



Defining Values

Solid growth, low attrition, and predictable revenue streams fuel high-value portfolios

By Lisa Dowling

Creating value in a declining economy is a challenge facing ISOs everywhere. But in the bank-card business, what comprises a strong portfolio?

Stable, recurring revenue is the most important component of an ISO portfolio, according to Bob Carr, CEO of Heartland Payments. But he doesn't necessarily see an industry standard that works for all portfolios.

"As with all things, it gets more complicated the more you dig into it," says Carr. "Is the portfolio for sale? Is it static, or are you valuing the sales organization that comes with it? If it is a bank, is there an ongoing relationship for lead generation? A bank portfolio with a contract for several years with continuing partnerships is worth a whole lot more money than one held by an ISO trying to raise money and keep its sales organization together."

Joe Kaplan, CEO of Innovative Merchant Solutions, defines the value of a portfolio by a combination of things. First, it must be growing and offer a durable advantage. In other words, it must possess a sustainable and strong infrastructure. It also must possess an effective marketing model that reflects the current industry standards. Without one, it is difficult to maximize value. Every portfolio holds value, in varying degrees, says Kaplan, but he deems portfolios with high attrition rates as the ones with the least value.

"I don't know if there is an industry standard per se, but a buyer will pay more if you can predict the revenue stream," says Kurt Strawhecker, co-founder and managing partner of The Strawhecker Group. "A lot falls under how you do that and if the revenue predicted is sustainable."

The basic components for such predictions can be found in the history of the portfolio itself. To demonstrate established value, it is critical to have an organized history that shows ratios of

revenue to sales, maturity of the portfolio, and an established history of merchants. Strawhecker likens it to how Wall Street places a high value on dependable growth, quarter after quarter, with no surprises. Buyers in this industry want the same things: solid growth, attrition no higher than the industry standard of 15 percent, and predictability.

Hard Numbers

The dollar amount ascribed to a portfolio can vary widely. Carr has seen values range from six times the monthly residual to more than a hundred times. The differences can be attributed to the buyers and what they are trying to get, he says.

"If the buyer has complete control over whether a portfolio can be sold, and he knows the seller is desperate, that brings down the value," says Carr. "When the country was in better economic shape, buyers wanting to get into our industry were willing to pay outrageous amounts of money because their only entry point was buying a portfolio at a high valuation. That's no longer happening."

Some people use net earnings to put a dollar amount on portfolios, says Strawhecker. Net earnings and dollar value are used to compare different deals and are a result, rather than an actual calculation, of the value of the portfolio. Instead, he believes value is determined through cash flow analysis and discounting future earnings.

Kaplan, on the other hand, argues that you can put a dollar amount on a portfolio when it is losing merchants. "You can start at maybe 20 percent attrition and then it is easy to figure out what it is worth," he says. "There's not a whole lot of thinking involved. It's more of a mathematical equation."

Building Value

To put together a portfolio with value, ISOs must be mindful of three important aspects: strong relationships with mer-

chants, diversification, and a solid financial management plan.

To build relationships, Carr and his team at Heartland have a simple piece of advice—sign up merchants and keep them. The quality of merchants is a critical factor in adding value to a portfolio. It's important to know what the likelihood is that the revenue stream will continue with the merchants you choose.

"The better job you do signing high-quality merchants and keeping them, the more your portfolio is going to be worth," says Carr. "Understand how your sales agents play into it. If you're going to sell your entire company, agents become extremely valuable. When buyers acquire organizations with the sales agents as well as the portfolio, they expect growth, not a static portfolio that has no chance of expansion."

Kaplan recommends putting together a diversified portfolio with the least amount of potential attrition.

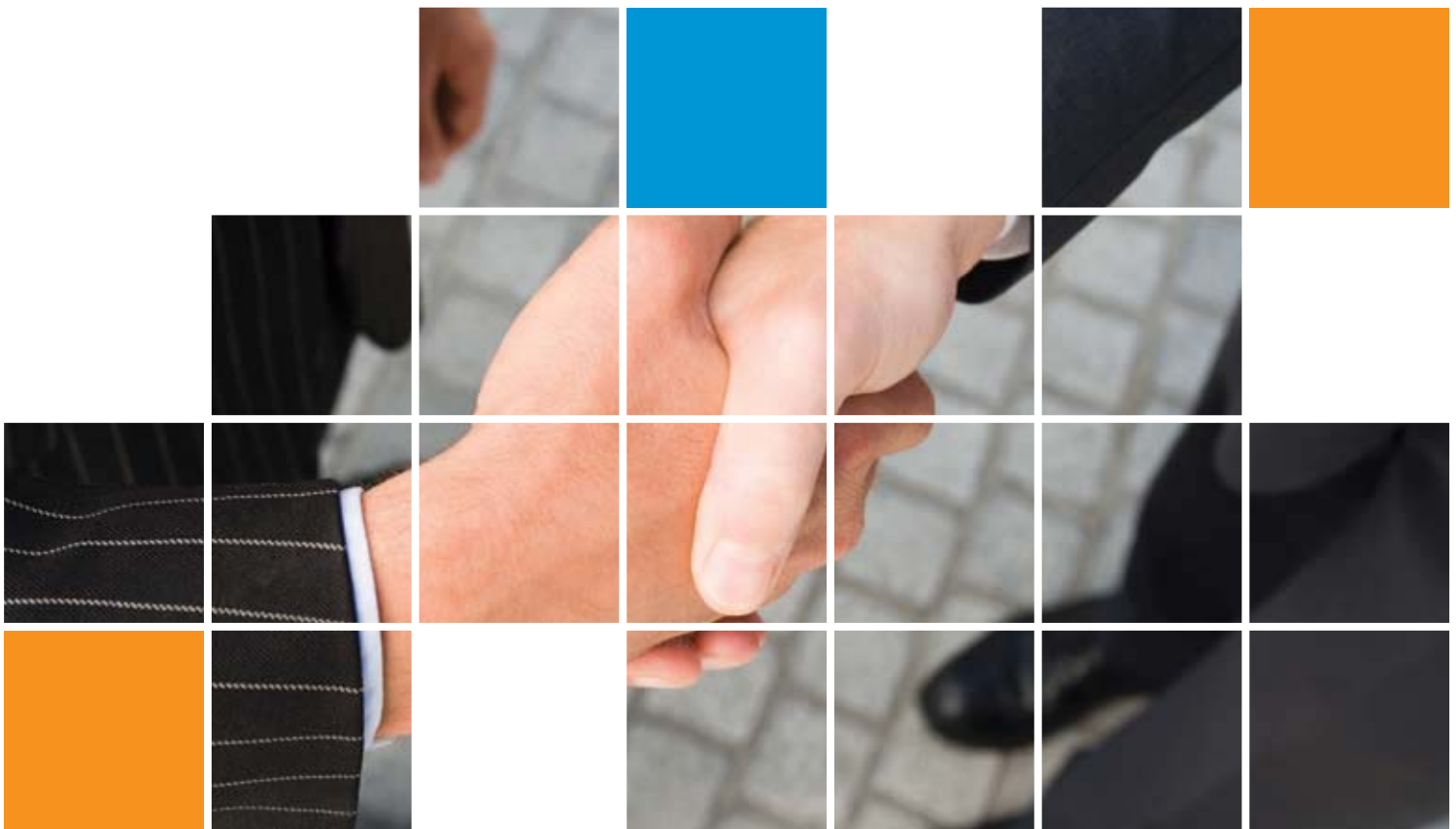
"Some buyers look for specialty portfolios, so you can put together a specific portfolio that attracts a few buyers, or you can have a portfolio with a broader base and dispersed risk," says Kaplan. "Too much of anything is not a good thing. The most alluring portfolios are geographically spread out with volume and risk in no singular concentration in any one individual group."

Strawhecker concurs with Kaplan. He advises his clients to avoid having 80 percent of their profits in the top 5 percent of their merchant portfolio.

"Stay away from certain verticals, and you certainly don't want the same type of merchants in your portfolio," advises Strawhecker. "Should a recession hit that particular type of business, it could wipe out your entire portfolio. Be aware of not having all your merchants in the same ZIP code as well."

In addition to losses, high-risk accounts, and attrition, not having clear financials, documentation, and a historical

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view of the portfolio will likely lead to devaluation.

“The single biggest thing an ISO can do is get an outside accountant to do your books so you have a clear record of the business,” says Strawhecker. “Once you have that record, you need to show a consistent earning pattern. If there is a lot of variation in the portfolio history, that will devalue it. If your pricing trend is either accelerating or decreasing, it will raise questions.”

Carr says that in the merchant acquiring business, you have to have a strong portfolio. “I did a reality check on this topic recently and the valuation of portfolios is still high despite the current credit crunch. There are willing buyers out there, and now may be a good time for those who want to take some money off the table.”

“Without a valuable portfolio,” says Kaplan, “you may live but you’re going to have to fight for it.” **TT**

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Portfolio Valuation in a Recession

By Richard H. Gamble

The criteria for determining how much an ISO portfolio is worth have not changed, but the assumptions buyers put into their return-on-investment formulas are changing to reflect the troubled economy. “The key numbers that would-be acquirers are plugging into their valuation models are being adjusted for an apparently worsening recession,” reports Greg Cohen, president of the USA group at Moneris Solutions. Portfolio buyers assume that merchant attrition will be higher in a recession, he notes.

For ISOs that want to sell, this can be bad news. “You can’t expect the same multiple another ISO got a month or two ago,” emphasizes consultant Kurt Strawhecker, managing partner of the Strawhecker Group. “Nobody will buy at that price today.” For the acquirer doing due diligence on an offered portfolio, there are many value components, but inputs, such as anticipated merchant attrition and declining merchant sales volume, will be adjusted according to how deep a recession we face, he observes.

Acquirers will look closely at ZIP codes and SIC codes. A portfolio heavily concentrated in the Detroit market, for example, will be devalued accordingly,” Strawhecker says. Diversified portfolios will hold their value better than portfolios concentrated in one industry or geographical region, he adds.

And don’t expect deals to close quickly. “Buyers have stepped up their due diligence at least a couple of notches,” observes consultant Les Riedl, president of Speer & Associates in Atlanta.

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