

MONEY GUY

IF THE REVENUE PIE GETS SMALLER, WHO GETS THE BIGGER HALF?

By Harold Montgomery



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I grew up with three older brothers. Whenever we shared anything, it always seemed to me that my portion was smaller than the other guys'. One time, when one of my brothers was cutting a cookie in two for us to share, I said "You can cut it as long as I get the big half!"

I sometimes feel that way about the ISO-Processor relationship. Each party is splitting the total pie of merchant revenues – and that's worked well throughout the history of the industry. From what I can tell, processors have historically gotten about 40% of overall merchant revenue and ISOs about 60%. While that number seems to have fluctuated a bit, it's been a pretty stable split over the years. So that means if a merchant is paying \$100 in fees to process payments (excluding Interchange and assessments,) then the ISO is receiving a residual of \$60 and the processor is keeping \$40.

What's interesting here is that the relationship between processor and ISO revenues seems to be holding even as the overall amount merchants are paying to process is declining over time. In the example I just gave the \$100 of total revenue is going down, but the 60/40 split is holding steady.

So the overall revenue pie is shrinking. Today merchants are paying less to process a dollar of volume than they did 5 years ago. In many cases, a lot less. Below is some real data from a large portfolio I examined recently.

The table below shows that in 2008, merchants were paying an amount to

process I call 100% - using that year as a base number against which to measure the following two years. In 2009, overall merchant revenues fell 8%. In the next year, they fell another 6%, for a total three-year decline of 14% overall. The pie got smaller. 14% is a pretty big number to manage to for several reasons:

■ **Increase in Merchant Count**

To make up the difference in a 14% drop in revenues AND preserve your profit margin at 2008 levels (forget about increasing the profit margin in this situation – there's no way,) you'll have to increase the merchant count by 16.3% to make up the difference. In other words, 100 merchants paying \$100/month is \$10,000 in total revenues. If revenues per merchant drop to \$86/month and you still need \$10,000 in total revenues, then you will need 116 merchants. Less revenue per merchant obviously means that you need more merchants.

■ **Attrition**

On top of that, you have to swim against the tide of attrition, which is typically another 18%-25% per year. That means starting the year out with a goal for your sales department generating new merchant contracts equivalent to 34% (16%+18%) of your starting customer base. That's almost double the sales group's previous production – 100% more merchants that need to come from sales to hold revenues flat.

■ **No Additional Costs in Sales**

In a falling revenue environment, nobody wants to increase costs to gain

new merchants, and so there's pressure on the sales budget to keep costs flat (or lower them.) Does anyone really expect sales to produce about 100% more merchants with the same resources?

■ **More Customers**

More merchants means more work to do – more customer service, more supplies, more of everything. Normally, that's a good problem to have because having more merchants means more revenue. But in this case, having more merchants means flat revenue and increased costs. Bad idea.

■ **The Future**

A company can limp along filling this gap for a while – maybe a year or two but not forever. Sooner or later this math catches up and revenue starts to fall. The industry has been creative in filling this gap with new fee revenue – notably PCI fees. But how many new fee points are there to charge? What happens when one of them goes away? Won't EMV mean that there's no more PCI?

If the pie is shrinking – who's going to get the big half from here on out? So far it's been ISOs getting two-thirds of the pie. Will processors allow that to happen in the future?

Merchants have shown recently that they can't be taken for granted in the payments puzzle. They exerted significant political muscle this past year and my guess is they are not yet finished. There will be more contests over interchange in the future and our industry had better fight back harder than it did on Durbin or we're done. Through competitive forces or legislation, we can expect revenue to go down.

Shrinking revenue in any industry is never a good thing. Think of it as a rubber life raft and the air is slowly leaking out. There's simply not enough room for everyone and so the crew draws straws to see who has to jump overboard. Are we heading for that scenario? ■

	2008 (bps over Interchange)	2009 (bps over IC)	2010 (bps over IC)	3 Year Change
Average Merchant Processing Cost	100%	92%	86%	-14%