

INSIDE ACQUIRING ANALYSIS

Issues in the Merchant Acquiring Business

Q3 - 2008

Dear Industry Colleague

This is the third in a series of occasional newsletters focused on key issues in the merchant acquiring business. I sent this to you because you are an industry opinion leader and also because I value your thoughts and insight into the business. I am hopeful that the analysis contained in this newsletter is helpful to you and provokes some creative thought about our industry and its future.

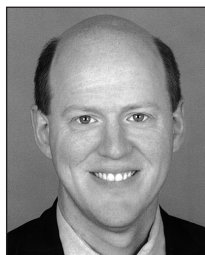
This newsletter focuses on the decline in margins for processing revenues that ISOs are seeing over time. The data presented here is taken from portfolios Calpian acquired between 2003 and 2007. The data suggests a clear margin decline over the four year period. The implications for the industry are profound.

Thanks for reading this, and let me know what you think.

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FALLING PROCESSING MARGINS IN THE MERCHANT ACQUIRING BUSINESS

Abstract

The purpose of this article is to document margin decline in the merchant processing business at the Independent Sales Organization (ISO) level and discuss the consequences of that decline and various ISO responses to it.

Summary Findings

- ▶ Margins on merchant processing at the ISO level have been falling for a number of years. When measured as a cash yield per merchant per month, yields have been declining at about 10% per year for at least the last 5 years according to Calpian data.
- ▶ ISOs often measure their success by merchant count, overall processing volume, or net spread over interchange. But the metric that matters most is cash yield per merchant per month.
- ▶ Declining yield per merchant means that more merchants are required to support fixed overhead. This observation has a number of consequences which are profound and far reaching for the ISO business.
- ▶ ISOs have a variety of responses to falling margins, including raising prices on peripheral offerings, adding

new products, negotiating lower costs with processors, and becoming more efficient through investment in technology or other means. In some cases, ISOs attempt to acquire other ISOs or their customers.

Methodology

To document margin decline, I examined the more than 200 portfolios that Calpian has acquired over the last six years. I excluded certain portfolios since they appeared to be composed of too few merchants (less than 100) or merchants which were not representative of the bricks and mortar mainstream (Internet, etc). I was left with a sample size of 89 separate portfolios. These portfolios have the following characteristics:

- ▶ They were created by a variety of ISOs.
- ▶ Each ISO has a selling style – telephone, in person, mail, etc. This group of portfolios represents a cross section of styles.
- ▶ The merchants in the study are dispersed over a wide geographic area.
- ▶ Each portfolio contains at least 100 merchants.
- ▶ All the portfolios were created between 2003 and December 31, 2007.

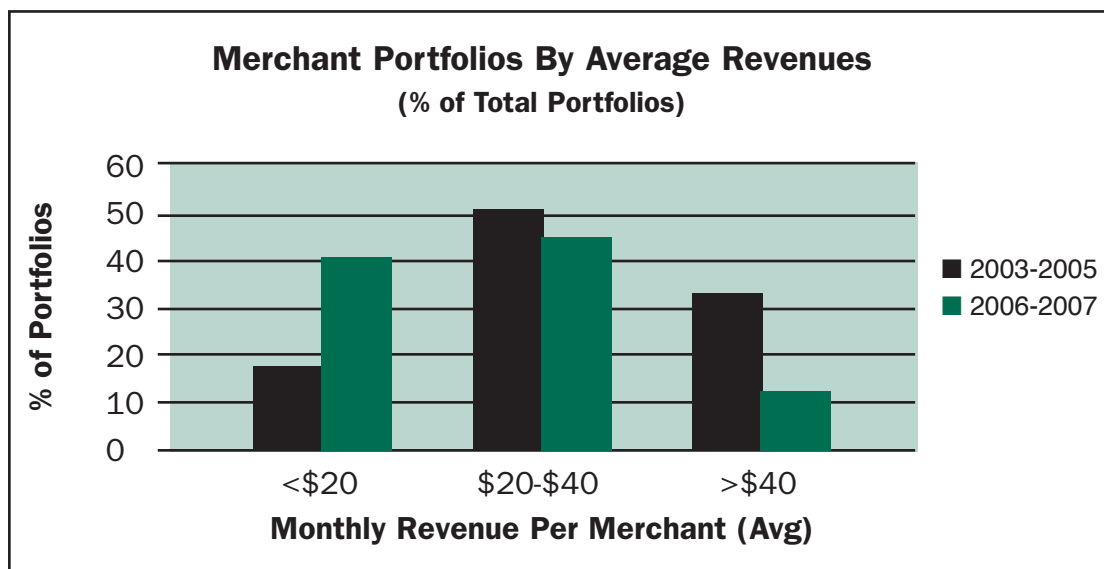
Falling Processing Margins in the Merchant Acquiring Business

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- ▶ Each portfolio was created by an ISO before acquisition by Calpian.
 - ▶ I averaged the yield per merchant for each portfolio in its first full month after acquisition by Calpian.
 - ▶ I charted the average yield per merchant for the first full month with Calpian regardless of the time of year of the first month. There could be seasonality in some of the data points.
- ▶ The per merchant yield ignores volume and price spread characteristics and focuses only on cash yield per merchant per month. Higher volume merchants may or may not yield more cash per month, depending on their price spreads over cost. In some cases, higher volume merchants yield less than low volume merchants due to fixed charges in merchant pricing.

The sample portfolios array in a table as follows:

	# Portfolios
2003-2005	51
2006-2007	38
Total	89



Discussion

The chart above shows two groups of portfolios – those created before January 1, 2006 (black bars) and those created between January 1, 2006 and before December 31, 2007 (green bars).

- ▶ The graph is best read by color group first. Black bars show that 15.5% of the pre-2006 portfolios yielded \$20 or less per merchant per month. 50.5% of this group yielded between \$20 and \$40 per merchant per month. 34.5% of the

black group had a yield of more than \$40 per month.

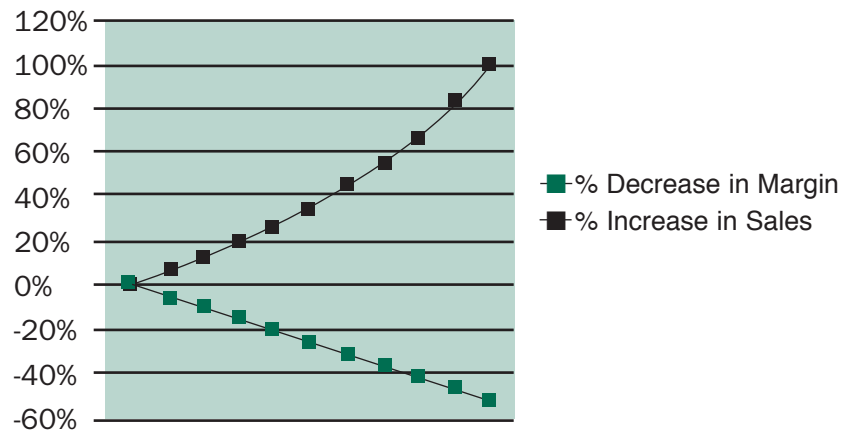
- ▶ The green group shows a noticeably different distribution. 40.5% of the merchants yielded less than \$20 per month. 46% were between \$20 and \$40, and 13.5% were more than \$40 per month.
- ▶ The shift toward lower margins shows most clearly in the <\$20 segment, which grew from 15.5% of the portfolios to 40.5%.

- ▶ All the growth in the <\$20 segment came at the expense of the >\$40 segment which declined over time to 13.5% from 34.5%.
- ▶ ISO profitability would suffer under these kinds of pressures since most ISOs make money when merchants yield more than \$40 per month. Most small and medium scale ISOs would find it hard to be profitable at less than \$20 per month.
- ▶ ISOs may not be noticing this trend since it occurs at the margin of new merchants added every month. When viewed as a First In, First Out (FIFO) inventory model, the dilemma becomes clearer- old merchants yield more than comparable new ones.

Therefore as a single high yielding old merchant attrits from the customer inventory more than one new one is required to replace the revenue stream.

- ▶ ISOs who measure success in terms of processing volumes or other metrics which assume margins to be stable, are missing margin corrosion and a steady erosion of value in their business.
- ▶ Falling margins have profound implications for measuring sales productivity. Sales productivity must increase faster than margins fall to hold revenues steady. Here is a graphical representation of the relationship between sales productivity and margin decline if revenue is to be fixed.

Increase in Sales Productivity Required to Offset Margin Decline



This chart clearly shows the inverse relationship between margin decline and increasing sales productivity. Sales forces can stretch to create a bit more revenues, but at some point this relationship becomes dysfunctional.

- ▶ ISOs have a variety of responses to falling margins including:
 - △ Raising prices where possible.
 - △ Introducing new products such as merchant advance.
 - △ Negotiating lower cost processing agreements.
 - △ Investing in technology which lowers costs (front end, etc).
 - △ Acquiring other ISOs or customers.



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Conclusions

Margins in the merchant processing business have been falling at about 10% per year for at least the last five years. Falling margins makes measuring merchant yield over time is a critical exercise for ISOs in managing their businesses. Falling margins have implications for almost all business activity from planning and budgeting to management and strategic decision making. Falling margins and their consequences are likely to heavily influence ISO behavior for the foreseeable future.

UPCOMING TOPICS:

- Cost of a Marginal Dollar of Revenue • Cost of Customer Acquisition
- Value of a Merchant Contract • Expenses Over Time