Slow Thaw for M&A

Sellers seek strategies to improve their chances at a deal, while buyers look for solid operations

By Richard H. Gamble

The deep freeze that shut down the merger and acquisition (M&A) market for ISOs and merchant portfolios in 2008 is slowly defrosting, but it’s from the top down. “The debt market is still difficult so it’s hard for a buyer to borrow what he needs to do a deal, but buyers with cash are finding sellers,” reports Chris Phillips, an M&A attorney at Waller Lansden Dortch & Davis in Nashville. Rather than a surge of activity based on an improving economy, it’s more a matter of sellers that had postponed sales are now making a move they had delayed for a year or two, he says.

The freeze ended in the fourth quarter of last year, and now is something of a seller’s market. “We’re seeing a lot of buyers—many of them new buyers,” says Kurt Strawhecker, managing partner of The Strawhecker Group in Omaha, Nebraska. “There are more would-be buyers than there are sellers, so the market has really shifted.” The Strawhecker Group, an active third party in portfolio valuations and sales, currently has four active assignments working. “Four at once is pretty busy for us,” he notes.

But others see a different environment. The situation for ISOs trying to sell small portfolios “is not improving, and multiples are still way down from where they were two-and-a-half years ago,” says Mark Dunn, president of Hartland, Wisconsin-based Field Guide Enterprises, who works mostly on sales of small ISOs and portfolios. Would-be buyers are still hard to find, and sometimes they lack the wherewithal to consummate a deal if they find a seller, he says.

But while buyers may be scarce, there’s no shortage of would-be sellers in the small ISO market, according to Dunn. “People want a cash event for a variety of reasons.” They may be sending children to college, paying for a wedding, paying for care for an aging parent, trying to start a new business, or paying off an adjustable-rate mortgage, he notes. “Many entrepreneurial small business owners who started in the ‘80s and ‘90s are now in their late 40s to mid 60s and going through transitions. They’d like to cash out their investment, but the buyers are few and the prices are disappointing.”

A few larger ISOs are building their portfolios by acquiring smaller ISOs, and some financial investors are shopping for bargains, Dunn says. What he doesn’t see are individual entrepreneurs wanting to enter the ISO business by acquiring an existing portfolio or starting a new one. “The startup rate has been low,” he notes. “It’s a crowded market. Margins are tight. Money to invest is hard to come by. Not many people have the appetite to try it.”

**Heat at the High End**

That appetite is there, however, among large ISOs, acquirers, and processors, and especially among well-heeled outside investors. Activity is up from last year, especially for high-end deals among larger players, reports Omid Tofigh, principal at First Annapolis Consulting in Baltimore and head of the firm’s M&A practice. “We’ve seen a few sizable transactions completed, and many more are still in the negotiations stage and could happen this year,” he says. Some established players are buying each other as industry consolidation continues, but what’s really driving the market is the entry of more private equity and venture capital firms with cash to invest.

“Financial investors like the ISO business model because it requires relatively little capital investment to succeed and grow and because it produces steady, predictable cash flow,” says Ray Sobczyk, senior associate at the Strawhecker Group. “Some of the venture capital and private equity guys are strictly financial investors. They want to buy good management and back-room operations with the portfolios, hold ownership of the portfolio while the economy recovers, and sell at a profit at some future date.”

But other financial investors are looking to add value by providing strong management and bringing human resources and information technology sophistication to the acquisition, Sobczyk explains. They look for bootstrapped companies and create value by providing the missing infrastructure. ISO owners looking to turn equity into cash but keep their jobs can find buyers to accommodate them. ISO owners looking to get out of the business can also find buyers looking for just such deals, he says.

ISO owners who want to sell the business but keep their jobs will make that one of the first points they negotiate, says Phillips. That’s easy if the buyer is a financial investor who wants to keep the old hands

**Ties That Bind**

A surprise deal-killer may lie in the fine print of the agreement an ISO has with its processor or acquirer, so pull out those contracts and review them before approaching a potential acquirer, says Field Guide Enterprises’ Mark Dunn. “The ISO may want to sell its interest in a portfolio, but there may be other interests. Typically, an agreement with a processor contains covenants that apply to the processor or even the bank acquirer. It may have been years since an ISO owner wanting to sell has read those agreements.” Dunn recalls that he worked with one ISO that found that its agreement stipulated that the processor had to approve the buyer and that processor would only approve one buyer, which happened to be its largest ISO.

Clauses in processor and merchant acquirer agreements may require notice before a sale or even restrict what you can sell and how a sale has to be structured, says the Strawhecker Group’s Jamie Savant. You need to know the fine points in your agreements and be able to explain them to a prospective buyer, he says.
there to run the business. Even in a merger of two operating companies, the seller may negotiate a role in the surviving company.

While the new money is welcome and is helping to support “reasonably good prices” for company or portfolio sales, Tofigh says these financial investors slow down the deal flow because they’re less familiar with the business dynamics and are taking their time with due diligence.

Cold Facts
In this difficult but not hopeless market, what can an ISO do to make the company or a merchant portfolio sell for top dollar? Certain characteristics generally make a portfolio more or less valuable, explains Harold Montgomery, CEO of Calpian Inc., an active buyer of small ISOs and portfolios based in Dallas. Low attrition rates obviously are good for value. Ties to a major, high-quality processor usually add value, while ties to a small super ISO that does its own processing can take value away. More buyers want a geographically dispersed portfolio than a concentrated one, Montgomery says.

When it comes to merchant pricing, moderate margins in line with industry norms are best. Too thin margins mean too thin profits. Too fat margins mean the portfolio is vulnerable to having merchants picked off by competitors offering lower prices, Montgomery says. “A high concentration of merchant owners makes a portfolio more vulnerable and less valuable. Merchants that require a high service level make a portfolio more expensive to support and therefore worth less up front,” he says. Buyers are particularly sensitive to risk in today’s market, so the greater the risk, the lower the perceived value of a portfolio. If you have a niche portfolio based on specialized technology or a targeted industry, the portfolio will be more valuable to some buyers and less valuable to others, he adds.

People wanting to sell can make their portfolios more attractive and get a better price, but not by making quick, cosmetic changes, Strawhecker says. “Even if your ISO is a small, private company, you need to start running it like it was a public company, especially if you’re thinking of selling,” he observes. “You need to know your business in a very granular way. You need to know your numbers, where your profits come from, your cost of getting and retaining new merchants, your attrition, and your contractual agreements. Are you just taking in money and spending it as you go, or are you operating the company by established budgets and targets?” he asks.

A portfolio that specializes in the right industry verticals (health care, education, green business, etc.) has an advantage over a diversified portfolio, adds Jamie Savant, a Strawhecker partner. “If an ISO develops specialized expertise, they create a portfolio that is easier to defend. We’re seeing more ISOs specializing in industry verticals or in business styles, and that’s a plus.”

Current valuations are still low by historical standards because the economy is still struggling, Montgomery reports. Merchant attrition is higher than it was two years ago Retail spending is weak, Issuers are still adjusting to the financial crisis and new regulations that are causing them to reduce credit available to cardholders. Financing is hard to come by and expensive. All these factors make would-be buyers cautious.

Ultimately, value is hard to pin down because there is just not enough information to find comparable sales, Montgomery cautions. “The market is stagnant enough that the data are just not there. You can’t be confident about what your asking price should be.”

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