HEARTLAND PAYMENT SYSTEMS INC
Form 10-Q
August 02, 2005

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION

Washington, DC 20549

FORM 10-Q

(Mark One)

ý **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended March 31, 2005

OR

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from to

Commission File No. 000-51265

HEARTLAND PAYMENT SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware	**22-3755714**
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification Number)

47 Hulfish Street, Suite 400 Princeton, New Jersey 08542

(Address of principal executive offices) (Zip Code)

(609) 683-3831

(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. o YES ý NO

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act). o YES ý NO

As of July 15, 2005, there were 16,461,600 shares of the registrant s Common Stock, $.001 par value, outstanding.

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Heartland Payment Systems, Inc. and Subsidiary

Consolidated Balance Sheets

(unaudited)

	March 31, 2005 (As Restated See Note 17)	December 31, 2004 (As Restated See Note 17)
	(dollar amounts in thousands)	
Assets		
Current assets:		
Cash and cash equivalents	**$ 12,706**	$ 13,237
Receivables	**64,664**	64,325
Investments	**1,340**	1,100
Inventory	**362**	818
Prepaid expenses	**2,989**	2,151
Current deferred tax assets, net	**2,179**	2,129
Total current assets	**84,240**	83,760
Capitalized customer acquisition costs, net	**35,586**	34,247
Deferred tax assets, net	**4,488**	4,651
Property and equipment, net	**11,827**	10,944
Deposits and other assets	**251**	324
Total assets	**$ 136,392**	$ 133,926
Liabilities and stockholders equity		
Current liabilities:		
Due to sponsor bank	**$ 45,465**	$ 45,153
Accounts payable	**26,891**	27,103
Current portion of accrued buyout liability	**10,258**	9,327
Merchant deposits and loss reserves	**8,145**	7,175
Accrued expenses and other	**5,932**	6,701
Current portion of borrowings and financing arrangement	**5,227**	5,286
Total current liabilities	**101,918**	100,745
Long-term portion of borrowings and financing arrangements	**7,324**	7,808
Warrants with mandatory redemption provisions	**1,655**	1,566
Long-term portion of accrued buyout liability	**16,665**	17,708
Total liabilities	**127,562**	127,827
Stockholders equity		
Series A Senior Convertible Participating Preferred Stock, $80 million liquidation preference, $.001 par value, 10,000,000 shares authorized, 7,619,048 issued and outstanding	**8**	8
Common Stock, $.001 par value, 100,000,000 shares authorized, 16,451,080 and 16,437,760 issued and outstanding at March 31, 2005 and December 31, 2004, respectively	**8**	8
Additional paid-in capital	**41,110**	41,065
Accumulated other comprehensive income (loss)	**(18)**	(10)
Accumulated deficit	**(32,278)**	(34,972)
Total stockholders equity	**8,830**	6,099
Total liabilities and stockholders equity	**$ 136,392**	$ 133,926

See accompanying notes to consolidated financial statements.

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Heartland Payment Systems, Inc. and Subsidiary

Consolidated Statements of Operations

(amounts in thousands, except per share data)

(unaudited)

	Three Months Ended March 31, 2005	2004 (As Restated See Note 17)
Revenue:		
Gross processing revenue	**$ 166,172**	$ 119,202
Other revenue, net	**3,693**	2,002
Total net revenue	**169,865**	121,204
Costs of Services:		
Interchange	**122,416**	86,372
Dues and assessments	**6,415**	4,785
Processing and servicing	**19,820**	14,748
Customer acquisition costs	**5,841**	4,135
Depreciation and amortization	**1,283**	876
Total costs of services	**155,775**	110,916
Selling and administrative	**8,989**	7,233
Total expenses	**164,764**	118,149
Income from operations	**5,101**	3,055
Other income (expense):		
Interest income	**110**	38
Interest expense	**(435)**	(298)
Fair value adjustment for warrants with mandatory redemption provisions	**(90)**	—
Other, net	**(3)**	833
Total other income (expense)	**(418)**	573
Income before income taxes	**4,683**	3,628
Provision for income taxes	**1,989**	1,482
Net income	**2,694**	2,146
Income allocated to Series A Senior Convertible Preferred Stock	**(1,295)**	(1,037)
Net income attributable to Common Stock	**$ 1,399**	$ 1,109
Net income	**$ 2,694**	$ 2,146
Other comprehensive income, net of tax:		
Unrealized gains (losses) on investments	**(8)**	7
Comprehensive income	**$ 2,686**	$ 2,153
Earnings per common share:		
Basic	**$ 0.09**	$ 0.07
Diluted	**$ 0.08**	$ 0.07
Weighted average number of common shares outstanding:		
Basic	**16,449**	16,296
Diluted	**34,672**	32,871

See accompanying notes to consolidated financial statements.

Heartland Payment Systems, Inc. and Subsidiary

Consolidated Statements of Stockholders Equity

(amounts in thousands)

(unaudited)

	Preferred Stock Number of Shares Outstanding	Preferred Stock Amount	Common Stock Number of Shares Outstanding	Common Stock Amount
Balance, December 31, 2004	7,619	$ 8	16,438	$ 8
Issuance of Common Stock— options exercised			13	
Accumulated other comprehensive income				
Net income for the period				
Balance March 31, 2005	7,619	$ 8	16,451	$ 8

	Additional Paid-In Capital	Accumulated Other Comprehensive Income	Accumulated Deficit	Total Stockholders Equity
Balance, December 31, 2004	$ 41,065	$ (10)	$ (34,972)	$ 6,099
Issuance of Common Stock— options exercised	45			45
Accumulated other comprehensive income		(8)		(8)
Net income for the period			2,694	2,694
Balance March 31, 2005	$ 41,110	$ (18)	$ (32,278)	$ 8,830

See accompanying notes to consolidated financial statements.

Heartland Payment Systems, Inc. and Subsidiary

Consolidated Statements of Cash Flow

(dollar amounts in thousands)

(unaudited)

	Three Months Ended March 31, 2005	Three Months Ended March 31, 2004 (As Restated See Note 17)
Cash flows from operating activities		
Net income	**$ 2,694**	$ 2,146
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	**6,844**	4,686
Fair value adjustment for warrants with mandatory redemption provisions	**90**	—
Deferred taxes	**113**	1,003
Changes in operating assets and liabilities:		
Increase in receivables	**(338)**	(4,144)
Decrease in inventory	**456**	106
Increase in capitalized customer acquisition costs	**(6,924)**	(6,142)
Increase in prepaid expenses	**(830)**	(386)
Decrease in deposits and other assets	**24**	347
Increase in due to sponsor bank and accounts payable	**100**	5,101
(Decrease) increase in accrued expenses and other	**(768)**	612
Increase in merchant deposits and loss reserves	**970**	177
(Decrease) increase in accrued buyout liability	**(112)**	1,710
Net cash provided by operating activities	**2,319**	5,216
Cash flows from investing activities		
Purchase of investments	**(250)**	(250)
Maturities of investments	**1**	252
Purchases of property and equipment	**(2,102)**	(1,119)
Net cash used in investing activities	**(2,351)**	(1,117)
Cash flows from financing activities		
Redemption of warrants issued in connection with debt financing	**—**	(1,055)
Principal payments on borrowings and financing arrangements	**(544)**	(934)
Issuance of Common Stock	**45**	(37)
Net cash used in financing activities	**(499)**	(2,026)
Net (decrease) increase in cash and cash equivalents	**(531)**	2,073
Cash and cash equivalents at beginning of year	**13,237**	13,004
Cash and cash equivalents at end of period	**$ 12,706**	$ 15,077
Supplemental cash flow information:		
Cash paid during the period for:		
Interest	**$ 409**	$ 225
Income taxes	**801**	273
Supplemental schedule of non cash activities:		
Amortization of other assets	**64**	64

See accompanying notes to consolidated financial statements.

Heartland Payment Systems, Inc. and Subsidiary

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

(unaudited)

1. Organization and Operations

***Basis of Financial Statement Presentation*—** The accompanying consolidated financial statements include those of Heartland Payment systems, Inc. (the Company) and its wholly-owned subsidiary, Heartland Payroll Company (HPC). The consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States of America. All intercompany balances and transactions with the Company s wholly-owned subsidiary have been eliminated upon consolidation. The accompanying consolidated financial statements are unaudited; however, in the opinion of management, they include all normal recurring adjustments necessary for a fair presentation of the consolidated financial position of the Company at March 31, 2005, the consolidated results of its operations and cash flows for the three months ended March 31, 2005 and 2004. Results of operations reported for interim periods are not necessarily indicative of results for the entire year.

The officers and directors of the Company represent a majority of the outstanding shares, and so control the Company.

As discussed in Note 16, all outstanding common shares, average common shares, earnings per common share and conversion amounts related to stock options, warrants and Series A Senior Convertible Participating Preferred Stock have been retroactively adjusted to reflect a two-for-one stock split on July 26, 2005.

***Business*—** The Company provides payment-processing services related to bank card transactions for merchants throughout the United States. In addition, the Company provides certain other merchant services, including the sale and rental of terminal equipment and supplies. HPC provides payroll and related tax filing services throughout the United States.

***Use of Estimates*—** The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America, requires management to make estimates and assumptions that affect the reported amounts of assets, liabilities, and disclosure of contingent assets and liabilities at the date of the consolidated financial statements, and the reported amounts of revenues and expenses during the reporting period. Estimates include, among other things, the accrued buyout liability, capitalized customer acquisition costs, loss reserves, certain accounts payable and accrued expenses and certain tax assets and liabilities as well as the related valuation allowances. Actual results could differ from those estimates.

Concentrations— The majority of the Company s merchant processing activity is processed by a single vendor. The Company believes that the vendor maintains appropriate backup systems and alternative arrangements to avoid a significant disruption of processing in the event of an unforeseen event.

Substantially all of the Company s revenue is derived from processing Visa and MasterCard bank card transactions. Because the Company is not a member bank as defined by Visa and MasterCard, in order to process these bank card transactions the Company has entered into a sponsorship agreement with a bank. The agreement with the bank sponsor requires, among other things, that the Company abide by the by-laws and regulations of the Visa and MasterCard associations and maintain a certificate of deposit with the bank sponsor. If the Company breaches the sponsorship agreement, the bank sponsor may terminate the agreement and, under the terms of the agreement, the Company would have 180 days to identify an alternative bank sponsor. The Company is dependent on its bank sponsor, Visa and MasterCard for notification of any compliance breaches. As of March 31, 2005, the Company has not been notified of any such issues by its bank sponsor, Visa or MasterCard.

The Company processes for merchants throughout the United States. California represented 15.8% of the Company s total processing volume in March 2005.

2. Summary of Significant Accounting Policies

Cash and Cash Equivalents The Company considers all highly liquid investments with original maturities of three months or less when purchased to be cash equivalents.

Receivables The Company carries receivables from its merchants resulting from the practice of advancing interchange fees to most of its merchants during the month and collecting those fees from merchants at the beginning of the following month. During each month, the Company s sponsor bank advances interchange fees to most of the Company s merchants so that during the month a payable to the sponsor bank is incurred. The payable to the sponsor bank is repaid at the beginning of the following month out of the fees the Company collects from its merchants.

Investments Investments consist of corporate and U.S. Government debt securities and certificates of deposit. The Company classifies its investments as available-for-sale and records them at the fair value of the investments based on quoted market prices. Cost is determined on a specific identification basis.

Inventories Inventories consist of point-of-sale terminal equipment held for sale to merchants, and are valued at the lower of cost or market price. Cost is arrived at using the first-in, first-out method. Market price is estimated based on current sales of equipment.

Capitalized Customer Acquisition Costs, net Capitalized customer acquisition costs consist of (1) up-front signing bonus payments made to Relationship Managers and sales managers (the Company s sales force) for the establishment of new merchant relationships, and (2) a deferred acquisition cost representing the cost of buying out the commissions of vested sales employees. Pursuant to Staff Accounting Bulletin Topic 13, *Revenue Recognition*, and FASB Technical Bulletin No. 90-1, *Accounting for Separately Priced Extended Warranty and Product Maintenance Contracts*, capitalized customer acquisition costs represent incremental, direct customer acquisition costs that are recoverable through gross margins associated with merchant contracts. The capitalized customer acquisition costs are amortized using a method which approximates a proportional revenue approach over the initial three-year term of the merchant contract.

The up-front signing bonus is based on the estimated gross margin for the first year of the merchant contract. The signing bonus, amount capitalized, and related amortization are adjusted after one year to reflect the actual gross margin generated by the merchant contract during that year. The deferred customer acquisition cost asset is accrued over the first year of merchant processing, consistent with the build-up in the accrued buyout liability, as described below.

Management evaluates the capitalized customer acquisition costs for impairment at each balance sheet date by comparing, on a pooled basis by vintage month of origination, the expected future net cash flows from underlying merchant relationships to the carrying amount of the capitalized customer acquisition costs. If the estimated future net cash flows are lower than the recorded carrying amount, indicating an impairment of the value of the capitalized customer acquisition costs, the impairment loss will be charged to operations.

Property and Equipment Property and equipment are carried at cost, net of accumulated depreciation. Depreciation is computed straight-line over periods ranging from three to ten years for furniture and equipment. Leasehold improvements are amortized over the lesser of the economic useful life of the improvement or the term of the lease. The Company capitalizes the cost of computer software developed for internal use and amortizes such costs over an estimated useful life of three years.

Long-Lived Assets The Company evaluates the potential for impairment when changes in circumstances indicate that undiscounted cash flows estimated to be generated by the related assets are less than the carrying amount. Management believes that no such changes in circumstances or impairment have occurred as of March 31, 2005.

Merchant Deposits and Loss Reserves Disputes between a cardholder and a merchant periodically arise due to the cardholder s dissatisfaction with merchandise quality or the merchant s service, and the disputes may not always be resolved in the merchant s favor. In some of these cases, the transaction is charged back to the merchant and the purchase price is refunded to the cardholder by the credit card-issuing institution. If the merchant is unable to fund the refund, the Company is liable for the full amount of the transaction. The Company may have partial recourse to the Relationship Manager originally soliciting the merchant contract, if the Relationship Manager is still receiving income from the merchant s processing activities. During 2003, the Company adopted FIN 45. Under FIN 45, the Company s obligation to stand ready to perform is minimal. The Company maintains deposits or the pledge of a letter of credit from certain merchants as an offset to potential contingent liabilities that are the responsibility of such merchants. The Company evaluates its ultimate risk and records an estimate of potential loss for chargebacks related to merchant fraud based upon an assessment of actual historical fraud loss rates compared to expected processing volume levels.

Accrued Buyout Liability Relationship Managers and sales managers are paid residual commissions based on the gross margin generated by monthly merchant processing activity. Until May 2004, Relationship Managers and sales managers had the contractual right to sell their portfolio equity at a fixed multiple to the Company. The Company has the right to buy out some or all of these commissions, and intends to do so periodically. Because of the Company s intent and ability to execute purchases of the residual commissions, and the mutual understanding between the Company and the Relationship Managers and sales managers, the Company has accounted for this deferred compensation arrangement pursuant to the substantive nature of the plan. The Company therefore records the amount currently payable (the settlement cost) to buy out non-servicing related commissions (owned commissions) from vested Relationship Managers and sales managers, and an accrual, based on their progress towards vesting, for those unvested Relationship Managers and sales managers who are expected to vest in the future. As noted above, as the liability increases over the first year of a merchant contract, the Company also records for vested Relationship Managers and sales managers a related deferred acquisition cost asset. The accrued buyout liability associated with unvested Relationship Managers and sales managers is not included in the deferred acquisition cost asset since future services are required in order to vest. Subsequent changes in the settlement cost, due to account attrition, same-store sales growth and changes in gross margin, are included in the same income statement caption as customer acquisition cost amortization expense.

The accrued buyout liability is based on the merchants under contract at the balance sheet date, the gross margin generated over the prior 12 months, and the contractual buyout multiple. The liability related to a new merchant is therefore zero when the merchant is installed, and increases over the twelve months following the installation date. The same procedure is applied to unvested commissions over the expected vesting period, but is further adjusted to reflect the Company s experience that 31% of unvested Relationship Managers and sales managers become vested.

The classification of the accrued buyout liability between current and non-current liabilities on the consolidated balance sheet is based upon the Company s estimate of the amount of the accrued buyout liability that it reasonably expects to pay over the next twelve months. This estimate is developed by calculating the cumulative annual average percentage that total historical buyout payments represent of the accrued buyout liability. That percentage is applied to the period-end accrued buyout liability to determine the current portion.

Warrants Warrants with mandatory redemption provisions are classified as debt and are recorded at estimated fair value.

Financing Arrangements Pursuant to EITF 88-18, the Company recognizes the transfer of merchant contracts as financing arrangements included under Borrowings and Financing Arrangements, until such time as the conditions for recognizing the transfer as a sale are met. The interest rates on these financing arrangements are computed based on the expected cash flows resulting from these contracts, reduced by an expected annual volume attrition rate of 15%. Any significant differences between actual future payments and expected payments will result in a change to that interest rate, which will be applied prospectively.

Revenue Revenue is mainly comprised of transaction and discount fees from the processing of merchant transactions. Revenue is recorded as bank card transactions are processed or payroll services are performed. The Company passes through to its customers any changes in interchange or association fees. Payroll revenue represents periodic and annual processing fees, which are recorded as services are performed.

Other revenue includes fees earned from customer service, termination fees on terminated contracts, fees for the sale, rental, leasing and deployment of credit card terminals and other miscellaneous revenue. These amounts are shown net of their associated direct costs, if any, and are recorded at the time the service is performed.

Income Taxes The Company accounts for income taxes by recognizing deferred tax assets and liabilities for the expected future tax consequences of events that have been included in the financial statements or tax returns. Under this method, deferred tax assets and liabilities are determined based on the difference between the financial statements and the tax basis of assets and liabilities using enacted tax rates.

Stock Options The Company accounts for its stock options using the intrinsic value method in which no compensation expense has been recognized for its stock-based compensation plan because the options are granted at an exercise price greater than or equal to the estimated fair value at the grant date.

Basic earnings per share is computed based on the weighted average number of common shares outstanding. Diluted earnings per share is computed based on the weighted average outstanding common shares plus equivalent shares assuming exercise of stock options, warrants and conversion of Series A Senior Convertible Participating Preferred Stock, where dilutive. As discussed in Note 16, weighted average shares outstanding and dilutive securities have been adjusted to reflect a two-for-one stock split on July 26, 2005. The following table presents the effect on net income and basic and diluted net income per common share had the Company adopted the fair value method of accounting for stock-based compensation under SFAS No. 123 (in thousands, except per share data):

	Three Months Ended March 31,			
		2005		**2004**
Net income	**$**	**2,694**	$	2,146
Deduct: Total stock-based employee compensation expense determined under fair-value-based method, net of related tax expense		**1,444**		—
Pro forma net income		**1,250**		2,146
Less: Income allocated to Series A Senior Convertible Participating Preferred Stock		**(635)**		(1,037)
Pro forma net income attributable to common stock	**$**	**615**	$	1,109
Earnings per share :				
As reported:				
Basic	**$**	**0.09**	$	0.07
Diluted	**$**	**0.08**	$	0.07
Pro forma :				
Basic	**$**	**0.04**	$	0.07
Diluted	**$**	**0.04**	$	0.07

New Accounting Pronouncements On December 16, 2004, the Financial Accounting Standards Board (FASB) issued SFAS No. 153, Exchanges of Nonmonetary Assets, an Amendment of APB Opinion No. 29. SFAS No. 153 addresses the measurement of exchanges of nonmonetary assets and redefines the scope of transactions that should be measured based on the fair value of the assets exchanged. SFAS No. 153 is effective for nonmonetary asset exchanges occurring in fiscal periods beginning after June 15, 2005. The Company does not believe adoption of Statement 153 will have a material effect on its consolidated financial position, results of operations or cash flows.

In December 2004, the FASB issued SFAS No. 123 (revised 2004), *Share-Based Payment* (SFAS No. 123 revised). This statement revises SFAS No. 123, *Accounting for Stock-Based Compensation*, and supersedes Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees*, and its related implementation guidance. The most significant change resulting from this statement is the requirement for public companies to expense employee share-based payments under fair value as originally introduced in SFAS No. 123. SFAS No. 123 revised is effective, as amended on April 21, 2005 by the Securities and Exchange Commission, beginning with the first interim or annual reporting period of the registrant s first fiscal year beginning on or after June 15, 2005. The Company will adopt this statement when effective, and continues to assess its impact.

In July 2005, the FASB issued an exposure draft of a proposed Interpretation, *Accounting for Uncertain Tax Positions an interpretation of FASB Statement No. 109.* This proposed Interpretation would clarify the accounting for uncertain tax positions in accordance with FASB Statement No. 109, *Accounting for Income Taxes.* An enterprise would be required to recognize, in its financial statements, the best estimate of the impact of a tax position, if that tax position is probable of being sustained if audited by a tax authority based solely on the technical merits of the position. Individual tax positions that fail to meet the Interpretation s recognition threshold would result in either (a) a reduction in the deferred tax asset or an increase in a deferred tax liability or (b) an increase in a liability for income taxes payable or the reduction of an income tax refund receivable. The proposed Interpretation would be effective as of the end of the first annual period ending on or after December 15, 2005. The Company does not believe the adoption of this proposed Interpretation will have a material effect on its consolidated financial position, results of operations or cash flows.

3. Receivables

A summary of receivables by major class are as follows at March 31, 2005 and December 31, 2004:

	March 31, 2005	**December 31, 2004**
	(in thousands)	
Accounts receivable from merchants	**$ 62,432**	$ 60,739
Accounts receivable from others		