

COVER STORY

By Lisa Dowling



What Lies Ahead?

Industry Experts Weigh In With Predictions for the Year

In the poignant words of John Lennon, “Life is what happens to you while you’re busy making other plans.” Many plans, policies and strategies were made in boardrooms across the industry this past year. What happened on the street while those plans were being formulated? And what’s likely to happen in 2008?

To get answers, *Transaction Trends* spoke with some of the industry’s leading players. All were keen to talk about what the new year may hold.

Data Security

When it comes to PCI compliance, Robert Carr, CEO of Heartland Payments, admits that the industry has become more serious about protecting card numbers from data thieves. But the current plan to deal with the main problem still is woefully inadequate.

“I don’t understand the theory behind allowing POS developers to charge \$15,000 to \$25,000 to upgrade non-compliant systems that were sold as

recently as 12 months before by their very own approved dealers,” says Carr. “Some POS developers and dealers look upon data security as a new profit center when they are the very ones who’ve created the data security problems in violation of the rules to start with! I don’t get it.”

Carr is eagerly awaiting Visa’s IPO, which will place Visa in the public arena with MasterCard, Discover and American Express. He sees MasterCard and Discover having become even better partners as public companies and predicts Visa will follow suit.

A big change he predicts for 2008 is the expanded role of third-party processors in handling Discover and American Express transactions.

“These changes are going to make life much easier for merchants accepting these cards and, in my opinion, are enlightened moves by these companies.”

Holli Targan, partner in the law firm Jaffae, Raitt, Heuer & Weiss, says security was an important issue in 2007. “As predicted, security breach was a big

deal in 2007 and it will surely continue in 2008,” Targan says. “In 2006, it was novel. In 2007, it was prevalent and therefore on the top of everyone’s mind, not only with industry players but also with card associations and how they tried to control it.”

Targan had predicted that there was going to be an evolution of the way card associations police the industry.

“That is a longer-term prediction but I believe we will still see it happen,” she says. “They’ve started to address more directly the way business is being done and that is a good thing. They have set the stage for change and have told the industry about it. Visa has already announced new payment application security mandates that run through 2008 into 2010. They have set specific things that acquirers are going to have to do and pass down to merchants. The card associations are delving even more into payment systems to insure everyone is covered and that will impact us all in 2008.”

Kurt Strawhecker, co-founder and managing partner of The Strawhecker Group, said last year that PCI compliance would dictate the tone and he was right on the money. His prediction for 2008 is even more decisive.

"Nothing had a bigger impact in 2007 than security breaches, as evidenced by the number of fines announced," says Strawhecker. "The real issue is compliant software, and ISOs need to determine if the systems their merchants are using are compliant. PABP—Payment Application Best Practices—was introduced in July 2007 and acquirers across the

too high a hurdle and the investment is just too great."

O.B. Rawls, a former senior vice president of International Sales for Hypercom, opened his own consulting firm, Transmark Advisory Services, which focuses on the international community.

"In terms of transaction growth and volume of terminal sales in Central and Eastern Europe, Brazil and Latin America, we did see remarkable growth," says Rawls. "I believe 2008 will continue to be robust because foreign currencies remain strong against the dollar. We'll see increased growth

M&A

Targan is seeing companies showing marked interest in acquiring viable merchant portfolios as opposed to complete buyouts. That speaks of the continued need for scale in the industry.

On the flip side is the deterioration of sponsor banks willing to play ball with ISOs. Targan sees it remaining a challenge in 2008.

"As we saw in 2007, the smaller ISOs and acquirers will continue to have a hard time finding sponsor banks directly," says Targan. "That means they won't be able to negotiate favorable terms. On the positive side, mid-tier players are attracting those smaller ISOs in droves. Smaller acquirers might have gone directly to the large institutions in the past, but they're not servicing them well and those small organizations are not willing to do deals with the major players anymore. That's great news for the mid-tier companies in 2008 who are gearing up to provide that much-needed servicing.

Targan also saw experienced industry veterans starting their own companies, and expects the trend to continue.

"They bring a fresh perspective and greater knowledge to new companies with new products and new business strategies," says Targan. "I predict it will continue because it is working. It's hard to get away from the industry once you are hooked. It is what you know and love—and they want to go at it again. The big question is the overall economy and the impact it will have on card volume as well as availability of credit and capital. I do believe we will see a continued evolution of the industry and forward movement."

Strawhecker predicted a new wave of acquisitions with acquirers.

"As far as seeing mergers and acquisitions for the next band of large acquirers, I was right and wrong," says Strawhecker. "KKR got First Data, Blackstone got Alliance Data, Cynergy Data acquired Abanco so we did see a consolidated mass for some companies. I don't see another big acquisition like First Data in 2008 but I still hold with

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—Ellen Hudec, Sterling Payment Systems

board must determine what version of software their merchants are using in 2008.

"There's a gaping hole in PCI compliance at present," Strawhecker continues. "Merchants are using outdated, noncompliant software. It has become a thorn in every acquirer's side. Even if most know what applications their merchants are using, very few know which versions. In 2008 we are going to see a very expensive push by acquirers to find out what versions are being used because they could be liable for the fallout."

International Markets

Targan predicted that the international market wouldn't have a great impact in 2007 and, except for the major players, it really didn't. Will that hold true in 2008?

"I don't see a lot happening in the foreign space for the most part," says Targan. "The bigger players are going overseas but for the littler guys, it is still

in the "BRIC" arena—Brazil, Russia, India and China. What we will see in 2008 are smaller countries of cash societies wanting to create a taxable base of revenue for themselves and that will be done through credit and debit transactions. That need to build an economic driven tax base will certainly continue to drive international growth in the coming year."

Cash Advance

"One phenomenon that began to catch on mid-year and will certainly continue to grow in 2008 is cash advance," says Rawls. "Merchants are using revenue streams to create business loans. That's the biggest thing that came out of 2007. I'm amazed at it. Who anticipated that it would be so successful? It's creating revenue streams for salespeople and processors. It will probably become a new standard in 2008 and, at some point, it may face some regulatory issues because of the high interest rates."

medium players that we'll see activity in 2008."

"Because 2007 incurred a credit crisis and a big change in the debt market, there was a temporary impact on mergers and acquisitions," says analyst Marc Abbey of First Annapolis. "My expectation is that we will return to a period of increased consolidation in 2008. Remember, the top 10 acquirers are private equity owned and those investors are not in for the long haul ... and the possibility of a recession is looming."

The Economy

While Rawls sees cash-advance products offering the biggest opportunity in 2008, he believes what presents the biggest challenge is the economy. And no wonder. The dollar dropped 10 percent against the euro and 6.4 percent against the yen in 2007.

"Who knows if the economy will tank in 2008 but one thing is for sure and that is that America is a land of consumers," says Rawls. "Transactions will continue to grow as debit will be used more. And, if consumers get in trouble, they'll turn to their credit cards. While the coming year may not be good for the overall economy, it will probably be so for acquirers. Ours is a simple business that requires attention to detail, forethought in the market and focus on cross-selling. For most participants in our industry, 2008 will be a good year."

Carr anticipated increased revenue and growth in 2007. He predicted that private equity funding wouldn't last, that the movement of Visa toward an IPO would bring transparency and that growth would come from the marriage of open- and closed-loop systems. He anticipated that the transition from dial to IP would increase substantially and PCI compliance would continue to be the biggest challenge.

"The economy held up pretty well far into 2007, but then fell off a cliff during the holiday season," Carr says. "The good news in this business is that this means merchants will take the time to better understand what they are paying for processing and make a

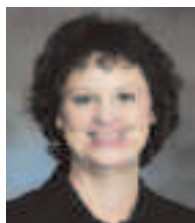
change, if they believe they will save a reasonable amount of money in the long term."

Regarding his view on private equity funding, Carr sees those investments becoming more mature in 2008 as many have learned that the acquiring business is not as easy as it looks.

"There have been some significant successes for private equity firms but there have also been some unmitigated disasters," says Carr. "I believe we will continue to see new monies come into the industry and that competition is

the playing field, but that field has changed.

"The overall numbers show that the industry is now highly connected to retail sales growth, more so than in the past," says Abbey. "As the economy hits a down cycle, acquirers will struggle for growth and that has unpredictable results. Exit decisions will be triggered. Intensification of competition will be triggered. Some acquirers will emerge on the other side having benefited from it. Others will emerge losers. It is both a good and bad scenario for



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—Holli Targan, Jaffae, Raitt, Heuer & Weiss

going to continue unabated for many years. Sometimes this money comes in supporting wacky business models that have little chance of success. That seems to be part of capitalism in America and I suspect that the long-term players will have to accept this as fact in the business environment for some time to come."

Abbey predicted for 2007 increased competitiveness, continued interest by venture capitalist, increased maturation of the business and innovation.

"Most card companies agree [2007] wasn't a year of great change, but there was a degree of increased intensity," says Abbey. "I do believe it will continue, but one of the things that may occur in 2008 is a recession. There will be cyclical factors impacting the acquiring business and it will certainly become a more adverse environment."

Abbey believes that the economic environment of 2008 will affect acquirers. He points out that the recessions of the '80s and '90s really didn't impact

2008. Anything and everything is possible and I am optimistic about the coming year."

Strawhecker shares Abbey's positive outlook.

"Regardless of the possible recession facing us in 2008, ours is a resilient industry and even if some prognosticators are looking at an economic downturn, our industry is still going to grow at a rapid pace," he says. "It should prove to be an exciting year, so buckle your seatbelts."

Customer Service

Rawls predicts the big boys will start focusing more on relationships rather than just revenue. And no matter what your size, prepaid, rewards and cash advance programs need to be a part of your 2008 tool kit.

"Look at First Data and their enhanced focus on maximizing customer relationships, growing existing relationships by selling multi-app services and incremental transaction growth," says Rawls. "I predict this

trend to really take hold in 2008 as it will make it harder to poach customers. Everyone is going to jump on this bandwagon. Acquirers are also figuring out that prepaid is the way to go, rewards programs are starting to grow and merchants are being tied to processors through multiple services. ISOs can't afford to let companies like AdvanceMe and First Funding get a hold of their

market," says Abbey. "Companies like Intuit and Mercury Payment Systems primarily focused on integrated solutions and competition was revolutionized because of this trend in 2007. It is clear that they will become more prevalent in 2008 and possibly dominant within the next decade. IP also saw movement but like most things in this business, it doesn't turn on a dime and

"I am still maintaining that new integrated type of solutions will certainly grow in the coming year, such as ISOs using integrated payment solutions within broader business software packages," says Strawhecker. "2008 will see a change in the selling proposition of some acquirers because of less reliance on feet on the street and a desire to get closer to the end user. We will see more direct contact."

"In 2008, I wouldn't be surprised if we see a few in-house processing programs announced."

—Kurt Strawhecker, The Strawhecker Group

merchants so we'll probably see more starting in-house cash advance programs in the next year. If you lose the primary basis of your relationship with your merchant, you'll have nothing."

Rawls believes value-adds will continue to increase penetration and make an even bigger impact in 2008 as they did in 2007. It's all about stickiness.

"Attrition is probably the largest single expense in any portfolio, so ISOs will need to sell every service they can in 2008 to lock their merchants in," says Rawls. "Merchants are starting to become smarter. They used to be the poorest consumer in America when it came to what processing services they bought. They didn't shop around and everyone had different models. Merchants saw it as a necessary evil and not a tool to improve their business. Now they are starting to understand that multi-apps and value-adds offer opportunity to leverage their customer base."

Abbey saw smaller companies bringing new concepts and energies to the marketplace in 2007, with integrated solutions being the buzzword.

"We did see growth in integrated solutions as more acquires focused on that

won't replace dial overnight. 2008 won't be revolutionary for IP but we will see dial losing market share to IP."

Alternative Payments

Carr believes that as more and more non-payment entities figure out how to dip their hands into the recurring revenue streams of small and mid-sized merchants, the amount debited from the merchants' DDA will become very high relative to the actual cost of processing.

"I believe the merchant community is becoming more and more knowledgeable about the acquiring business and that the cost per transaction over interchange will come down due to the competitors who have a competitive advantage with fewer hands in the revenue stream and more efficient platforms," says Carr. "Interchange increases are not the problem for small and mid-sized merchants so much as surcharges on top of non-qualified transactions. The financial engineering in our industry is nothing short of breathtaking."

Strawhecker predicted a conducive environment in 2007 that would bear witness to growth in new distribution channels as opposed to traditional methods.

Contactless

Rawls predicted in 2007 that wireless would take off and that contactless would depend on whether banks would promote and issue the cards.

"Despite some movement in 2007, wireless is still a niche product in the U.S. because landlines infrastructures are still affordable and reliable," says Rawls. "More wireless products may have sold this past year, but it didn't set the world on fire. There are probably about 200,000 wireless terminals in use as compared to 6 million landline terminals. There's just not a great need for it yet. I don't see any pronounced movement in wireless for 2008 in the U.S. Outside the U.S.—absolutely."

Rawls sees the same scenario for contactless. No one issued cards. No one really promoted it. He poses a good question when he asks why merchants would build an infrastructure to support contactless unless there are cards to utilize it.

"We were fooled with the predicted advent of smart cards and the same holds true for contactless," says Rawls. "It is a solution looking for a market. Contactless works. It's safe and secure but not ubiquitous and won't be for a while. There will have to be a demand at the countertop for it before we'll see any impact."

Strawhecker believes emerging alternative payment solutions will see unprecedented growth in 2008, driven in part by the younger consumer groups, which are technologically driven. Mobile payments may very well be the trend to watch in 2008.

Trends

Strawhecker predicted in 2007 a movement toward bringing processing in-house. A year later, he admits there were not the big conversions as seen in previous years but that there is activity just around the corner.

“What I sense and hear anecdotally in speaking with major acquirers is that the number of companies considering this move has increased and they are seriously looking at in-house options,” says Strawhecker. “In 2008, I wouldn’t be surprised if we see a few in-house processing programs announced.

“But they may not be fully operational in the coming year as it is a relatively long process,” he adds.

As for innovation, Abbey points to the rapid emergence of cash advance and the emerging success of products like Google’s Checkout, BillMe and PayPal shaping the future of the

industry. What can we expect to see in 2008?

“Anything that will take us off in a different direction,” says Abbey. “I don’t know of anything specific that has that potential in 2008. There’s a lot of little innovation in payment products and some are falling on hard times. They may be collectively important but they won’t represent a changing path.”

Abbey also predicted Visa and MasterCard would adopt new strategies and set a new tone for the bankcard business.

“That didn’t become apparent in 2007 but I still think it is possibility in 2008,” says Abbey. “As Visa heads towards its IPO it will become a different company and new strategies will emerge. It’s hard to know what the next year holds and whether it will constitute a departure from current strategies. If I were sitting in their

headquarters, I might make different decisions based on the current market dynamics.”

As for emerging product trends, Abbey believed that stored-value apps and Check 21 as holding promise in 2007. Did they make good on that promise?

“Check 21 did not make a major impact in 2007, while prepaid had high growth rates and will be extremely interesting and exciting in 2008,” says Abbey. “Prepaid is still small in the large scheme of things, but some have real legs. Another area to watch in 2008 will be ACH. There are a number of payment services that are being created with ACH being the underlying platform. We’ll surely see continued innovation from that community in the next year.” **TT**

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