PORTFOLIO PURCHASE PITFALLS - SELLER

By Paul A. Rianda, Esq.

As promised, this month in the second article of this two part series I will discuss portfolio purchase pitfalls from the perspective of the seller of a portfolio of merchants or the residual stream associated with those merchants.

Who Gets Last Month's Residuals?

When you are selling a portfolio, it is important to identify when the purchase will be effective and how that effective date will be defined. A buyer will usually try to make the agreement effective immediately so that it can receive the next residual payment. Say the transaction is to close on the 1st of May and the next residual payment for transactions processed in April is due on May 25th. If the transfer of the residual payments is effective immediately on the closing date, the buyer will paid the residuals for transactions processed in April when the seller arguably still "owned" the portfolio of merchants.

From the seller's perspective, to avoid this result, the seller should ask that it be paid the residuals for all transactions processed while the buyer still "owned" the portfolio. In the example above, seller would insist that it be paid the residual payment that was made on May 25th for transactions that were processed in April. In this manner, the seller is able to secure for itself one more residual payment that effectively increases the multiple it is paid for the residual stream by one additional month.

Liquidated Damages Provisions:

Some portfolio purchase documents contain liquidated damages provisions that can be very costly to the seller. A liquidated damages provision contains language to the effect that if the seller violates certain provisions in the purchase agreement, the buyer can in effect fine the seller. The typical liquidated damages provision is linked to the non-solicitation provision in the purchase document.

The non-solicitation provisions prohibits the seller from taking any of the merchants that it has sold and moving those merchants to another processor, typically for 5 years after the seller sells the merchants to the purchaser. If the seller violates this provision, the liquidated damages provision states that the seller will be liable to pay the purchaser a stated amount, typically $2,500 to $5,000. This leaves the seller in a situation where if it moves one merchant that only generates $20 per month in residuals, the seller could be faced with paying a huge penalty. For that reason, sellers should try to make absolutely sure they do not move any of the merchants that they have sold if they cannot get the buyer to remove those types of provisions.

Delayed Payments:

Many people focus to their detriment on the "multiple" that they are being paid for their portfolio. The important thing is not the multiple, it is when you are paid the money and whether the

money is guaranteed. Again by way of example, most people would believe that getting paid a multiple of 36 times is always better than getting paid a multiple of 25 times. However, that is not always the case.

For instance, take for example an offer to pay the seller a multiple of 36 times that is spread out over 2 years. The buyer makes an offer to pay 18 times on the close of the transaction, another 9 times one year after the close of the transaction and another 9 times two years after the close of the transaction. Assuming the portfolio has little or no attrition (I know that's not very realistic but see below where I explain the concepts of minimums), the seller is not getting much for its portfolio.

If the seller had just held on to the portfolio and collected the payments, the seller would have collected 24 payments for itself. The seller is only paid a 36 multiple so an argument can be made that at the end of two years, under this payment scheme the seller was only paid a multiple of 12 times (the 36 times he was paid over two years less the 24 times he would have gotten if he had not sold the portfolio). Contrast that with a payment of 25 times up front with no later payments and no minimum attrition guarantees the seller is arguably better off as will be explained in more detail below.

Like I said above, almost every portfolio has a tendency through attrition for the monthly residual payment to reduce over time. So, almost any purchaser that is paying a high multiple is going to make the seller subject to minimum guaranteed residuals payments as paid over time to the buyer, in order for the seller to get delayed payments.

For example, if we talk again about our 36 times offer payable (i) 18 times at close (ii) 9 times at the end of year one and (iii) 9 times at the end of year two, if the residual payment was averaging $10,000 a month on the date of the sale, the buyer might have a provision in the contract that states if the residual payment is less that $9,000 at the end of year one the additional 8 multiple at the end of years one and two does not have to be paid. In that example, if the residual payment had dropped to $8,900 at the end of year one the seller who thought it was getting paid a 36 multiple would end out getting paid the initial payment of 18 times and nothing more.

In order to avoid this type of outcome, many sellers prefer not to take payments over time but instead choose to be paid a lower up front multiple (say 25 times in my example) rather than be subject to potentially not getting part of the purchase price. If you are subject to these types of attrition guarantees, it is important as a seller to be able to replace merchants in the portfolio that leave through attrition. That way, as a seller at least you have the opportunity to take matters into your own hands and guarantee you are paid the later portions of the purchase price by replacing merchants in order to meet the attrition guarantees.

Claw-Backs

Claw back provisions are similar to attrition guarantees. However, with a claw back provision instead of not getting paid some delayed part of the purchase price, the seller may have to actually repay part of the purchase price. Claw back provisions typically also focuses on the attrition in the portfolio that is being sold. If the portfolio does not perform up to the required level, the overall purchase price is reduced pro rata based upon the drop in the value of the portfolio.

Using another example, say a portfolio that generates $10,000 per month is sold for a 25 multiple or $250,000 total purchase price. But, the purchase agreement has a claw back provision that states if at the end of one year after the purchase, the portfolio is not still producing at least $10,000 per month that the seller has to pay back a part of the purchase price based on the shortfall. Assuming at the end of year one the portfolio was only producing $8,000 (a 20% drop in the residuals), typically the seller would have to pay back from the purchase price 20% of the $250,000 or $50,000 back to the purchaser. Again, to protect against losing part of the purchase price the seller should ask to be allowed in the purchase contract, to replace merchants that fall out of the portfolio.

Sellers can obtain a substantial benefit by selling their portfolios. By utilizing some of the tips in this article they can avoid having the transaction turn out to be more of a nightmare than a dream.

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