value from that revenue stream.

The experts at Infinicept can walk with you through your unique position and help you understand how to best use merchant pricing and marketing strategy to get the most from payments on your own platform. Contact us to get started.

ABOUT INFINICEPT

Infinicept is a FinTech company that provides payment solutions for software companies, payments companies, and financial institutions, no matter where they are in their payments journeys. Its Launchpay program allows software companies to monitize payments today, while having the freedom to grow and scale their payments program tomorrow. Its PayOps software-as-a-service (Saas) platform offers underwriting, onboarding, and merchant management solutions that allow companies to have total ownership of their payments strategy.

By embedding payments into their products, Infinicept enables companies to exponentially amplify growth and increase revenue by tapping into the $585 billion embedded finance marketplace. More than 300 leading software companies, payment processors, sponsor banks, and others rely on Infinicept to help them transform to the new era of software-led payments.

Ready to have control over your payments program? Talk to an Infinicept payments expert to learn more about the payment facilitator model and how to get started.