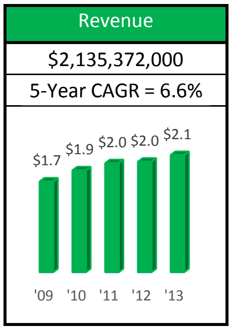
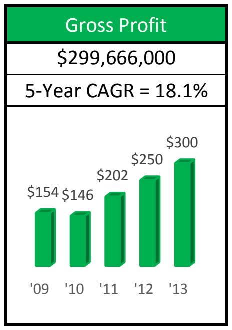
SELECTIVE
WEALTH MANAGEMENT

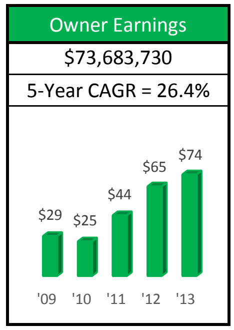
Heartland Payment Systems Inc.
April 11, 2014

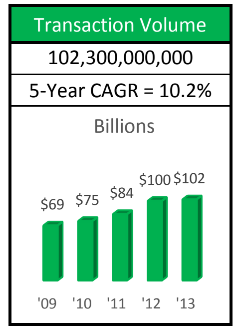
## General Overview

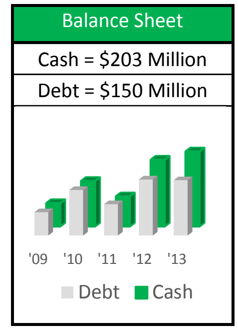
Heartland Payment Systems (HPY) provides electronic payment processing for merchants. They install point-of-sale terminals for their Small and Midsized Enterprise clients (SME) and Network Services clients. In exchange for the installation and processing of electronic payments they receive a small percentage of each transaction equal to roughly 0.50%.




*Purchase Logic*

We purchased our stake in HPY at a per share price of $37.83. The total value of the business at this price $1.35 Billion. We anticipate earnings in the next twelve months of approximately $90 million which equates to a purchase price of 15.2x earnings. We paid a fair price for an outstanding company. The business boasts a return on tangible equity in excess of 70%, healthy growth between 5%-20% per year, and extremely predictable future earnings. For this investment to be a success the company simply needs to continue executing the existing plan with excellence.

*Future Expectations*

We anticipate HPY to continue steady and predictable growth in the upcoming decade that would yield satisfactory investment results if the price multiple remains constant. Due to the unique nature of the customer base the company rarely has negative surprises when reporting because the majority of the company's revenues and income is contractually bound for three year periods. The primary driver for price movements is the 'new margin installed' which is a measure of new customers signed up during a quarter. If the new margin installed is unusually low the share price will fall and we intend to increase the size of the position. If the new margin installed is unusually high the share price will likely climb and we would carefully evaluate a possible sale. We do not anticipate any material changes in the business model for the foreseeable future.

Heartland Payment Systems operates in five divisions: Payment Processing, school nutrition payment solutions, full-service payroll, payment processing for higher education loan services, and prepaid card solutions.

**Problem & Solution**

Problem

Merchants would like to accept electronic payments for goods and services. In order to accomplish this task information about the card holder, the merchant & customer banks, and the card processing network, must be routed safely and securely to the appropriate parties.

Solution

HPY installs terminals at merchant locations to process card information and send the appropriate information securely to all the correct parties. This enables electronic transactions.

**How To Win**

In order to win in this business you need to provide the lowest transaction fees as a percentage of dollars processed. The lowest cost provider, coupled with solid security solutions, will win. The business is very sticky with multi-year contracts so another critical element is distribution. The companies with the lowest costs and highest customer retention rate will win. HPY is the leader in both of these categories.

**Critical Metrics**

1. Processing Fees (Lowest) – This number needs to be as low as possible to help win business as well as retain existing clients.

$$Processing\ Fees = \frac{Net\ Processing\ Revenue}{Dollars\ Processed}$$

Here HPY is really a winner. They average roughly 50 bps, or 0.50%, compared to 1.2% for GPN and an industry average of approximately 1.0%. They are able to accomplish this through their direct sales force and fully integrated solutions. The direct sales force cuts costs associated with paying ISOs to sign up merchants and increases the retention rate. The fully integrated solution allows them to process more and more payment volume over a fixed costs, rather than a variable cost, if they have to pay a third-party to assist in processing payments.

2. Retention Rate (Highest) – This number needs to be as high as possible to maximize the value per client.

$$Retention = \frac{\#\ of\ Clients\ At\ End\ of\ Period - \#\ of\ New\ Clients}{\#\ of\ Clients\ At\ Beginning\ of\ the\ Period}$$

The retention rates for HPY are industry leading at 87% - thanks in large part to their direct sales force. Their direct sales force is paid only on commission and has a large incentive to service clients well. An independent sales organization, or ISO, may offer a merchant several choices for their processing solutions (like GPN or HPY, etc.) and does not have a preference on which merchant acquirer they select. The ISO is paid either way. This makes distribution through an ISO more risky because retention rates are much lower and fees are typically higher. The average retention rate for a merchant acquirer is approximately 80%.

**Products & Services**

HPY provides transaction processing for merchants and full-service payroll processing related to tax filings services, marketing solutions including loyalty and gift cards, and sell and rent point-of-sale devices.

HPY also provides school nutrition and associated payment solutions, including online prepayment solutions, and open- and closed-loop payment solutions and higher education loan services to colleges.

### Customers

At December 31, 2013 HPY provided bankcard payment processing services to approximately 169,994 active SME bankcard merchants across the United States. This was a slight decrease from 171,801 at December 31, 2012. The SME merchants produce between $50,000 and $5,000,000 in card volume annually with an average of $447,000. The SME processing volume by industry category:

| | Month of December | | |
|---|---|---|---|
| | **2013** | **2012** | **2011** |
| Restaurants | **34.6%** | 36.0% | 34.8% |
| Retail | **17.5%** | 18.0% | 18.2% |
| Convenience, Fast Food & Liquor | **12.3%** | 11.2% | 10.9% |
| Automotive | **6.4%** | 6.5% | 7.5% |
| Professional Services | **7.1%** | 7.3% | 7.1% |
| Lodging | **4.8%** | 4.5% | 4.3% |
| Petroleum | **1.8%** | 1.9% | 1.9% |
| Other | **15.5%** | 14.6% | 15.3% |

HPY also provided bankcard solutions to 12,000 merchants in Canada and 396 Network Service Merchants with 42,669 locations. The interest in Canada was sold in January 2013. All together they service more than 200,000+ locations with an extremely fractured customer base. This makes their income very stable and predictable.

### Sales & Marketing

The product is distributed through their direct sales force and all expenses are commission based. They also partner with other trade organizations and pay referral fees for recommending their services.

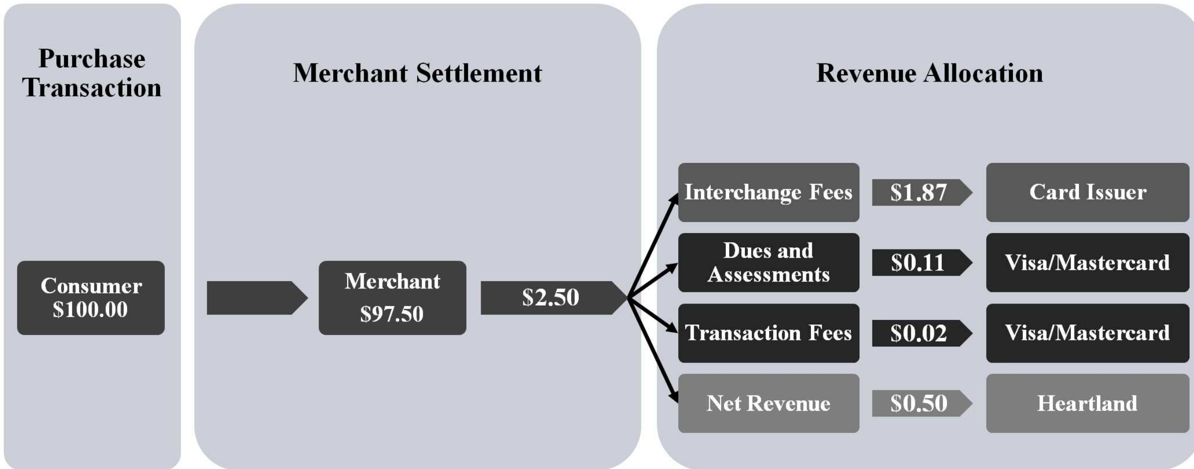
The pay structure is describe in detail in the expense section.

### Revenue Creation

When an individual uses a debit or credit card to make a purchase at a merchant, such as a restaurant or gas station, a small percentage is taken from the transaction to pay several companies:

1) The cardnetwork is paid, such as Visa or Mastercard
2) The merchant's bank and the customer's bank is paid. For example, if I bank at Wells Fargo and Walmart banks with Bank of America, when I make a purchase at Walmart Wells Fargo and Bank of America both receive "interchange" fees.
3) The merchant acquirer that provides the terminal and software to make the purchase gets paid. This is HPY.

Below is a diagram:




A customer purchases $100 worth of goods at a merchant. The merchant keeps $97.50 while $2.50 is paid to Heartland. That $2.50 is then divided up where $1.87 is paid to two banks, such as Wells Fargo and Bank of America ("Card Issuer"), $0.11 + $0.02 is paid to Visa or Mastercard (depending on the card type) and Heartland Payments keeps $0.50. They would report $2.50 as gross revenue, but only $0.50 as net revenue since $2.00 immediately went to other parties. HPY takes roughly 0.50% per transaction while the industry average for SME is closer to 1%. A company like Square charges approximately 1.5%.

This format makes HPY's revenue highly dependent on the total dollar volume processed at their customer merchants. As they sign up more merchants, or their merchants do more business, their revenue grows. In 2012 there was a slight decrease in the number of merchants serviced, but each merchant did more business which increased the total dollar volume processed. This demonstrates the very favorable economics for the business.

| | Year Ended December 31, | | |
|---|---|---|---|
| | **2012** | **2011** | **2010** |
| | | (In millions) | |
| SME merchants | **$ 71,724** | $ 67,499 | $ 63,058 |
| Network Services Merchants | **27,894** | 15,533 | 11,319 |
| Canada | **770** | 666 | 562 |
| Total bankcard processing volume (a) | **$ 100,388** | $ 83,698 | $ 74,939 |

(a) Bankcard processing volume includes volume for credit and signature debit transactions.

**Expenses**

A major expense for HPY is their customer acquisition costs. Unlike many competitors who rely on Independent Sales Organizations (ISOs), Heartland has a direct sales force. They have 844 Relationship and Territory managers (up from 739 in 2012) and 58 Senior Product Advisors ("SPAs") who are payroll specialists. The compensation is entirely commission-based and is paid as a percentage of the financial value of new merchant accounts installed (called 'gross margin'). The annual gross margin installed is calculated by deducting the cost of processing (on a per-transaction basis) and servicing (measured in dollars per month) from the expected first-year net revenue the account is expected to generate. This installed margin is gross profit to Heartland.

The Relationship Manager is paid a signing bonus of 50% of the first 12 months' estimated gross margin. The Relationship Manager also receives, beginning in the month installed, 15% of the gross margin generated from the merchant account each month as residual commission for as long as the merchant remains a customer. Additionally, the Division Manager receives 25% of the amount paid to the Relationship Manager. The Executive Director receives an amount equal to 25% of that paid to the Division Manager.

Example:

| | | | |
|---|---|---|---|
| **Signing Bonus:** | | | |
| Estimated gross margin for first 12 months | $ | 1,000 | |
| Signing bonus paid to: | | | |
| Relationship Manager | $ | 500 | 50.0% |
| Division Manager (plus Territory Manager) | $ | 125 | 12.5% |
| Executive Director | $ | 31 | 3.13% |
| | | | |
| **Residual Commission:** | | | |
| Estimated monthly gross margin | $ | 83.33 | |
| Monthly residual commission paid to: | | | |
| Relationship Manager | $ | 12.50 | 15.0% |
| Division Manager (plus Territory Manager) | $ | 3.12 | 3.75% |
| Executive Director | $ | 0.78 | 0.94% |

These expenses are capitalized and then amortized over a 3 year period as 'customer acquisition costs'. These costs are variable in nature, but have outstanding return characteristics for the business. The following is a table that aggregates all cash flows paid to each manager and calculates HPY cash flow based on $1,000 of installed margin.

| Year | Gross Margin | Signing Bonuses | Residual Payment | HPY Cash Flow |
|---|---|---|---|---|
| Initial | $ - | $ 656 | $0 | $ (656) |
| 1 | $ 1,000 | $ - | $ 197 | $ 803 |
| 2 | $ 1,000 | $ - | $ 197 | $ 803 |
| 3 | $ 1,000 | $ - | $ 197 | $ 803 |

Internal rate of return on a 3-year contract = 109%

The remainder of the business, from software development to security solutions, is largely fixed in nature and gives excellent operating leverage.

### Real Income

Despite the complexity of the accounting due to the capitalization of their customer acquisition costs – the reported income is essentially identical to their actual income. The amortization and depreciation expenses are both very real for the business.

### Growth

In 2012 HPY accounted for 4.5% of the 72.9 billion of purchase transactions processed by all bankcard acquirers in the United States. They have an opportunity to continue to grow through gains in market share as well as the general size of the payment processing market increasing. Growth is a critical element to this investment thesis. We are assuming they continue to grow through increased sales at existing merchants, the addition of new merchants, and further penetration of electronic payments as a whole. We are anticipating growth in earnings between 4% and 11% for the next 10 years. This is likely due to being the lowest cost provider.

### Competition

As a merchant acquirer they compete against First Data Corporation, Global Payments Inc., Vantiv Inc., Chase Paymentech Solutions, Bank of America Merchant Services, Elavon Inc., and Total Systems Services Inc.

They compete based on the following factors: Sales force effectiveness, Range of product offering, quality of service, reliability of service, professional association endorsements, ability to evaluate, undertake and management risk, speed in approving merchant applications, price and brand name. The primary driver, however, is price. In this respect they currently have a lead for SME. Larger merchants typically can receive better pricing than HPY offers and they are not their target customer.

As a food service technology company their largest competitor is Horizon Software Solutions.

As a payroll processor their largest competitors are ADP, Paychex, Ceridian, and Intuit.

In the unattended payments industry the largest competitor is USA Technologies.

### Consolidated Balance Sheet

The company presently has roughly $30 million in cash and $150 million in long-term debt. This represents 1.5x their earnings before interest and taxes. The company is eligible to borrow up to $350 million under their current revolving debt facility and intends to further their leverage their balance sheet in the future. They currently cover their interest payments 10:1. We will watch any increases in debt very carefully.

Overall we believe the balance sheet is prudently managed.

### Accounting Quality

The firm was audited by Deloitte & Touche LLP and received an unqualified opinion. This indicates sound accounting practices according to Deloitte.

**Legal**

In January 2009 the company publically announced the discovery of a criminal reach of its payments systems environment. There have been several lawsuits filed against the company with respect to this intrusion. The following class action lawsuits have been combined into one:

| Name of the Court | Date Filed | Principal Parties |
|---|---|---|
| United States District Court for the District of New Jersey | February 6, 2009 | *Lone Summit Bank v. Heartland Payment Systems, Inc. et al.* , 3:09-cv-00581 |
| United States District Court for the District of New Jersey | February 13, 2009 | *TriCentury Bank et al. v. Heartland Payment Systems, Inc. et al.* , 3:09-cv-00697 |
| United States District Court for the Southern District of Texas | February 16, 2009 | *Lone Star National Bank v. Heartland Payment Systems, Inc. et al.* , 7:09-cv-00064 |
| United States District Court for the District of New Jersey | February 20, 2009 | *Amalgamated Bank et al. v. Heartland Payment Systems, Inc. et al.* , 3:09-cv-00776 |
| United States District Court for the Southern District of Florida | March 19, 2009 | *First Bankers Trust Co., N.A. v. Heartland Payment Systems, Inc. et al.* , 4:09-cv-00825 |
| United States District Court for the Southern District of Florida | March 31, 2009 | *PBC Credit Union et al. v. Heartland Payment Systems, Inc. et al.* , 9:09-cv-80481 |
| United States District Court for the Southern District of Texas | April 22, 2009 | *Community West Credit Union, et al. v. Heartland Payment Systems, Inc. et al.* , 4:09-cv-01201 |
| United States District Court for the Southern District of Texas | April 22, 2009 | *Eden Financial Corp. v. Heartland Payment Systems, Inc. et al.* , 4:09-cv-01203 |
| United States District Court for the Southern District of Texas | April 28, 2009 | *Heritage Trust Federal Credit Union v. Heartland Payment Systems, Inc. et al.* , 4:09-cv-01284 |
| United States District Court for the Southern District of Texas | May 1, 2009 | *Pennsylvania State Employees Credit Union v. Heartland Payment Systems, Inc. et al.* , 4:09-cv-01330 |

Since the Processing System Intrusion they have incurred $114.7 million in settlements of claims and $33 million in legal fees. They do not anticipate any further losses from these lawsuits.

**Market**

According to The Nilson Report, in 2011 they were the 6$^{th}$ largest merchant acquirer in the United States ranked by transaction account and 9$^{th}$ largest merchant acquirer by processed dollar volume. The rankings include 2.8 billion transactions and 4% of the total U.S. bankcard processing market.

The market is growing at a considerable pace, roughly 8% per year, simply on increasing penetration rates for electronic payments nationwide. We believe the market will continue to expand and electronic payments will become the norm.

In general HPY has been stealing market share from their competition due to the lower rates they charge per transaction. We believe this general trend will continue. The market is sufficiently large not to limit their growth.

### Allocation of Capital

It is our expectation that they will allocate approximately 10% of their earnings to dividends, 35% to share repurchases, and the remainder on acquisitions and organic growth. This allocation expectation is consistently with managements recently announced intentions on their most recent conference call. Additionally allocations to share repurchases would be most welcome.

### Risks

- Security Breach – This occurred in 2008 and was very expensive for HPY (more than $148 million in legal fees or 2 years of annual income). Security is always a risk for merchant acquirers. A security breach in the future is very likely and ongoing ownership of HPY should factor in a security breach and required payouts on a periodic basis, such as once every 15 years.
- Visa or MasterCard fines and termination – If Visa or MasterCard no longer allowed them to utilize their networks it would cripple the business. This is not likely because Visa and MasterCard earns substantially all of their income through merchant acquirers that distribute their product. They have a vested interest in their ongoing membership and success.
- Sponsor bank termination – If their sponsor banks no longer allow them to process Visa and MasterCard transaction through them it would cripple the business. This is not likely because sponsor banks receive income from HPY and compete for HPY's business. HPY is typically in the driver seat with respect to membership.
- Changes in laws and regulation – If new laws imposed maximums on merchant acquirer fees it would hinder the business. This is not likely because merchant acquirers compete against each other based on price. This is *very* different from the interchange fees and dues that are under high scrutiny. Any change in interchange fees would not impact HPY and may actually be a positive catalyst (interchange is a pass-through expense for HPY).
- Chargeback Liability – In the event of a billing dispute between a cardholder and a merchant the merchant must 'chargeback' the transaction and refund the cardholder. If the merchant is bankrupt or not able to refund the cardholder HPY is responsible for the refund. In order to mitigate this risk HPY typically only hires merchants that receive cash for goods and services as they are performed, such as a restaurant. The chargebacks in these industries is very low.

### Moat

They have a direct sales force for SME which is very unique in the industry. Other merchant acquirers sell through ISOs and have significantly lower retention rates.

The competitive moat actually is derived from the nature of the industry. The merchant acquirer industry has outstanding economics and the multi-year contracts across fractured customer bases make income's highly predictable. The top 25 SME's accounted for less than 4% of their overall revenue.

### Works Cited

1) Heartland Payments Systems Inc. *Annual Report - SEC Filing 10-K.* EDGAR, 2013.

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