



Beating Margin Compression

ISOs can compete without giving away the store. New study and tested wisdom point the way.

By Richard H. Gamble

Intense competition has driven down the prices ISOs charge for transaction processing and made margins painfully thin, an ailment that probably is chronic but not hopeless—and certainly not fatal—according to a new in-depth study from the ETA ISO Advisory Committee.

One key finding: Margin compression is not unique to the merchant acquiring industry. Rather, it occurs in most mature, market-saturated industries, especially those with low barriers to entry, notes Todd Linden, senior vice president of operations at National Processing Co. and chair of the ETA ISO Advisory Committee, which is preparing a white paper on the subject. “There are precedents that show how to combat it successfully—with technology, product development, sales strategy, and training,” he observes.

Payroll processing is one industry that has successfully met the challenge. “The market leaders there generally are the providers charging the highest prices,” says Linden. “But they continue to add technology and services that bring efficiency to their clients, who are happy to pay a little more to get a more efficient process. You can intelligently preserve margin when you increase the number and the value of the services you offer as a package.”

Using card processing as a foundation for creative, profitable packaging relieves margin pressure in two ways, Linden says. One is by taking an essential but low-margin service (transaction processing) and folding in several higher-margin products or services to increase aggregate margin. The other is to build stickiness through deeper relationships, which prevents ISOs from competing on price alone.

Defining ‘Margin’

The severity of compression is partially gauged by how one defines “margin.” While the margin for card transaction processing—the difference between the cost to provide a particular service and the price charged for it—is tightening, the gross



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profit margin of the ISO/acquirer/processor is looking healthy in some cases.

“The large acquirers still are reporting record profits,” says Marc Abbey, a partner at First Annapolis Consulting. Chase Paymentech, the largest and one of the most innovative acquirers, just reported a profit margin of 45-50 percent. “The search for higher profits is driving consolidation, and it’s working,” Abbey observes. “If you build revenue through acquisition and then drive down costs, you can really improve your profit margin.”

Most of that profit still comes from transaction processing. Chase Paymentech, for example, “sells the whole array of ancillary services, but it all starts with the Visa and MasterCard processing,” Abbey points out. “If they don’t get that, they don’t get the other business. They are as innovative as any big player, but the economics still are dominated by core processing. I’d estimate that 90 percent of their revenue comes explicitly from core processing or from immediate adjuncts to it.”

Abbey vigorously disputes the notion that transaction processing has become a commodity. “There are all kinds of market niches with different characteristics,” he argues. Some merchant segments accept higher than average pricing, he points out, and some segments show a huge standard deviation (range of prices above and below the mean price), while other segments show very little deviation.

For example, among large retail merchants that have gone through four, five, or six RFP cycles, the standard deviation is small and the pricing margins are tight. But among public sector acceptors and B2B acceptors that are relatively new to the card world, margins tend to be fatter and standard deviation tends to be loose. As a market segment becomes highly competitive, mature, and efficient, margins and deviation generally decline.

Rather than accepting transaction processing as a commodity, ISOs often fare better when they select an underserved market segment and then specialize in



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meeting the particular needs of that market, Abbey suggests.

And the penny-pinching characteristics of small merchants have been exaggerated. If an ISO can help solve a high-priority problem in conjunction with selling card processing, it will do better than if it tried to win that merchant's business with slightly lower pricing.

Getting Creative

Margin compression remains a nagging problem and one that has gotten worse lately, partly due to the economic downturn sapping normal business growth. "The experienced players always have a pricing floor, which determines how low they can go and still make a profit," says consultant Les Reidl, president of Speer & Associates. "But there are players who try to win business with irrational pricing, and that makes it difficult for everyone else."

"Irrational pricing" can be defined as pricing at cost or barely above cost in order to win business. Start-up ISOs sometimes do it to get started and then migrate to rational pricing. Some unethical ISOs, however, use irrational pricing to set disclosed prices at or below cost and make

money from undisclosed fees. This threatens established ISOs, at least temporarily, because these start-ups use the low prices to poach accounts.

The large merchants, which account for 90 percent of card transactions, have been the target of fierce pricing competition, subjecting ISOs to "tremendous pricing compression," Reidl says. The middle market used to be the sweet spot for many ISOs, but the pricing compression has spread to the middle market as well, he reports. "The large acquirers, the smaller ISOs, and even the value-added resellers are slugging it out in the same market. You can even go to Costco and buy a terminal off the shelf now, and you can go online to find the lowest prices," he explains.

Nevertheless, besides packaging processing with higher-margin complementary products or services, ISOs can improve profit margins by emphasizing service and relationship management. Small merchants need service and don't necessarily care about all the latest bells and whistles or even rock-bottom pricing.

"If they know you and like you, and if you give them reliable service and cultivate a relationship, they'll stick with you and gladly pay a small pricing premium

for the peace of mind you bring them," Reidl says. "You'll win out over the guy who is in and out with the fancy terminal. Providing good service is the low-hanging fruit for many ISOs."

Another tip: Renegotiate with your processor. Processors are also responding to greater competition with lower prices, so if you haven't renegotiated in the past year, you may not be getting the best rates.

Also, learn not to repeat old mistakes. Offering free terminals started out as a way to win business while charging higher transaction prices, and it worked for a while, Linden points out. Then more ISOs and processors started offering free terminals and lower prices, and pretty soon ISOs faced the same old pricing compression without revenue from terminals.

Beating margin compression requires fresh thinking about sales strategy. While sales compensation has not changed dramatically, a perceptible shift has occurred with more focus on relationship-driven sales. **TT**

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