

# 2009 Outlook Murky, But Optimistic

Rough waters ahead but great destinations for those who navigate well

By Richard H. Gamble

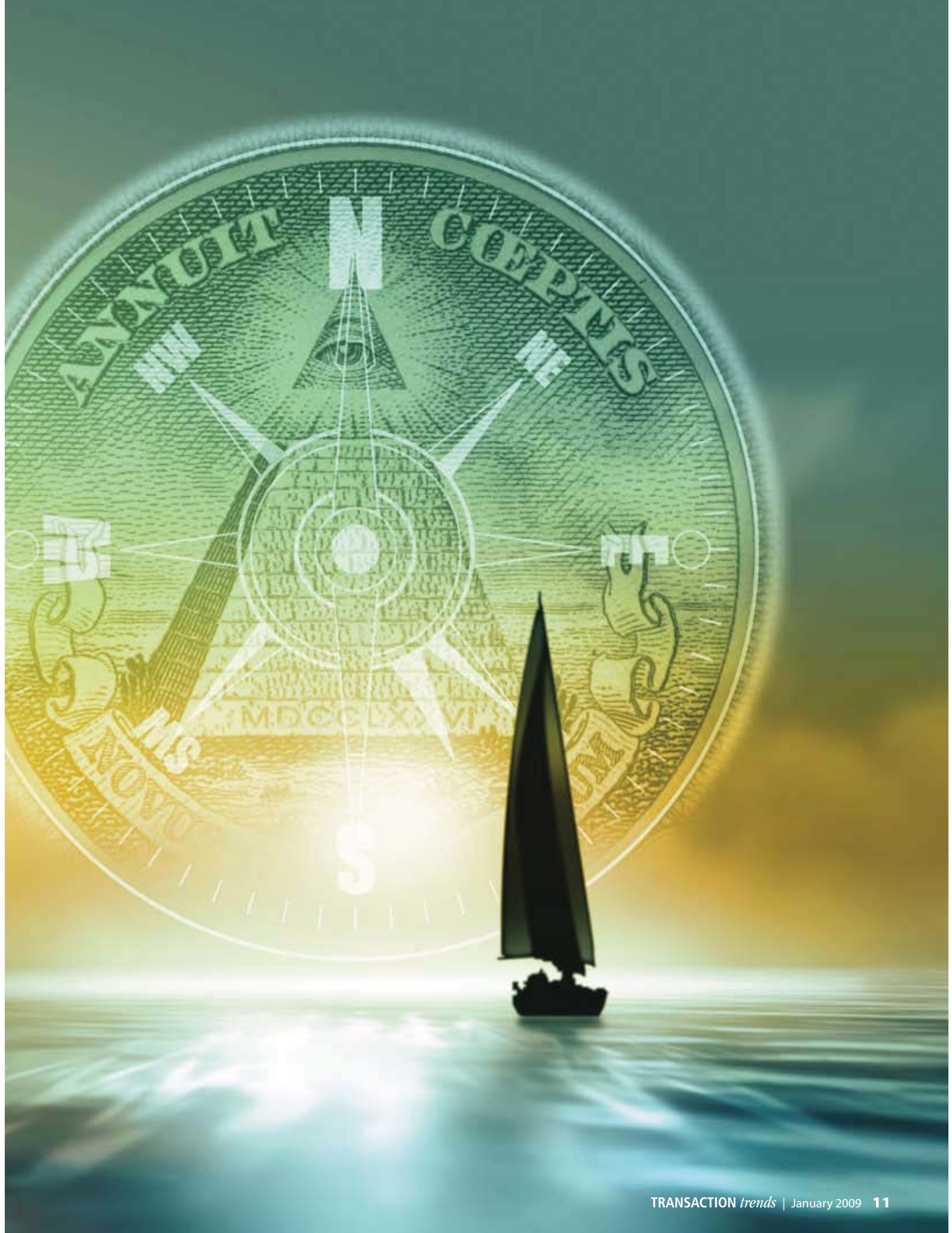
## KEY NOTES

- ▶ In an industry that has enjoyed double-digit growth rates for at least 15 years, slower growth is a shock to the system.
- ▶ The four big challenges in 2009 are declines in consumer spending and use of payment cards, cutbacks from the issuing side, declining merchant profits, and more bank failures.
- ▶ The electronic payments industry must continue to take advantage of growth opportunities, cut expenses, sell new-generation PCI-compliant terminals, and consider mergers/acquisitions.

It's batten down the hatches time for electronic payments professionals as they prepare for 2009. Most experts agree consumers, merchants, ISOs, merchant processors, value-added resellers (VARs), and acquiring banks face a tough 12 months. That said, there are a few bright spots, and times of great challenge also bring great opportunities to those with the foresight and resources to seize them.

In an industry that has enjoyed double-digit growth rates for at least 15 years, slower growth is a "shock to the system," says Kurt Strawhecker, managing partner of the Strawhecker Group, Omaha, Nebraska. "That rising tide had pretty much lifted all boats. This is the first time in memory, even for us veterans, that growth has slowed." Some processors have reported that both transaction volume and dollar value in October 2008 were down from October 2007 levels.

"It's different now than it has ever been," agrees Donna Embry, senior vice president for business and product development for Payment Alliance International, Louisville, Kentucky. ISOs, acquirers, and processors are "redoing their budgets for next year to reflect lower expectations. Some players may fall off the cart, but they will be the ones who are closest to the edge."



“This economy certainly is challenging,” observes Chris Hylan, vice president for growth at Innovative Merchant Solutions, (IMS), Calabasas, California. “Who will prosper and who will not survive depends on their financial strength going into the crisis, their relationship with merchants, their reputation, and how they respond.” IMS intends to respond aggressively, promoting new products and going after new customers, he reports.

## IDENTIFYING THE CHALLENGES

In 2009, acquirers, processors, VARs, and ISOs will have to deal with four primary challenges, suggests Harold Montgomery, CEO of Dallas, Texas-based Calpian.

**1. Serious decline in consumer spending and use of payment cards.** “Consumers are restructuring their personal finances,” Montgomery notes. “I’ve heard predictions of a decline in gross domestic product of 3 to 5 percent.” The latest economic bad news by early November was the substantial cutback in consumer spending heading into the all-important holiday season. Frightened consumers are unwilling to use even the borrowing capacity they still have in this economic environment, notes payments consultant Les Riedl, president of Speer & Associates, Atlanta.

**2. Cutbacks from the usually bullish issuing side.** “Credit card issuers are going through a deep and thorough rethinking of their business strategy,” Montgomery points out. With \$1 trillion of consumer credit card debt outstanding and a serious recession, less debt will be paid off and more will be written off, he notes.

## A shakeout among restaurants and small- to mid-size retailers is bound to occur. And that shakeout could bring more fraud.

As issuers scale back their marketing and reduce credit limits, growth on the merchant side will be tamped down. Without a doubt, the number of cards in consumers’ hands will shrink and bring down their buying power, says Greg Cohen, Chicago-based president of U.S. operations for Moneris Solutions Inc. Bank of America now includes MBNA and Merrill Lynch, both large issuers of credit cards, he says. If Bank of America simply consolidates those card programs, some consumers will go from three cards to one. And credit standards will tighten among issuers, he adds.

**3. Merchants seeing their business decline and their profits evaporate.** “We have already seen a wave of merchant bankruptcies, and others are clearly struggling. Restaurants and small retailers are under huge pressure,” Montgomery observes. Many of the chains have overbuilt, and a shakeout among restaurants and small- to mid-size retailers is bound to occur, he predicts.

That shakeout could bring more fraud. “Desperate people do desperate things,” Cohen cautions. “We know that merchants some-

times give themselves personal advances through their business card terminals, so it’s time to shift resources to fraud prevention and risk mitigation to try to catch those transactions,” he says. “Time once spent on creative marketing will now be spent on minimizing losses. The downturn is forcing us to protect ourselves.”

Most ISOs, processors, and acquirers have sophisticated underwriting systems that can adjust quickly as merchant credit quality declines, Montgomery notes. “The challenge won’t be making underwriting adjustments; it will be getting reliable current information in an environment where credit quality can change quickly,” he explains.

**4. More bank failures and shotgun mergers.** “We’ll have to see if some of the bank failures include clearing banks that are big ISO sponsors and what the impact will be on ISOs and merchants if such banks fail,” Montgomery says. Banks in a bind due to other credit problems may have to sell off their merchant acquiring business as a way to raise cash, Strawhecker says, citing the case of Humboldt Merchant Services. “They had a good portfolio, but the bank owner was in trouble over mortgage-related assets.” Then the FDIC stepped in to shut down the bank before the sale could close, he notes. “A healthy asset is something you try to sell when you have to raise cash to stay afloat.”

That won’t happen often, however. Most large acquirers will stay in the business, Cohen predicts. “Banks for the next few years will be working to raise deposits, and merchant acquiring brings deposits to banks,” he notes. “Unless a bank is in dire need of liquidity, it won’t sell its merchant portfolio to raise cash.”

Those banks that have made BIN (bank identification number) sponsorship a primary business are likely to stay, while banks that have dabbled in that business are getting out, Riedl reports. “The dabblers are leaving because their risk management folks don’t understand the business well enough to be comfortable. The big players know the risk well and see that they get paid for taking it,” he says.

## TACKLING THE CHALLENGES

If the challenges are so daunting, what can acquirers, processors, ISOs, and VARs do about it?

**1. Continue to take advantage of growth opportunities.** Smart ISOs will react to the economic challenge by selling more services to existing merchants as a revenue replacement strategy. There still are opportunities to sell loyalty cards and both open-loop and closed-loop gift cards, Embry says. “The prepaid mall card is an opportunity waiting to take off for ISOs,” she notes. “They’re a proven hit for people shopping for gifts or commodity items like prepaid phone cards.” Merchants are gradually realizing the benefits of putting in a rack of gift cards for popular retail chains and making a profit on their sale.

Look for growth in self-serve kiosks like the “Red Box” installations now found in some McDonald’s restaurants that dispense popular movie DVDs, charged to credit or debit cards, Embry suggests. You find these new-generation vending machines popping up in airports and malls, she notes. “More of these programs will take hold next year,” she suggests. “They provide ISOs with



opportunities to sell hardware and capture new revenue.”

**2. Sell new-generation, PCI-compliant terminals.** “Some terminals are at their end-of-life stage. Both Hypercom and Verifone are discontinuing some older models, which gives ISOs an opening to swap out those terminals for newer models,” Embry says.

Another strategy is to go into defensive mode. With volumes falling and attrition rising, it’s time to focus on core business, Cohen says. The emphasis should shift from breadth to depth, he suggests. And retention should become a prime focus. “I know that we have moved people and other resources to retention activity that weren’t there in 2007,” he reports.

“It’s time to focus on deeper relationships, enhanced service, and attrition control, even though some attrition is probably inevitable,” Riedl advises. “There simply will be fewer new merchants to enroll, more business failures, and fewer transactions with existing merchants as consumers cut back their spending.” To build a fortress around revenue, try to cross-sell more products. Prepaid cards are the most promising product to promote, he says.

**3. Cut expenses.** The most promising cost-cutting tactic may be to renegotiate contracts with processors and pit competitors against each other to try to drive a better deal, Riedl suggests. ISOs that historically have stuck with one processor may now start shopping. “It will be a tough year. ISOs will be looking to squeeze all the cost they can out of every relationship,” he predicts.

The most complicated cost-cutting may involve shifts in how sales staffs are compensated. If merchant applications tail off, ISOs may have to lay off salaried salespeople, Embry notes, which could bring greater reliance on a commission-only sales force. “Companies like Avon prosper in a down economy,” Cohen points out.

Lower sales compensation could mean lower motivation, however. As volumes, residuals, and commissions decline, more of the merchant-level sales force is likely to view the activity as a part-time job. “They will still do it to make a little extra money, but they won’t have the same commitment because sales will be harder to make and commissions will be lower,” Montgomery explains.

Squeezing the sales force could be a mistake. “This is not the time to cut sales resources,” Strawhecker insists. “The worst time to cut advertising is when business is down. The same is true for sales. We’ve had several inquiries about recruiting solid salespeople, both at the street level and the management level,” he reports.

**4. Consider mergers and acquisitions.** Consolidation will occur as the strong take advantage of the weak to pick up portfolios at lower valuations, Cohen suggests. It presents an

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opportunity for strong firms with foresight. “Now is the time to take advantage of market conditions and prepare for the recovery. Many of the most successful players in any industry have defined themselves by the strategy they took in a downturn and how they played the rebound,” he points out.

Many ISOs, VARs, and even processors are structured and financed on the premise of growth, Montgomery explains, and 2009 is unlikely to be a growth year. “Revenue already is starting to drop for the first time ever in the experience of many ISOs, acquirers, and processors,” he notes. They are not built or prepared to ride out revenue downturns, which may force them to look for a buyer. But with

profits thin and volume declining, attracting acquisition financing could be dicey, he suggests. “Growth covers a lot of mistakes. It’s easier to get financing when you’re growing.”

Declining volumes and profits will have a big impact on the prices acquirers will pay, Montgomery points out. “The multiple you can get for a growing business is greater than the multiple for a steady-revenue business, and the multiple for a declining-revenue business is lower still,” he says. If ISOs balk at the low multiples acquirers offer or if acquirers can’t line up financing, some ISOs and VARs may be stuck with “nonliquidation workouts where they have to take what they have and find a way to make it work,” he says.

Riedl is more bullish about the M&A opportunities. “There’s still venture capital available and players looking to make acquisitions. They see this as a good time to buy companies or portfolios.” Good acquisitions remain scarce, he notes.

Some companies will just hang on. What happens in 2009 depends “on who is left standing,” observes consultant Paul Martaus, president of Martaus & Associates, Mountain Home, Arkansas. “Many ISOs can survive, although they will be smaller and less profitable for a while. The bigger question is what will happen to the banks. They appeared to be in serious trouble, but the government intervention probably will keep too many of them alive.” The big acquiring banks—Wells Fargo, USBank, Chase, and First of Omaha—are all solid and will keep “doing their thing,” he suggests.

There is plenty of reason to hope, Strawhecker insists. “We will recover. The migration from paper to electronic payments won’t stop. Business-to-business card payments still are growing strongly. Overall, the industry is still very sound.” The biggest cause for hope: “Recessions typically play out after about six months,” Embry notes. **TT**

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