

KEY NOTES

- ▶ Acquirers looking to boost volume should target markets outside of the United States where many people do not yet use debit or credit cards.
- ▶ Buyers are becoming more strategic, seeking out companies that can help them fill gaps in capability, geography, or segmentation.
- ▶ Because of the credit crunch, strategic buyers now have a much better chance at winning M&A auctions than they used to against private equity firms.

New Day in M&A

While the pace of acquisitions slows overall, strategic marriages that expand capabilities or geographic reach remain attractive

By Bryan Ochalla

What a difference a decade makes. The payments industry was in quite a different place in the 1990s, when mergers and acquisitions reigned supreme.

The reason for that uptick in activity, according to Marc D'Annunzio, a partner at McKenna Long & Aldridge LLP in Atlanta, is that the payments business is scale-intensive. "It isn't just about building a system that can support merchant transactions on a given volume," he says. "Once you've built the system, there are a lot of fixed costs you have to incur before you can get it up and running, operational, and compliant."

After a company has cleared those hurdles, however, most adopt the theory that "the bigger you can get and the more transactions you can run through the system you've built, the more revenue you can generate and the more money you can make," he adds.

Those at the top of the proverbial heap today figured out that once they built a system that could handle a certain kind of volume, they could become profitable by

obtaining that volume through mergers and acquisitions. As a result, a lot of acquirers rapidly consolidated in the late 1990s and the early part of this decade by "buying up other acquirers and bank portfolios in an effort to get to the size they needed to make more revenue off of a cost base that was largely fixed," says D'Annunzio.

Now, the credit crunch that's currently gripping the industry, as well as the maturity of the U.S. credit card market, have shifted the industry away from massive amounts of mergers and acquisitions.

"From an issuing standpoint, that means most of the people in this country who want a credit card and can qualify for one, already have one," D'Annunzio adds. "From a merchant standpoint, that means most of the market has been consolidated."

As a result, attention has turned toward more fragmented markets outside of the United States, such as China, which has a rapidly modernizing economy and many people who don't yet have credit or debit cards. "Savvy acquirers are looking at those markets and

trying to figure out how to get into them,” D’Annunzio says, because they’ll soon be responsible for a lot of volume that someone has to process.

Of course, expanding into foreign markets is no small feat. It can be particularly complicated for payments companies because they’re dealing with different jurisdictions and laws that may not be intuitive. In addition, they must also contend with foreign arms of the card associations that don’t always interpret rules the same way they do in the United States.

“Doing business internationally is harder in practically every way,” D’Annunzio explains. “There’s more to think about, more inherent time and costs, more surprises.”

Despite the operational and legal headaches, international expansion remains an appealing option for many acquirers. “That U.S.-based companies are willing to put up with those headaches says a lot about the potential of those markets,” he notes. “They think the headaches are worth it because the markets are so big and so potentially profitable.”

New Strategies

Consolidation in the card industry is responsible for another shift in M&A tactics, according to Marc Abbey, managing partner at First Annapolis Consulting in Linthicum, Maryland.

In the past, he says, “a lot of the buyers in this market were just pursuing share strategies or roll-up strategies—they were trying to acquire and aggregate multiple component portfolios. You don’t see that particular acquisition strategy used as much as you did in the past. Sure, there are players out there who are still using acquisitions simply as a share move, but it’s less common than it once was.”

In the current environment, however, strategic buyers are looking to plug gaps they may have in capability, geography, or segmentation. “It’s a new sort of motivation that has become a more important and prevalent factor” in M&A activity in the past few years, according to Abbey.

What caused that shift? “On one hand, you have strategic players who have been in the business for a while and are reaching the point where acquisitions have lower marginal value to them,” Abbey says. “These companies have developed national distribution models, and they have a presence across the country. So buying an incremental business has less value to them than it once did.”

On the other hand, he adds, “you have this second tier of acquirers who are trying to become first tier and are using acquisitions to get them there.”

D’Annunzio says he is seeing more of that sort of vertical integration occurring in the payments industry as well. “There are so many payment options right now, and more are emerging every day. People can pay with cash, check, credit, debit, gift cards, key chains—even their fingerprints. Mobile payments have become a hot topic, too.”

Savvy acquirers are watching the emergence of these payment technologies and are trying to figure out a way to get in on the action. The answer for some is to acquire or merge with smaller companies that provide one or more of these new payment methods.

“If you’re an acquirer that thinks mobile payments are going to be the next big thing and



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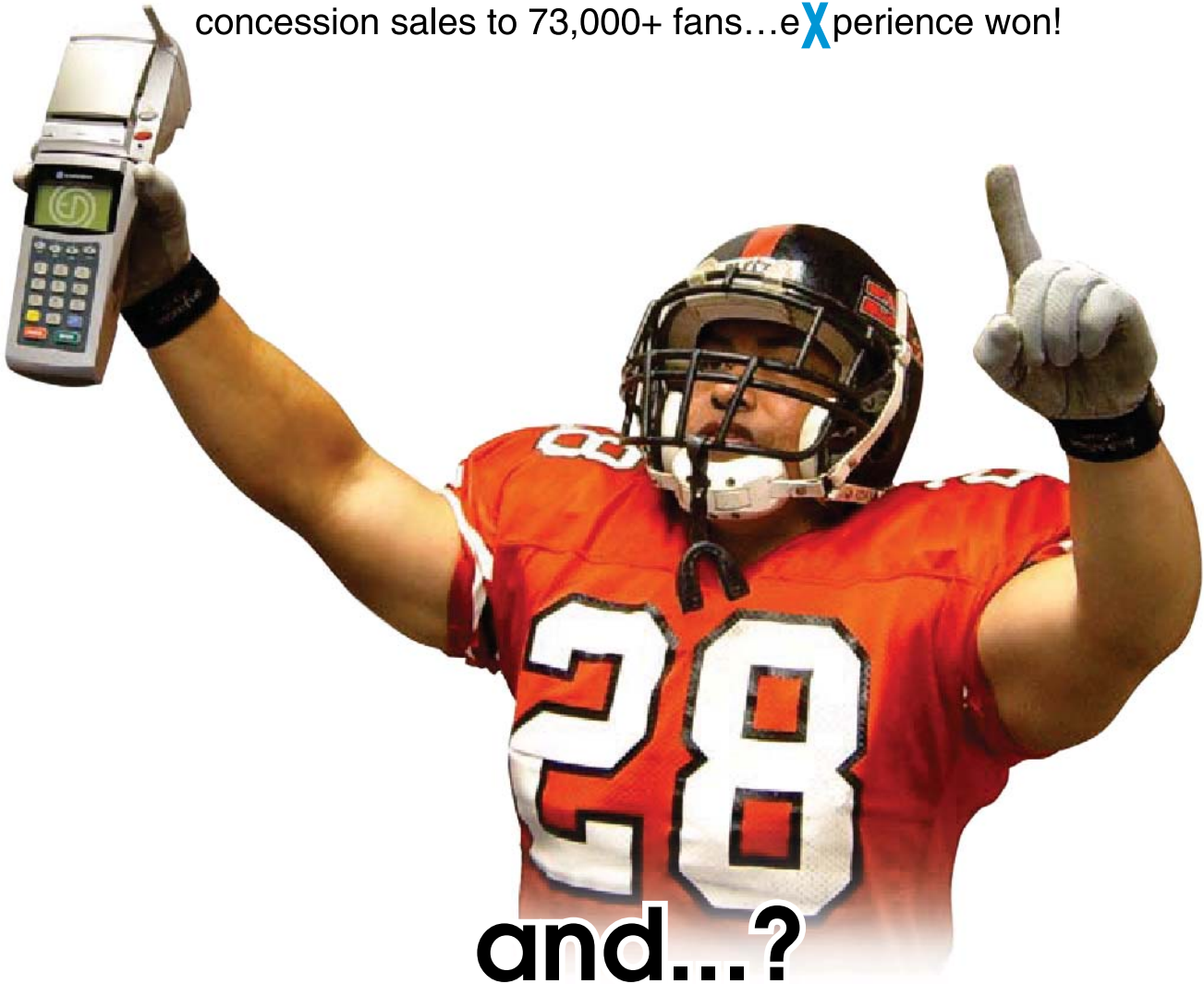
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you can't currently process those, you might acquire a smaller company that does," D'Annunzio says. "Or, you might acquire a company that processes gift cards, if that's an area you want to get into but currently don't have the capabilities or expertise."

D'Annunzio calls this kind of activity "add-on acquisitions."

"So many acquirers are trying to boost their capabilities in one area or another," he adds, "and simply buying capabilities or expertise they don't already have in house is a good way to accomplish that."

Buyer's Market

Acquirers interested in mergers and acquisitions—for whatever reason—are in a better position than they have been for some time, according to Keith Meyers, senior vice president of the business and financial services group at Atlanta-based Morgan Keegan & Co.

"For the past several years, private equity firms have been more active in this space as the debt multiples went up," he says, citing Kohlberg Kravis Roberts & Co.'s (KKR) headline-making acquisition of First Data last year as evidence.

This wave of private equity buying was enabled by the fact that it was easy to receive large amounts of credit, says D'Annunzio. "So when a private equity company would buy one of these companies, it would buy it with some cash and a lot of debt, because the debt was cheap. In fact, the debt was so cheap that in a lot of cases—in a lot of M&A transactions—the seller conducted an auction."

During these auctions, the highest bidder usually won. For the last few years, however, private equity firms have had an advantage. "They often would make bids that involved some cash and some debt," D'Annunzio explains. "Since the debt was so cheap, their bids almost always ended up being higher than the bids brought forward by the strategic buyers—because they could raise money so cheaply and leverage the company and pay off the debt."

All of that changed last summer when the credit markets tightened up rather drastically. Debt stopped being a cheap source of funding as interest rates shot up and availability declined.

"Now, one of the trends we're seeing is that strategic buyers have a much better chance at winning M&A auctions than they used to against private equity firms," says D'Annunzio. "It used to be that a strategic buyer could only raise so much cash, and private equity firms always came up with a higher number. That's no longer the case."

Meyers acknowledges the same shift. "Strategic buyers have been much more competitive lately when companies have come up for bid," he says. "They should be, because they have more synergies on both the cost and revenue side of things and can better leverage their target client base than they could in the past."

Although Meyers expects private equity firms to remain "a very meaningful component" of merger and acquisition activity within the payments industry, he also expects strategic buyers to continue to be more and more competitive as the credit environment stabilizes.

"I definitely see a trend back towards more traditional times," he adds, "which means more 'strategics' will be buyers again. That said, private equity firms still have a lot of capital and shouldn't be discounted."

More Opportunities

Looking ahead, Abbey, D'Annunzio, and Meyer see many M&A opportunities for players in the payments space.

A good example, according to D'Annunzio, is changes in ownership—such as what happened when First Data was bought by KKR—which present an interesting opportunity for other acquirers.

"Private equity firms are famous for weeding out any company they buy," he adds. "They tend to give these companies a good, hard look and then trim some fat to make it more profitable."

What that means is that First Data—or any other payments companies that are or will be under ownership of private equity funds—may "end up divesting some of their current assets because their new owners believe they're non-core assets," he continues. "They may decide to get rid of those assets so they can focus on the things they do really well."

Should that happen, it would open the door to other acquirers itching to grow or expand. "It just goes to show that there are still plenty of drivers for M&A activity in the United States," D'Annunzio says. "They're just different than they were, say, a decade ago." **TT**

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