THE MONEY GUY

WHAT'S YOUR PORTFOLIO TELLING YOU?

by Harold Montgomery

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I travel around the country to various trade shows in our industry and listen to what people are telling me about the conditions they face in the business today. The majority of the comments I hear are that the business is tougher now than it used to be. This thought has three parts to it: (1) merchants are more price sensitive than ever, (2) margins to ISOs are generally going down and (3) attrition is up relative to historical norms. A weak retail economy contributes to all three of these factors.

I have been wondering what all this means for merchant portfolio valuations. Attrition going up and margins going down combines to create a phenomenon known as 'negative margin substitution', (which I am going to refer to as NMS in this article). NMS means taking out a high margin merchant and replacing it with a low margin merchant – say, $50 per month replaced with $40 per month for a reduction in margin of $10 per month – hence the negative margin difference.

This kind of thing happens every day. In fact, you don't even have to lose the merchant from your portfolio entirely. If you give the merchant a price reduction in order to keep him in your portfolio, then that's the same as losing the merchant and replacing it with another one at a lower margin. In either case, sales or price concession, NMS results.

What does this mean for a portfolio and its value? Take the above example to a larger level. Let's say the ISO in question sells 100 new merchants a month and has attrition of 100 deals a month—in other words no net growth in merchant count. That would be typical in today's world – 5,000 merchant base with 2% a month attrition – 100 out, 100 in.

Most ISOs I know evaluate their growth on merchant count. But what about the revenue on the 100 lost merchants vs. the 100 new ones? Is that the same? If the total revenue from the lost merchants was higher than the total revenue from the new ones, NMS results.

Here's a table that illustrates the generic example:

residuals, it's worth an amount (you can put whatever multiple on that you want.) If you take another group of 100 merchants producing $4,000/month in residuals, using the same multiple, it's worth 20% less.

Year Portfolio Created	Number of Merchants	Average Net Residual Per Merchant Per Month	Net Revenue Total
2006	100	$50	$5,000
2010	100	$40	$4,000
Net Difference	0	-$10	-$1,000

This is the case in a world where industry margins are falling gently over time as has occurred in merchant processing for several years now. If you think of your merchant base as a collection of merchants sorted by the year in which they were added to your customer base, then you start to get a handle on this concept. Think of it as merchants by vintage year, like wines. Not all years are the same. In fact, the margins ISOs recieved on 2006 sales were higher than 2007, which were higher than 2008 which were higher than 2009 and so on. Over a period of 5 years, comparing merchants from the 2006 price era to the 2010 price era, will yield an interesting set of data.

Further, most merchants have a life of about 5 years in a portfolio before they switch or go out of business. My research shows that about half of attrition comes from competitive price chopping and the other half comes from merchants going out of business (at least in the small merchant segment). The ones that are now leaving are from the prior vintage years which means the higher margin eras. The replacement merchants are from the current (meaning lower) margin era.

The real issues is what this means for the value of the portfolio and the company as a whole. If we take a set of 100 merchants producing $5,000/month in

Therein lies the issue with NMS – falling value of the portfolio due to falling cash flows per merchant per month. If cash flows from merchants fall, value of the portfolio falls because the merchants will produce less cash over their lifetime.

It's easy to analyze this in your own portfolio. Take all the merchant residuals you added to your portfolio in some span of time, say the Q3 2006. Take a look at the average amount of residuals those merchants produced for you. You can easily find this data from your residual reports by using "merchant activation date" as the sort criterion, taking the net revenue from that group and dividing it by the number of merchants in the group. Next, do the same for the group you added in Q3 2010 and calculate the result. Be aware that if PCI fees or other non-processing fees were introduced during this period, that can cloud the results. Be sure you're comparing like kinds of revenues. (PCI fees don't have the same value as processing residuals.)

If you're seeing NMS in your portfolio, it's time to think through the options. Continuing to substitute low margin merchants for high margin merchants is a recipe for diminishing the value of the portfolio over time. ■