PORTFOLIO PURCHASE PITFALLS – BUYER PERSPECTIVE

In this two part series of articles, I will discuss common pitfalls in the portfolio purchase process when a willing buyer decides to purchase a portfolio of merchants or the right to residual payments from a willing seller. This month, I will discuss that topic from the buyer's perspective. Next month, I will address the issue from the perspective of the seller of the portfolio.

It's All About Risk:

From the buyer's perspective, purchasing a portfolio effectively is all about assessing risk. The buyer has to make sure that it makes a reasonable return on its investment. To that end, if there are certain risk factors present in a transaction, the buyer may either want to reduce the purchase price for the portfolio or decide to forego the transaction altogether.

When evaluating a portfolio, I tend to view the process as a series of steps where the portfolio is analyzed to make sure that there is a very low risk that the buyer will lose money on the purchase.   If at any point a large risk factor is identified, I usually advise my clients to pass on the purchase. Most people do not have unlimited cash to spend on portfolios so it is usually better to wait for a better portfolio to buy then buy one where there is a high risk of losing your money.

The risk factors vary but there are some important factors to consider as a buyer as follows: 1) historical merchant attrition, 2) any large merchants in the portfolio and 3) problems with the seller's agent agreement and the company that is paying the residuals. I will analyze issues related to each of these points below.

Merchant Attrition:

One of the first things a buyer should analyze is historical merchant attrition. If merchant attrition is high, it is a good indicator that the buyer may not make the expected return and in fact may lose money on the deal.

To evaluate any portfolio, a buyer needs to see a minimum of 3-6 months worth of residual reports. For larger portfolios and more security, a buyer would be prudent to look at an entire year's worth of residual reports. The key when looking at these reports is to determine how fast the portfolio is losing merchants and income. In addition, one needs to try to identify any large merchants that may leave the portfolio.

The importance of attrition cannot be underestimated. As a buyer, anything more than 10-15% attrition per year usually leads me to believe there could be some sort of problem with the portfolio that may cause the buyer to potentially not be able to recoup its investment and make the expected return. If the attrition is greater than that, it becomes incumbent upon the seller to explain the high attrition rate. If the seller cannot do so then it is usually time to walk away from the transaction.

Concentration of Risk:

Another issue to consider is where there are a small number of merchants that make up a large percentage of the portfolio. This leads to a situation where if only a small number of merchants are moved by the seller or even if the merchants leave of their own free will, the buyer cannot recoup its investment. The competition is intense for large merchants so they have a tendency to switch processors often to find a better rate. In addition, the seller has every incentive to move those merchants and therefore retain the bulk of the residuals that it sold, while still getting paid the purchase price. This is often too great of a temptation for the seller and more of a risk than the buyer should take.

Who is Paying the Residuals?

It is important to understand the risk relative to the company that is paying the residuals (which I shall call the "Paying ISO") that are being purchased. Some companies in our industry do not have the best reputation for paying their residuals on time, accurately and over the length of the term of the merchant agreement. There have been various companies in the industry that have been accused of terminating residuals without cause. The seller may actually be selling the residuals for that very reason. Consequently, it is important for the buyer to investigate the reputation of the Paying ISO. It's a small industry and one can usually get a sense of the Paying ISO's reputation by asking the right people.

Another potential issue with the Paying ISO is that it has to consent to the purchase. This can take the form of the Paying ISO having a right of first refusal to purchase at the same price that the buyer is offering. This can leave the buyer in the unprofitable position of making an offer to purchase the portfolio and having the portfolio bought out from under it by the Paying ISO. Or, the Paying ISO could just decide that it will not allow the transaction to occur. Again, investigating the reputation of the Paying ISO may allow the buyer to find out there is a problem and avoid wasted effort making an offer on a portfolio that the Paying ISO will not allow to be sold.

The Impact of the Agent Agreement:

Another area to assess for risk relates to the agent or ISO agreement that governs the portfolio that is being sold. That agreement should be closely scrutinized for potential ways that the residual stream that is being sold can be terminated or the residuals payments reduced, again increasing the risk the buyer will not make the expected profit.

Many agent agreements have provisions that state if the agent does not submit a certain number of approved merchant application, the residuals can be terminated. Other agreements provide that the portion of profits paid to the agent or other costs charged to the agent can be changed by the paying ISO which could drastically reduce the residuals that are paid under the agent agreement. All these potential risks need to be identified. Once they are identified, it is prudent for the buyer to ask for those provisions to be waived by the Paying ISO. Otherwise, it may not be worth the risk of going through with the sale.

These are some of the main risks but there are others that can derail a transaction. As a buyer, it is important to discuss the transaction with the seller and to determine the seller's reason for selling. In most transactions, a little bit of conversation with the seller can help you determine if this will be a profitable transaction or one that could be fraught with problems. Next month, I will discuss pitfalls for the seller to watch out for in a portfolio sale.

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* Paul A. Rianda, Esq. is an attorney who has specialized in providing legal advice to the bankcard industry for over 10 years. For more information about this article or any other matters, please contact Mr. Rianda at www.riandalaw.com, (949) 261-7700 or via email at paul@riandalaw.com