



# 60 YEARS OF CREDIT CARDS

The industry's state of affairs

By Professor Arturo Bris - February 2010

IMD

Chemin de Bellerive 23  
PO Box 915,  
CH-1001 Lausanne  
Switzerland

Tel: +41 21 618 01 11

Fax: +41 21 618 07 07

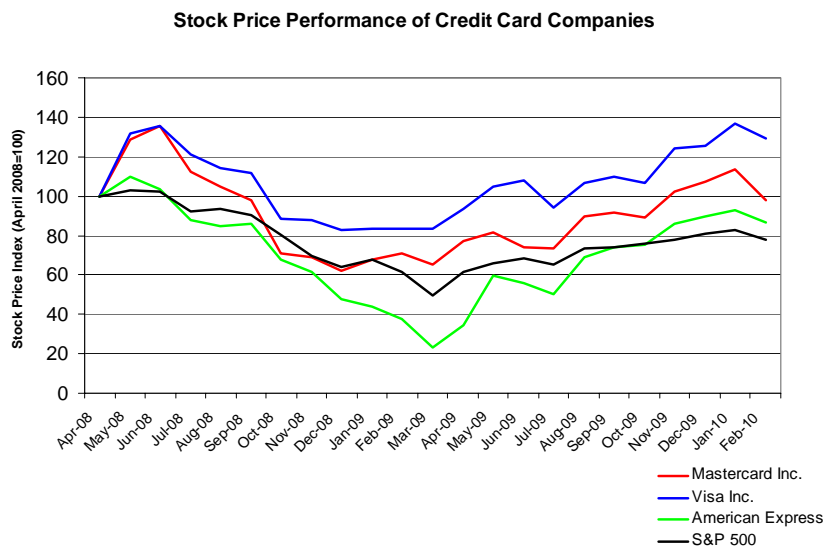
info@imd.ch

<http://www.imd.ch>



## 60 YEARS OF CREDIT CARDS | The industry's state of affairs

Back in February 1950, the first Diners Club credit card was unveiled. The Diners Club card, used mainly for travel and entertainment purposes, became the first credit card for widespread use and eventually changed the way consumers make purchases. Sixty years later, what are the state and the future of the credit card industry?



Despite the 2008 downturn being a credit crisis, not much has been said about credit card companies and their role as capital providers to individuals and households. Banks were the culprits, but also the victims of the largest drop in stock market indices in decades. Yet, the stock price performance of credit card companies which are publicly traded (American Express, Mastercard and Visa) has been impressive. Since April 2008, with the S&P 500 index losing almost

33% on a cumulative basis, all three companies have out-performed the market with respective total returns of -2%, +29%, and -14% respectively (see the graph). The case of Visa is exceptional, as it went public in March 2008, so part of its stellar performance can certainly be attributed to its market debut.

The market performance of credit card companies is not surprising. While the reduction of interest rates resulting from the recession has allowed financial institutions to lower their borrowing costs and therefore to emerge almost harmless from the crisis, individual consumers and households seem to have not enjoyed such a favorable environment. Indeed, Visa's Net Operating Income in fiscal year 2009 was \$2.0 billion, up 13% from the previous year. Competitors have not fared so great, but the outside perception is that the easy credit that financial institutions enjoy has not been transferred to households. Not to be forgotten is that credit card companies are typically owned / controlled by large banks. For instance, JP Morgan Chase is the largest shareholder at VISA, and Diners International is a fully owned subsidiary of Citibank.

How do credit card companies operate? Any credit card transaction involves — in addition to the cardholder and the credit card company — a merchant (let us say a retail store), the cardholder's bank (also known as the issuer in the industry), and the merchant's bank (the acquirer). A credit card company is only a network of processing services, by which issuers

and acquirers transfer payment from the cardholder to the merchant. In the process, merchants pay fees for the payment processing, and cardholders pay interest on their credit card balances.

This is a very profitable business model, but it would be a mistake to assume that credit card companies issue credit cards. Nor do they determine the rates they charge to customers, or the fees that merchants pay to acquirers. Visa, Mastercard and AMEX make money from fees that issuers and acquirers pay. Such a profit generating system translates into an atypical balance sheet structure. Mastercard for instance is a \$6.4 billion company (at the end of 2008), of which \$4.3 billion are cash and other liquid assets, \$700 million are intangibles, and \$500 million deferred income taxes. On the right hand side, the company has virtually no debt, and it is financed mostly by current liabilities, and \$2.0 billion in equity. Visa is even impressive, with \$20 billion in intangibles out of a total size of \$32 billion, of which \$8 billion are liquid assets.

Who would not want to invest in companies like these? They are swimming in cash, are extremely profitable and can sail through a financial crisis by transferring their interest rate risk to customers, issuers and acquirers. Since its IPO in 2005, the cumulative return on Mastercard stock has been more than 500% (even taking into account the 2008 financial crisis!), which is equivalent to a 38% annual return.

Well, unfortunately if there is something that credit card companies do not need, it is investors. They are rich, do not need to finance heavy capital investments, and their largest owners are banks, which are indeed happy capturing most of their profit. It turns out however that Mastercard did go public, as did Visa in 2008. Their reasons were however non financial. Mastercard had a severe problem of image: in 2004 Forrester had published a survey where hundreds of customers were asked to "*indicate your level of trust in ads for the following type of products.*" About 69% of respondents said that they completely trusted ads by retail companies, for instance. However, only 21% said the same for credit card companies, which ranked the worst in a list that included movies, consumer electronics and autos. Mastercard solved its problems by going public, earning a great reputation through its aftermarket performance and... by putting most of the money raised in the IPO in a foundation.

Visa followed suit, essentially after witnessing the amazing performance of the Mastercard stock. But also for its owners to cash out (remember we did have to endure 2008) about \$19 billion, Visa had to create an escrow account that would cover litigation (some \$3 billion) started against the company by Discover and Amex, among others.

So despite the stated intention of these two companies to use IPO proceeds to create a foundation (Mastercard) or pay for lawyers (Visa), their public offerings were among the most

successful of recent years (Visa's is indeed the largest IPO in the US to date). The market, that is forward looking, cannot be easily fooled.

What would happen though if, as some commentators say, the next financial crisis is a personal credit crisis? First of all, such a crisis seems now further away than ever. With low-interest rates and social pressure, a household credit crisis would be the last event that any government could now afford. Additionally, I hope this article clarifies that it would not be the credit card companies that would suffer the most — they are cash shielded, do not get directly impacted by the default of the final customer and are owned by banks, which are by far healthier than two years ago.

Following the launch of the first credit card 60 years ago, there is little reason to doubt that it will continue to thrive and be a part of our every day lives for the decades ahead.

*Arturo Bris is Professor of Finance at IMD. He will direct the "News Ideas in Corporate Finance: Addressing Financing Gaps" stream during Orchestrating Winning Performance (June 20 – 25, 2010).*

*He also directs the Advanced Strategic Management program and teaches on the Program for Executive Development as well as the Strategic Finance and Building on Talent programs.*

## RELATED PROGRAMS



### **ADVANCED STRATEGIC MANAGEMENT - <http://www.imd.ch/asm>**

Driving sustainable business results

Program Director Arturo Bris

- For executives taking on new and significant leadership responsibilities, who are looking to sharpen their analytical skills and strategic leadership effectiveness – as business-unit, region, division, function or country leaders
- Prepare to boost performance at individual, team and business-unit levels
- Ensure that your organization is keeping ahead in a constantly changing business environment



### **ORCHESTRATING WINNING PERFORMANCE - <http://www.imd.ch/owp>**

The global business program for individuals and teams

Program Directors Bettina Buechel and Seán Meehan

- For individuals and teams who seek the latest management thinking and practical, innovative solutions for their business
- Anticipate global business trends
- Boost your performance, broaden your perspectives and expand your global network
- Design the program that suits you