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Credit Card Killer

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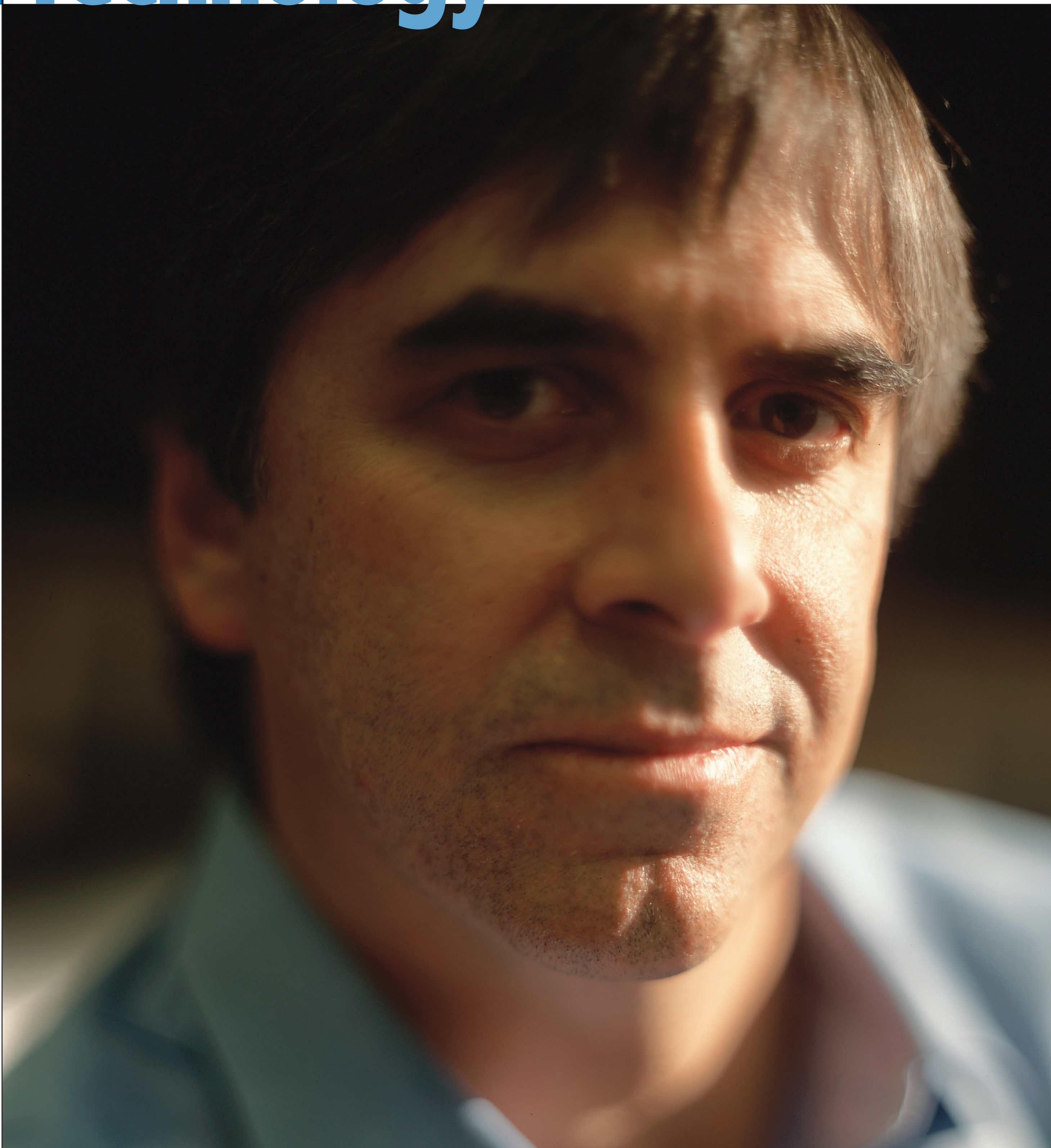
Technology



DAVID DEAL FOR FORBES

E-COMMERCE

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YOU'D BE A FOOL TO TRY TO get in between Visa or MasterCard and their merchants. Visa handles $3 trillion in purchases worldwide each year, has 1.6 billion cardholders and 24 million locations willing to take a swipe. The two card associations battled Wal-Mart, the Limited, Sears and 1 million other retailers for seven years in court over alleged price-fixing of card fees. The plaintiffs settled for $3 billion. No big deal: Banks issuing Visa cards take in $30 billion a year in transaction fees and the card companies jacked up their rates to compensate.

But here is Gary Marino, a 50-year-old entrepreneur, lacing up his gloves against the heavyweights. His company, I4 Commerce in Timonium, Md., is out to displace credit cards as a means of paying for goods online. Best of luck: So far it has taken him five years and $100 million in venture backing to persuade 2 million shoppers and 300 online retailers to try him out.

Marino knows how to pick a fight. While e-commerce has boomed over the past decade—$100 billion spent online by U.S. consumers in the past 12 months—it amounts to only 2.6% of the $3.9 trillion in U.S. retail sales. Only 54% of U.S. adults who use the Web have bought stuff there, according to 2003 census data. Blame slow broadband penetration, security fears and the hassle of having to rummage for a credit card when it's time to check out. Half of all online shopping carts are abandoned at checkout and half of 5,000 Web users polled recently by Gartner said they worry about data theft.

Yet online sales are growing 25% a year. "That's not good enough," says Marino. "E-commerce should be growing 50% a year. We're going to help it get there."

I4's service, called Bill Me Later, is the Internet-age equivalent of asking the neighborhood butcher to put the pork chops on your tab. Instead of using a credit card number at checkout, a shopper clicks on the Bill Me Later button and is greeted as if the service already knows him; it asks for the last four digits of his Social Security number and his date of birth. If their credit is good, I4 pays the merchant and sends the shopper a bill within two weeks. One can pay right away or later, with interest. You can pay your bill online through your bank or with a check by mail. I4 doesn't take Visa. Marino expects to process $1 billion in online purchases this year. His revenue from merchant fees and interest charges should hit $50 million by year-end and could grow to $100 million in 2007. Continental.com, Walmart.com, Shoes.com, Overstock.com and Ebags offer Bill Me Later.

As if taking on Visa and MasterCard weren't enough, Marino also must contend with big online brands such as PayPal and Google. PayPal started as a person-to-person payment option but now serves big merchants such as Barnes & Noble and 1-800-Flowers. PayPal (bought by Ebay for $1.5 billion in 2002) has 120 million customers and processed $35 billion in payments in the past 12 months, clearing $1.3 billion in revenue.

The new Google Checkout is not a Visa alternative, but it tries to make the payment process easier by automatically filling out shipping and billing forms. Google still uses your credit card to complete the purchase.

But even if a merchant goes with Google, Visa still has to be paid. Credit card issuers typically charge online retailers 2.5% to 3% per transaction, often twice what they charge real-world retailers for processing. (Sketchy e-tailers and porn sites can pay as much as 12%.) That gives Marino an edge: Bill Me Later provides the convenience and speed of plastic but charges only 1.5%.

"That puts pressure on Visa and MasterCard to lower their fees," says Brad Wolansky, head of e-commerce at Orvis Co., which sells $300 million a year of fly-fishing gear and apparel online and offline. "Before Bill Me Later there wasn't anything from a free-market point of view to keep the credit card companies in check."

Bill Me Later lets retailers extend to customers interest-free financing, something credit card firms don't offer. Orvis, for one, pays I4 a little bit more for such transactions, typically 3% of each sale. Why? Orvis' average order jumps from $150 to $250.

On Walmart.com's checkout page, Bill Me Later gets top billing of all credit payment options. Bradford Matson, head of marketing at discount luxury goods site Bluefly.com, says he launched Bill Me

Later's service a year ago and says it boosted his sales. Bluefly's customers typically shop three times a year at the site, but its Bill Me Later customers buy four times a year. Their average order value is also 15% higher.

Online buyers told Continental Airlines in surveys and unsolicited mail that they like Bill Me Later because it is more convenient than credit cards. A 90-day grace period frees up room on their credit cards for customers to spend more while on vacation, says Kenneth Penny, who runs Continental.com.

Marino is coming at the credit card industry with the experience of a former insider. He spent 15 years at Citibank, rising to chief credit officer. He left in 1996 to run the credit and marketing operations at First USA, then a small but fast-growing card issuer with $4 billion in receivables. Bank One bought First USA the next year, and Marino helped boost its receivables to $70 billion by 2000. He left that year—smack in the whorl of the tech bubble burst—to start a new business in the payment industry. "Even in a very senior position I felt paralyzed to innovate quickly," he says. "I felt stymied."

Marino consulted on a venture that sought to bill online shoppers via their phone bills, but it went nowhere. Marino decided it was a good time to hash out the raw outline of his Bill Me Later scheme with his old contacts at First Data Corp. and Chase Paymentech, which own the two biggest credit card processing networks for merchants.

He was asking to be let into what was traditionally a very exclusive club. The only payment processors then permitted on Paymentech and First Data's networks were Visa, MasterCard, American Express and Discover. So instead of trying to reinvent money like dot-bomb cash alternatives such as Beenz, Flooz and Cybercoin, Marino's venture would work just as easily as Visa and MasterCard, but at a lower cost to retailers. "We worked hard to fit the way the retailers already do business," Marino says.

"When he pitched me his idea, I thought, 'Whoa, this could be huge. If you're an Internet merchant, why wouldn't you want to use Bill Me Later?'" says Michael Duffy, chief of Paymentech, with $1 billion in annual revenue.

Bill Me Later's push-button simplicity masks layers of hard-core engineering. When a shopper clicks the Bill Me Later icon for the first time, I4 rummages through 30 million pieces of data in 11 public databases used by credit bureaus and utilities. I4 cross-checks your Social Security digits and birth date against the usual credit data as well as esoterica such as known fraudulent addresses and bank accounts.

After I4 scrubs the data of duplication and error, it adds the new shopper to its database. All told, the system took almost four years to build, at a cost of $11 million. Every subsequent purchase triggers I4's software to use complex mathematical techniques such as fuzzy logic and regression analysis to decide if a shopper is who he says he is, and how likely he is to pay his bills. All this happens in less than three seconds and costs I4 about $1 per inquiry. I4 makes money even after that cost because its average transaction is $215.

"Your systems have to be extraordinarily precise to make a smart lending decision in less time than it takes to swipe a credit card," Marino says. He claims that fewer than 2% of I4's users stiff on the bill, below the industry average.

Marino persuaded Paymentech to let I4 use its electronic railways in 2001. Paymentech's salespeople now pitch Bill Me Later as a service, which saves Marino the trouble. He has spent less than $10 million on sales and marketing in I4's five years of existence.

Marino then signed JPMorgan Chase, which owns 52% of Paymentech (First Data owns the rest), to underwrite his credit risk. That let Bill Me Later customers carry a balance at a credit-card-like 18% annual rate. In turn, I4 pays JPMorgan the prime rate plus a few basis points on these balances. (Paymentech has a small equity stake in I4.)

Marino launched his first test customers, Ebags and Baby Universe, in late 2002. I4 went through three versions of its credit software engine before it began selling the service in earnest in late 2004. It takes months to persuade a merchant to take on Bill Me Later, and it can take months more to stitch I4 into a merchant's own billing, accounting and fulfillment systems. Orvis required 1,300 man-hours of programming to plug Bill Me Later into its checkout process.

"We were cautious about getting involved with another payment type because it goes through the very heart of every transaction," says Orvis' Brad Wolansky. "Something like Google Checkout is different because you're still paying with Visa or MasterCard. With Bill Me Later it's actually a different type of payment."

Different will take time to catch on, but it may be what e-commerce needs. **F**

Swiped

Below are estimated fees a Web merchant would pay on the sale of this $1,790 Burberry tote. Bill Me Later has the edge.

Traditional Credit Card	Bill Me Later Purchase
–$40.50 goes to merchant's bank	–$27.00 goes to Bill Me Later
–$0.20 processing fee	–$0.25 processing fee
–$0.40 goes to Visa (brand license)	
$1,748.90 left for merchant	$1,762.75 left for merchant

Plastic Planet

Web shoppers spent $100 billion last year. Credit cards get almost all of the business.