

# TRANSACTION

## TRENDS

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# HUNTING FOR A CAPITAL INFUSION

**At some point, most ISOs simply can't expand their businesses without additional capital. Getting it can be tough, but not impossible, provided an ISO is willing to apply a little due diligence.**

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# HUNTING FOR A C



**At some point, most ISOs simply can't expand their businesses without additional capital. Getting it can be tough, but not impossible, provided an ISO is willing to apply a little due diligence.**

# CAPITAL INFUSION

By Peter Lucas

**IT'S INEVITABLE THAT AFTER A FEW YEARS OF OPERATION MOST INDEPENDENT SALES ORGANIZATIONS WANT TO GROW THEIR BUSINESSES ONLY TO FIND THEIR FINANCING OPTIONS LIMITED. INDEED, MANY BANKS ARE RELUCTANT TO UNDERWRITE A LOAN FOR A SMALL BUSINESS IN WHAT IS CONSIDERED TO BE AN EXTREMELY PRICE COMPETITIVE AND VOLATILE MARKET. NOR ARE THEY LIKELY TO LEND AGAINST WHAT THEY CONSIDER TO BE AN INTANGIBLE ASSET - FUTURE REVENUES ON MERCHANT PROCESSING CONTRACTS.**

Turning to a third-party investor can be equally frustrating. Most venture capitalists typically expect a return of 30 percent or more on their money, in addition to having a say in how the business is operated, a steep price to pay for many small business owners not ready to share profits or decision-making duties.

Rather than come away empty handed in their quest for funding, many ISOs will dig deeper into their own pockets by taking second mortgages on their homes, racking up huge sums of credit card debt or selling off portions of their portfolios.

While viable, none of these options makes a great deal of sense. Sure, many entrepreneurs have used home equity loans to launch or grow businesses, but it is a risky strategy as delinquency can lead to the loss of one of their biggest personal assets. Credit cards can provide a quick and easy source of funding, but once the teaser rates expire, the cardholder is left paying double-digit interest rates.

## The Financing Tightrope

Without a doubt, the last option is the least appealing because it is counter intuitive to achieving their goals and in some cases may actually mean the loss of lucrative individual

accounts, since they will command the greatest value from a prospective buyer (Why Portfolio Sales Don't Add Up, p. 11). Nevertheless, many ISOs in a bind for cash will opt for one of these three choices.

"ISO financing is not a particularly good storyline right now," affirms C. Marc Abbey, a partner with Linthicum, Md.-based First Annapolis Consulting. "Most ISOs are self-financed and portfolio sales to raise cash to grow a business are common. They usually end up taking two steps backward to get the funding they need to take one step forward. It's saw-tooth progress."

That's the bad news. The good news is that ISOs willing to do their homework can secure the funding needed to grow their businesses without having to mortgage their future or sell off part of their businesses. This is not to say that getting funds will be a snap, because it won't be. What it means is that ISOs have more options to obtain working capital than they might think otherwise.

## Creative Financing

The brightest prospect on the horizon is the emergence of a handful of lenders focusing on making loans to ISOs. Many of these companies specialize in finance as opposed to banking, which means

their lending criteria are often less stringent than those of a bank. And because these companies are actively lending to ISOs, their understanding

of the processing business enables them to put the value of a merchant contract in perspective and float a loan against future revenues.

# A Guide to Third Party Financing

**American Express Co.** – AmEx’s Small Business Network (i.e. Open), offers several sources of funding for entrepreneurs. From small business loans to business cards with credit lines up to \$50,000, the options are plentiful. As a processor AmEx understands the value of a merchant contract as collateral.

**Banks** – A more traditional source of funding, but they can be tough when it comes to demonstrating future profits and sound auditing practices. Going to a BIN bank for a loan can help pave the way, but only if the lending department understands the processing business, which is not a certainty.

**Finance Companies** – Several of these players are willing to provide debt financing to ISOs. While their lending criteria may be less stringent than a bank’s, they still want to see a solid business plan and auditing procedures. Finding them also can be tough, so ask around.

**The Small Business Administration** – A good place to make contact with banks willing to provide micro loans (i.e. loans of \$50,000 or less). Documentation requirements are stringent and setting up sales offices in an economically depressed area may be required. Business owners also must show an equity stake of at least 20 percent.

**Venture Capitalists** – An obvious choice, but they usually want a 30 percent return on their investment, which may mean taking the company public. Also expect them to demand a say in how the company is operated.

Known as debt financing, the practice enables ISOs to secure funds using their merchant contracts as collateral. In most cases, the ISO will grow its revenues at a much higher rate than the interest rate charged on the loan.

“Debt financing is the best source of funding, economically and logistically, for the ISO,” explains David E. Putnam, president of Chevy Chase, Md.-based Resource Financing Co. “A lot of ISOs don’t know debt financing is available, so they don’t investigate it.”

Resource Financing is one of about a half a dozen companies actively willing to provide working capital to ISOs. Others include San Francisco-based Gryphon Investors, New York-based Windward Capital and Chicago-based GTCR, which has invested in Boulder-based TransFirst Inc., a rapidly growing ISO. In addition, GTCR recently entered into an agreement last June to infuse capital into Santa Clara, Calif.-based terminal manufacturer VeriFone, Inc.

In most cases, banks and private equity companies require about a \$50,000 minimum for a business loan, according to financing experts.

“There are also a number of BIN banks that will make loans to ISOs,” Abbey adds. “As a processor, they have a vested interest in ISOs. They can also make loans at a fraction of the residual stream.”

As good as debt financing looks on paper, securing it is not a lock. Potential lenders and investors insist on seeing not only a solid business plan from the ISO but sound auditing procedures. The latter is receiving even more scrutiny in the wake of corporate accounting scandals that forced Enron Corp. and WorldCom, Inc. to file bankruptcy, leaving unsuspecting investors holding the bag while management walked away with millions.

## Straight Up Accounting

Such catastrophes have only served to stress the need for small businesses to demonstrate their ability to repay a loan, according to a recently published article by Jim Oberman, a financier and director with Retriever Payment

# WHY PORTFOLIO SALES DON'T ADD UP

**No independent sales organization really wants to sell off a piece of its portfolio, but the sad reality is that many ISOs see no other option when it comes to raising cash to grow their businesses. The shortsightedness of this strategy is often bred by the allure of obtaining quick cash, which the ISO intends to use to grow business and recoup the loss of volume.**

The trouble is such projections rarely pan out because most ISOs must wrestle with attrition anyway. Hence, selling off accounts to raise cash only intensifies the pressure of replacing lost revenue. In short, portfolio sales ought to be viewed as an option of last resort.

"By selling a piece of your portfolio you cannibalize your business," declares Richardson Roberts, CEO of Verus Financial Management, Inc., a Nashville, Tenn.-based payments processing company. "It's the equivalent of robbing Peter to pay Paul. You don't really come out ahead."

Earlier this year, Verus, which was founded using venture capital money, reached an agreement to purchase Network 1 Financial, a McLean, Va.-based electronic payments processor. The deal was its first acquisition.

"Getting funds through venture capital or banks based on the strength of your business is a traditional way to grow," Roberts adds.

"If your business is strong, it doesn't make a lot of sense to sell part of your portfolio."

Nevertheless, many ISOs resort to such tactics because they are turned down for loans by banks that don't understand their business or that view them as competitors to what has traditionally been a service banks provide to merchants.

Worse still, many ISOs put a portion of their portfolios on the block without any consideration of the accounts they are selling, which means they can lose some highly profitable accounts.

"Most ISOs will sell a block of accounts processed through a particular bank because

it is cleaner," explains C. Marc Abbey, a partner with Linthicum, Md.-based First Annapolis Consulting. "There is really not a lot of sophistication that goes into the decision to sell accounts."

Even if an ISO tries to protect its core business by electing to sell off some lesser accounts or a tiny fraction of the portfolio, chances are the rate of return will be severely discounted. That makes the

prospect of getting enough capital to fuel expansion slim.

"A larger block of accounts and more profitable accounts command a higher

price," says one financier that requested anonymity. "The multiple on these types of accounts only increases and they are more apt to get sold. You don't get much for a portfolio of low volume merchants."

Rather than take the quick cash a portfolio sale can provide, financing experts recommend ISOs look for alternative sources of capital, even if it means having to float business expenses on a credit card.

"Selling part of your portfolio is counterintuitive," says Putnam. "There are a lot of better options to get capital for growth."

Why sell if you don't have to?

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Systems, a Houston-based ISO. Oberman goes on to say that while ISOs tend to be successful entrepreneurs, they often neglect such basic business disciplines found in larger companies as producing monthly financial statements, filing timely tax returns and hiring independent auditors to review and verify their earnings statements.

Sound financial reporting is a requirement any lender expects even in scandal-free times, because the purpose of their business is to minimize risk while maximizing the return on investment. About half of all small businesses fail within five years of launching and 80 percent fail within 10 years, according to financing experts.

"Investors and banks want to see proof of a viable business," says John Barrickman, president of New Horizons Financial Group, a Rosewell, Ga.-based financial consulting firm. "That means producing financial statements to show that you can service debt, especially in adverse economic times, and contracts for current and future business. You need to show you have the volume to create revenue flow and profits."

Volume and profits are critical. One of the most common problems that plague ISOs is the failure to plan ahead in order to cover expenses during downturns in business, which in most cases are inevitable. The unexpected drop in consumer spending after the attacks on September 11, 2001, is a prime example. Economic conditions also must be taken into consideration. While consumer spending has remained relatively strong despite the sluggish economy, it has been uneven.

"There are going to be months your business goes like gangbusters and others when it slows, any business owner has to plan for it," says Dee Brown, a partner in Phoenix-based Profit Dynamics, Inc., a consulting firm that helps entrepreneurs secure funding. "Lots of small businesses don't plan ahead for this and wind up short on cash. You have to save cash to have it during the months there is a deficit. There are always going to be downturns, whether it is through attrition or whatever, and that is something you can't predict."

## Long-Term Thinking

Having sufficient cash flow to ride out the tough times means the ISO has built a solid business, one that generates steady revenues from core clients, an aspect many lenders find attractive. Getting to that point can be tough, since many new ISOs make the mistake of focusing too much on terminal sales after the start-up phase, because it generates quick cash flow.

"A lot of ISOs look at equipment leasing as a way to turn a \$300 machine into a \$2000 sale over a few years, which means about \$40 of monthly revenue during the contract," says Marty Blank, co-owner of Automated Merchant Services, a Coral Springs Fla.-based ISO. "The trouble with focusing too much on equipment leasing and equipment sales is that you never enjoy the full benefits of income from residual business, which comes from merchant contracts. That's where the real long-term money is."

But let's say that an ISO wanting to grow its business meets all the reporting requirements of a private equity lender or BIN bank but doesn't want or need the minimum amount these lenders insist on supplying. What then?

There are still choices for ISOs that may want a loan of less than the \$50,000 minimum established by many banks. One option is to apply for a line of credit. Most banks will offer small businesses credit lines between \$10,000 and \$50,000. The difference between a line of credit and a loan is that the business owner can borrow the amount needed, as opposed to a minimum. Interest is paid only on the balance due, and in some cases, payments on the principal can be postponed for a short period. In most instances, no financial statements or tax returns are required to apply.

Financing experts recommend that an ISO apply for a line of credit before the need to grow its business arises. "It's usually easier to borrow when you don't need the money," says Blank, who adds he is frequently solicited for offers of credit lines and loans despite operating a profitable business. "If you have a positive balance sheet it's easier to get funding."

The drawback to a line of credit is that the lender can withdraw it at any time for any reason. "The business owner can make regular, timely payments on the balance due and the line of credit can dry up without explanation," Brown cautions. "Business owners need to be aware that credit lines may not always be available when they need them."

## Don't Forget Government Programs

If the risk associated with a line of credit is unappealing, ISOs that prefer a more conventional method of funding can turn to the Small Business Association (SBA). While the SBA does not provide loans, it does put small business operators into contact with lenders that do.

The advantage of working through the SBA is that it will guarantee up to 80 percent of the loan, thereby reducing the lender's risk. This guarantee enables small businesses to qualify for loans they might not otherwise qualify for under a bank's lending criteria. The lender, however, must agree to make the loan with the SBA guarantee. Borrowers must provide proper documentation of projected earnings and costs and have at least a 20 percent equity stake in the company. Interest rates on SBA guaranteed loans are usually 1 to 2.75 percentage points above the prime rate.

Under the SBA's MicroLoan program, businesses can borrow up to \$35,000. The average SBA MicroLoan is about \$10,500. Rates are fixed and repayment is required in six years or less.

As always, there is a catch. Businesses borrowing funds with the aid of the SBA may be subject to certain requirements in return for the SBA's guarantee of funds, including increasing their staff or opening new offices in economically depressed areas. "What federal and state lending programs want is some type of economic value from the business receiving the loan," Brown adds. "It's a cross between providing the lender a high rate of return and an equity position in the business."

## On the Wings of Angels

One of the more intriguing options for funding is the so-called angel lender, an indi-

vidual who is willing to provide capital in return for an equity position. While many angel investors tend to be experts in the industry in which they are supplying capital, ISOs need to be selective.

Although there are many wealthy individuals eager to offer personal savings to help a business grow, they are not necessarily accredited lenders, according to Brown. "An accredited angel lender is someone who has more than \$1 million in net worth, excluding their residence, and an annual income of \$200,000 for an individual or \$300,000 jointly," says Brown, co-author of *Attracting Capital from Angels*. "Angels also have extensive knowledge of the industry in which they are investing and can impart it to help borrowers grow their businesses. You don't want someone unfamiliar with the industry investing his or her life savings."

To find potential angel lenders, ISOs can talk to stockbrokers, attorneys and consultants within their industry. It also is recommended that the individual seeking an angel lender prepare a brief marketing campaign that explains his business idea in such a way so as to motivate the prospective angel to want to learn more. Also known as an elevator pitch, these presentations usually last less than a

minute, so they must be powerful yet concise, according to the National Association for the Self-Employed's Web site.

ISOs turning to angel lenders must be prepared to provide an equity stake in return for the capital and in some cases take the company public in a few years. Consequently, most angel lenders will only do business with companies that have plans for accelerated growth. Typically, angel lenders have a floor of \$50,000 when investing in a company.

"Angel investors usually want a return of about 30 percent on their money and it's hard to achieve that without a public offering or some sort of stock debenture," consultant Barrickman adds. "That's why angels only work with companies that can show an exceptional rate of growth."

### The Bootstrap Approach

If there are no angels in an ISO's future, it might be able to find the cash it needs to expand by making a few adjustments within its own business. Known as bootstrap financing, the practice entails tightening credit and collections policies to minimize the time between delivery and shipping of goods and collections of receivables. That means

getting merchants up and running sooner and following up immediately on invoices that are past due, since the prospect for recovery becomes slimmer with each passing day.

Bartering with vendors is another form of bootstrapping. Often small businesses in need of computer or office equipment will barter their services in return for equipment. If an exchange of services does not work, ISOs can always ask vendors to restructure their debt to free up more cash. Finally, ISOs looking to bootstrap their finances need to

consider dropping marginally profitable or unprofitable accounts and lines of business.

Saying no to business can be tough, but the payoff from giving more attention to your most profitable clients or lines of business means a higher rate of return on investment and can actually lead to more business from those clients, according to small business management experts.

"ISOs are always looking for ways to grow by adding new services or technology, but you want to make sure they fit your core business," financier Putnam explains. "You want a rate of return that exceeds the cost of the investment. When it doesn't, then you need to look at contraction."

When all else fails, ISOs in need of cash can turn to family and friends. While this is one of the most common forms of organic growth for ISOs, taking on a partner, whether he is silent or not, can be tricky because the partner may not always share your business philosophy, Blank cautions. It also means putting a personal relationship on the line, which can become strained if the ISO's business begins to falter. "Taking on a partner also means you are sharing your revenues, so you never realize 100 percent of any growth you have from that point," Blank adds.

With so many funding options available, an ISO really doesn't need to sell off a piece of its portfolio. Nevertheless, ISOs searching for a capital infusion need to weigh all the pros and cons of the options available to them before making a decision on which source of funding is best to tap.

"Difficult economic times produce opportunities for those with the wherewithal to take advantage of them," Putnam says. "Just look at the successes Warren Buffet has enjoyed."

Due diligence does breed success.

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As individuals who provide financing to help entrepreneurs grow their businesses, angel investors are worth seeking. In most cases, they are individuals who have made a lot of money in the industry to which they are offering financial assistance and are looking to reinvest their money and knowledge. Finding them, however, can be tough.

## Spotting The Angels Among Us

Here are a few Web sites that can help ISOs locate angel investors:

[www.thecapitalnetwork.com](http://www.thecapitalnetwork.com)  
[www.garage.com](http://www.garage.com)  
[www.angellegacy.com](http://www.angellegacy.com)  
[www.angelinvestorsonline.com](http://www.angelinvestorsonline.com)  
[www.capital-connection.com](http://www.capital-connection.com)

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