PURCHASING A PORTFOLIO

By Paul A. Rianda, Esq.

Portfolio purchases are becoming more and more common in the Bankcard industry. Below, I will discuss the reasons for making a portfolio purchase, considerations for valuing the portfolio and important contractual provisions in the portfolio purchase agreement.

Why Purchase a Portfolio?

There are many different reasons to purchase a portfolio, but the underlying reason is generally to further either a financial or strategic objective. In a strategic portfolio purchase, the acquiring company desires to expand its merchant base along with obtaining additional merchant acquisition partners. By making the proper strategic portfolio purchase, a company can expand its geographic reach by purchasing a portfolio that has sales agents in markets where the company is not currently operating. Such a purchase can also allow a company to expand its product offerings though the acquisition of new technology, such as an internet payment gateway.

Another important reason for some of the larger portfolio purchases is the ability to profit from economies of scale and added value that such a purchase can provide. By economies of scale, I mean that for the most part, a large ISO can easily absorb the customer service and other obligations necessary to service the merchants that are purchased with very few additional employees. An ISO's existing customer service, risk and technology personnel can service the new merchants, allowing the ISO to dramatically reduce its operating costs per merchant.

In addition, in our industry the old adage "the whole is greater than the sum of its parts" holds true. There are many smaller ISOs that when consolidated are worth considerably more than then the ISOs were on an individual basis. The stock market has rewarded those in our industry who are able to build a large portfolio of processing merchants.

Although they do occur, strategic portfolio purchases are the exception rather than the rule. Most portfolio purchases are entered into primarily for financial reasons. The bulk of the smaller portfolio purchases occur when someone wants to purchase the ongoing residual stream from an agent in order to obtain a certain return on their investment. The purchaser may not necessarily want to obtain the merchants but instead would like to merely acquire the residual payments associated with the merchants. The purchaser decides upon a purchase price based upon the expected cash flow from the merchants as compared to the purchase price. The purchaser will generally make an acquisition only when it believes it will obtain a certain return on its investment.

Portfolio Valuation:

There are a number of metrics that are used in determining the value of a portfolio. For instance, attrition rate is a very important factor in determining what value to place on a portfolio. The attrition rate is also related to how "seasoned" the portfolio has become. The longer a portfolio has been in existence and the less merchants that have recently been added to that portfolio, the more likely

it is that the merchants will stay processing with the same processor. The type of merchants is also important to the extent that traditional brick and mortar merchants are more likely to continue processing with the same processor versus internet businesses where the capital outlay by the owner of the business is substantially less. In addition, when purchasing a portfolio, it is always prudent to look at the detailed residual reporting for each merchant to make sure that there is not a concentration of processing in a few large merchants that could leave the portfolio.

Portfolio Purchase Agreement:

Once the price has been determined, the next step is to draft a definitive agreement for the purchase of the portfolio. The keys terms of such an agreement include price, who bears the risk of merchant losses, duties to service the merchants, and indemnity obligations between the parties.

As to the price, it is very common that the payment of the purchase price would be made over time. This allows the purchaser the ability to collect some revenue from the portfolio in order to fund the purchase of the portfolio. In addition, it keeps the seller of the portfolio "honest" to the extent that it will be less likely to try and take merchants from the portfolio and move them to another processor (even though it is likely the seller would not be able to do so under the written agreement).

One of the important things in a portfolio purchase is the distribution of risk for merchant losses and the respective obligations under the agreement. Most portfolio purchase agreements will provide for the purchaser to be liable for any losses that occur after the closing date of the transaction. Similarly, the seller of the portfolio would likely be obligated to pay for any such obligations that occur prior to the closing date.

The issue of who will service the merchants is also an important consideration. If the agent who is selling the portfolio has some duties to service the merchants, the purchaser may not wish to take on those obligations if they are not making a strategic purchase. There may be some need in the agreement for the selling agent to continue to service the merchants either because the purchaser does not wish to do so, or because of an existing personal relationship between the merchants and the selling agent. Of course, the selling agent would likely ask for some kind of compensation if it is obligated to continue to service the merchants. On a related note, the purchaser would likely be obligated to indemnify the seller of a portfolio for any post closing date lawsuits that occur related to the merchants.

One very important but often overlooked issue in regard to a portfolio purchase, is ensuring that the credit card processor consents to the transaction. In nearly every agent agreement, the credit card processor prohibits any sale of the residual stream or the merchants without its consent. In a purely financial transaction, the credit card processor would likely have to cease paying the originating agent, and instead, pay the purchaser of the portfolio. The credit card processor's consent is key to the transaction. If the portfolio sale goes through without the consent of the credit card processor, conceivably the credit card processor could in the future, cease paying the residual based upon the fact that it did not provide its consent to the transaction.

A portfolio purchase offers sales agents the ability to obtain lump sum payments to expand or fund additional operations. They also allow the purchaser to receive a tidy return on their investment. For these reasons, and the reasons set forth above, portfolio purchases will most certainly continue to be an important part of this industry.

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* Paul A. Rianda, Esq. is a partner in the Southern California law firm of Kring and Chung, LLP, and has worked in and with the bankcard industry for the past 8 years. For more information about this article or any other matters, please contact Mr. Rianda at (949) 261-7700 or via email at prianda@kringandchung.com.

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