



COST OF MARGINAL CUSTOMER ACQUISITION AND WHY IT MATTERS

by Harold Montgomery

I am frequently asked how to measure whether an ISO is successful or not. Of course, there are a number of ways to judge success, and everyone has a slightly different take. I tend to look at an ISO and ask whether it is building wealth everyday through its core activity – creation of new merchant revenue streams based on credit card processing.

To me, the main purpose of being in business is to create economic value. Value comes in two ways. One is current, the other long term. Current value is current cash flow – is there enough money month to month to pay bills, salaries and overhead to stay in business? If so, then the business is generating enough economic value to sustain itself and its key resources – vendors and employees.

Above that, is the business generating long term value? This is usually a longer discussion filled with intangible concepts of value like brands, market share and the like. Nothing wrong with those, of course, they're important, but I always want something a bit more concrete to measure. I assume that because a business is in business day to day over a long period, that it's building intangible value by definition. There's value in just being there, doing business each day for a long time.

Entities in the merchant acquiring business can actually look to concrete measures to show that they're creating value on a monthly, if not daily basis.

Here's how:

Think of your business as a factory that produces a product and that product is new merchant processing contracts and the revenues they generate. But what's the cost of producing these revenue streams? How much do you spend each month to support the functions necessary

to acquire a new customer? This is not as simple as calculating the cost of sales commissions. Commissions are part of the cost, but the real estate rent, office overhead, paperwork, supervisor time, executive time, etc. all should be added into a fully loaded cost analysis. When it comes to judging the gray areas of what to add and what to leave out of this analysis, think to yourself "Can sales survive without this function?" If the answer is "No," it has to go into the cost analysis.

Tracking the cost of the sales department is the easy part. But tracking what they produced is a little more subtle. The easiest way is to track the number of merchant contracts activated in a month. It has to be activated accounts, not accounts sold or contracts signed or applications submitted, but real live revenue producing customers.

Take the cost of the sales department for a given period of time and divide into the number of merchants and you have a good start on tracking this crucial measurement of performance.

But number of merchants is not the best measuring point. What if the revenue on each merchant goes down? That's a problem. You could be originating merchants at a steady cost and finding revenues going down in the process and never know what hit you.

Rather than merchant count, I recommend that you look at the revenue productivity of the sales function. Take the costs of the sales department, and divide them into the revenues the sales department produces in the same period of time and see what you get. That number describes the cost of acquiring a marginal dollar of revenues.

So now you have the cost of your product and you can measure it each month. You can easily contrast this measurement with your expected value of that revenue stream. The multiples paid for revenues of the kind you're generating (whether residuals or gross merchant revenues with risk and ownership) are generally known. You want to know that the cost of acquiring a dollar of revenues is lower than your expected value of those revenues – that dynamic creates value.

Further, you want to know that your cost is lower than the value you expect to apply at the time you intend to sell the merchants. That's a trickier estimate, of course, but it pays to track the trends in merchant valuation to make sure that your sales costs don't eat up your expected future profit margin.

If you see that the cost of originating merchants is higher than the expected value of the revenues they drive, you have a problem. In that case, you're spending more to acquire revenues that they are worth and no ISO can do that for very long. ■

Harold Montgomery is the CEO of Calpian, Inc., a Dallas, Texas-based provider of financing opportunities to all levels of merchant acquirers. In 2008 Montgomery submitted expert testimony to Congress regarding Acquiring Industry Legislation, including the Credit Card Fair Fee Act of 2008 (HR 5546.IH) and the more recent Credit Card Interchange Fees Act of 2008 (HR 6248 introduced June 11 by Rep Peter Welch, D-VT). In August 2008 Montgomery was named the most Influential Acquirer by Transaction World Magazine for 2008. You can contact Harold at 800.589.1173 or portfolio@calpian.com.

