What went wrong with First Data? Payment processor shows signs of trouble

by Eric Grover

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Has the $26 billion-valuation LBO -- the largest ever -- of the world's biggest payment processor, **First Data Corp.**, failed? While it's still too soon to render a definitive judgment, signs are not encouraging.

With $22.6 billion of debt, First Data's debt-to-Ebita ratio is 10.5. The payment processing behemoth will not be able to pay off this mountain of debt out of operations. It may have to hive off assets and certainly has to raise equity capital, likely attempting an initial public offering in 2010, market conditions permitting.

First Data's enormously ambitious leveraged buyout was predicated on: (1) a healthy economy and robust secular card payments growth tailwinds; (2) a benign regulatory environment; (3) that the processing mastodon was marbled with unnecessary costs; and (4) that as a private company, with the new management, ministered to by private equity firm **Kohlberg Kravis Roberts & Co.**, cost and competitive synergies could be realized across its portfolio of payment-processing assets.

At least several assumptions haven't panned out: The architects of First Data's LBO did not bank on the Great Recession.

Card payment transactions and volume growth slowed, putting a damper on First Data revenue. Credit card use is declining; transaction size is down; and consumers shifted spending from credit to less-profitable debit and from small to more thinly priced giant merchants, all of which reduce the payment processor's revenue.

While payment processing has long been vigorously competitive, the recession and retail bank consolidation have exacerbated pricing pressure. In the third quarter, First Data's financial services business renewed 131 clients but experienced brutal price compression -- "typically 18% to 20%." Some of this was fallout from card issuer consolidation. Larger card issuers pay less per account and transaction. For smaller issuers, First Data said price compression has been less severe, running from "marginal to 8% to 10%" -- still worrisome.

First Data faces unprecedented regulatory headwinds. Congress is assaulting the credit card industry on multiple fronts. The Credit Card Accountability, Responsibility, and Disclosure Act enacted in May curbs credit card companies' interest, administrative and penalty fees, suppressing card issuance and volume, particularly to nonprime consumers comprising almost 40% of American adults.

House Rules Committee Chairwoman Louise Slaughter, D-N.Y., has proposed capping credit card interest rates at 16%. This would further reduce card issuance and use.

And, Senate Majority Whip Dick Durbin, D-Ill., has proposed imposing price controls on card acceptance fees, which would savage First Data's largest business: merchant acquiring.

While for the moment First Data benefits from its LIBOR interest rate benchmark falling to 1%, with $450 million in quarterly interest expenses, reining in costs has to be at the top of mind.

First Data has long had an opportunity to eliminate redundant infrastructure costs associated with duplicate delivery platforms acquired over the years. Data center and administrative consolidation was the low-hanging fruit. The payment-processing company reduced its U.S. data center fleet from 12 to two.

Software application rationalization, however, is more challenging. Before the LBO, First Data was aiming for one merchant and one issuer processing platform each in the U.S. and abroad. It has tempered its objectives, now working toward three U.S. merchant processing platforms and two abroad -- eMAXS, acquired with Germany's largest payment processor GZS Gesellschaft für Zahlungssysteme mbH as its primary platform, and its previous standard eponymous OmniPay, developed with Irish software firm OmniPay Ltd., in which it's the majority shareholder. Given the eMAXS commitment, one could question the rationale for continuing to hold the OmniPay stake.

In contrast, acquisitive multinational processor **Global Payments Inc.** is migrating to one front and back-end platform worldwide.

For credit card issuer processing, First Data will stick with its legacy in the U.S. and with FirstVision, picked up with PaySys in 2001, overseas.

First Data contends that by 2010 it will have eliminated $500 million in ongoing operating costs. If that's all fat, it would be powerful testimony to brutal and real LBO value creation and a stunning indictment of the previous management of Ric Duques and Charlie Fote. If, however, the burning debt service imperative impelled excessive cost cutting, there will be a price to pay.

While debt can be cheap capital magnifying equity returns, the massive debt burden has an opportunity cost.

A global payment-processing land grab is under way, with First Data at the head of a pack including Global Payments, **Total Systems Services Inc.**, **Atos Worldline SAS** and **Elavon Inc.** But for the past several years, First Data has mostly stayed on the sidelines. Except for acquiring half of European ATM network processor **Trionsis SCRL**, it has done little since the LBO to take advantage of or drive consolidation among Europe's payment-processing and network patchwork. Europe's largest acquirer and merchant processor, **RBS WorldPay**, is for sale. Pre-LBO, this is a business First Data would have taken a run at.

Up until the recession, global card payments had been increasing 14% to 15% per annum. While the U.S. is considered a mature cards market, ample growth displacing cash and checks remains. The world's second-largest electronic payments market, Europe, is consolidating. Before the LBO, First Data acquired the U.K.'s largest processor Signet, Germany's largest processor GZS, Poland's largest processor Polcard, APSS, Delta and Europrocessing International, among others. More attractive long-term growth lies beyond western Europe in big emerging payments markets such as Brazil, China, India, Russia and Turkey.

All of First Data's businesses face challenges.

Check guarantee and verification is shrinking as check use continues its inexorable decline.

Its card issuer-processing business suffered from stepped-up competition from Total Systems Services and credit card issuer consolidation. Larger U.S. card issuers have had greater wherewithal and inclination to process in-house. First Data needs to better harness processed and third-party data to provide more value-added risk and marketing services to clients such as **Wells Fargo & Co.**, **General Electric Co.**'s GE Money, **Citigroup Inc.**'s retail card business and **Barclays plc** in the U.K.

Merchant acquiring and processing is First Data's most important business. While as a result of the LBO its acquiring joint venture with **J.P. Morgan Chase & Co.** was dissolved, earlier this year **Bank of America Corp.** -- battered by the financial crisis -- put its merchant-servicing business in a joint venture with First Data.

For acquiring businesses to grow profitably, cost-effectively originating and servicing small merchants is critical. First Data continues to originate merchants across multiple channels, direct sales, through independent sales organizations, and bank referrals and JVs. It's also attempting to increase retailer-switching costs and capture more of the value chain by pushing proprietary point-of-sale terminals. **Intuit Inc.** has been an exemplar reaching small merchants, providing acceptance to its back-office software clients and by enabling mobile-phone card acceptance serving electricians, plumbers and exterminators on-site.

First Data is also in the network business, having acquired the U.S.' largest PIN-debit network, Star, in 2004. There's little evidence, however, that Star has benefitted from First Data's bank and merchant relationships. Since the acquisition it's bled market share, principally to **Visa Inc.** The Star brand has no power with consumers or merchants -- a huge problem for any retail network. Banks increasingly treat Star as a commodity utility. Its recent partnership with **PayPal Inc.** enabling cardholders to transact online is one of the first tangible enhancements that may generate more transactions and bolster pricing.

In aggregate First Data is arguably worth less today than its LBO valuation and indeed less than its outstanding debt. At multinational merchant processor Global Payments' revenue and Ebita valuation multiples of 2.2 and 9.3, First Data's enterprise value would be $23.9 billion and $19.8 billion, respectively. At multinational payment processor Total Systems

Services' revenue and Ebita valuation multiples of 1.7 and 7.4, its enterprise value would be $16.4 billion and $15.8 billion, respectively.

That said, there is upside. When the economy and payment card use revive, First Data will enjoy outsized bottom-line benefits. Most delivery system costs are fixed. When issuer processor and network transactions increase, real incremental costs aren't material. While merchant acquiring has significant variable merchant origination and servicing people costs, it enjoys operating leverage as well.

First Data's unrealized challenge remains to compellingly demonstrate housing the world's largest portfolio of related payment-processing assets under one roof makes the whole more competitive and therefore more valuable.

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