<u>Portfolio Valuation Techniques</u>

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One of the questions I often get asked is how does one determine the value of a portfolio of merchants and consequently the value of one merchant. In this article I will discuss various ways of determining the value of a portfolio or of merchants using three common financial techniques, namely: (i) discounted cash flow; (ii) comparable sales; and (iii) value of merchants in the public market.

Discounted Cash Flow

One of the most common ways of valuing a portfolio of merchants, or any revenue stream, is through the use of discounted cash flow analysis. Discounted cash flow analysis seeks to determine the value of a particular revenue stream by taking into account risks associated with receiving the future residual stream. In addition, the procedure also takes into account the fact that a payment in the future is worth less than cash that is available immediately.

A typical transaction where the use of discounted cash flow analysis would be appropriate, is where an agent is receiving a monthly residual from an ISO and the agent wishes to sell that residual stream to a financial buyer. The buyer in this instance needs to pay a lump sum to the agent based upon the buyer's perceived value of the residual stream after applying a discounted case flow analysis.

Assuming that no more merchants will be added to the portfolio, there are a number of items typically that reduce the value of the residual stream in the eyes of a buyer. These risks include merchant attrition from the portfolio, the potential for the ISO to cease paying the residuals, the potential that the agent could try and move merchants causing the residual to be terminated as well as a host of other considerations that lead the typical buyer to believe that there is a significant risk that the residual in question could be reduced or even terminated. For that reason, a buyer will typically substantially discount the amount that it is willing to pay for such a residual stream.

In regard to discount cash flow analysis, the buyer has to pick a risk factor or factors that accurately reflects what it believes are the risks associated with purchasing a portfolio. The larger the risk factor, the lower the value that the buyer will be willing to pay. This risk factor, expressed as a percentage, is used in the discounted cash flow analysis to determine what a reasonable price would be to pay for the portfolio. The larger the risk factor, the less that the buyer will be willing to pay for the portfolio.

In addition, discounted cash flow takes into account the time value of money. What this means is that $10,000 today is not worth the same amount as $10,000 to be paid in two years. This is because if you receive $10,000 today you can invest that money and it will be worth more than $10,000 in two years. Consequently, a discounted cash flow analysis also has to take into account this time value of money as a further reduction to the price most buyers are willing to pay for a residual stream.

Comparable Sales

Another way of valuing portfolios and indeed merchants, is to look at comparable sales of merchants that have occurred in the industry. This is a technique that is often used to value entire companies that are sold. This type of comparable sale analysis, along with the discounted cash flow analysis, can be used in conjunction to provide a more accurate picture of the true value of a merchant or portfolio of merchants.

In our industry, there are sales of portfolios or companies on a fairly regular basis. One can look at this historical data in order to ascertain what could be the potential value of a merchant or a portfolio of merchants. For instance, Bank of America recently purchased National Processing, Inc. for $1.4 billion in cash. Since National Processing, Inc. indicates that it has approximately 700,000 merchants, this implies that the value of each merchant to Bank of America was approximately $2,000. On the other hand, iPayment, Inc.'s recent purchase of the First Data Corporation portfolio of merchants implied a substantially higher value. iPayment purchased a portfolio of 25,000 merchants for $130 million in cash implying a value of $5,200 per merchant.

Figures such as these are helpful in determining the value of a merchant portfolio but are not necessarily absolute values that can be relied in valuing a particular portfolio. In the two transactions above, it would still be necessary to determine whether for example, the merchants acquired were similar in quality and size, as well as other relevant considerations.. Price per merchant is just one way of looking at the transaction. An alternative method such as basing a valuation on the processing volume of the merchants could yield different results.

<u>Public Valuation</u>

Yet another way of determining merchant value is to look at the value of publicly held companies and the value the public market places on the merchants. Using iPayment again as an example, just before its purchase of the FDC portfolio, the company had a total market value, commonly called a market capitalization, of approximately $635 million. Information provided by iPayment indicates it had approximately 100,000 merchants at that time implying a value of $6,350 per merchant. This means that even though iPayment may have paid $5,200 per merchant in the First Data transaction, the public sector believes those merchants have a higher value and hence the purchase buy iPayment would tend to increase its total shareholder value.

However, the public market values companies differently. For instance Pipeline Data had a market capitalization of approximately $23 million as of the date of this article and listed 10,000 merchants. The implied value of these merchants is $2,300 which is substantially different from the value that is placed by the public market on the iPayment merchants.

As is shown above, the values that can be derived using different methodologies can vary greatly. Most portfolio valuations will generally determine the value of the portfolio or merchants under each of the three different techniques above. By taking an average of all the different values that result, a more accurate picture can be presented of a reasonable value for a portfolio or a particular group of merchants. The important thing is not to rely upon one particular type of valuation method, but to use all of them for a more accurate determination of the true portfolio value.

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