

HEARTLAND PAYMENT SYSTEMS INC
Form S-1/A
July 20, 2005

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As filed with the Securities and Exchange Commission on July 20, 2005

Registration No. 333-118073

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

Amendment No. 4
to
Form S-1
REGISTRATION STATEMENT
UNDER
THE SECURITIES ACT OF 1933

HEARTLAND PAYMENT SYSTEMS, INC.

(Exact name of registrant as specified in its charter)

Delaware
(State or other jurisdiction of
incorporation or organization)

6153
(Primary Standard Industrial
Classification Code)
47 Hulfish Street, Suite 400
Princeton, New Jersey 08542
(609) 683-3831

22-3755714
(I.R.S. Employer Identification No.)

(Address, including zip code, and telephone number, including area code, of registrant's principal executive offices)

Robert O. Carr
Chairman and Chief Executive Officer
Heartland Payment Systems, Inc.
47 Hulfish Street, Suite 400
Princeton, New Jersey 08542
(609) 683-3831

(Name, address, including zip code, and telephone number, including area code, of agent for service)

Copies to:

Kevin T. Collins, Esq.
Nanci I. Prado, Esq.
Dorsey & Whitney LLP
250 Park Avenue
New York, New York 10177
Telephone: (212) 415-9200
Facsimile: (212) 953-7201

Raymond B. Check, Esq.
Cleary Gottlieb Steen & Hamilton LLP
One Liberty Plaza
New York, New York 10006
Telephone: (212) 225-2000
Facsimile: (212) 225-3999

Approximate date of commencement of proposed sale to the public:

As soon as practicable after the effective date of this Registration Statement.

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If any of the securities being registered on this Form are to be offered on a delayed or continuous basis pursuant to Rule 415 under the Securities Act of 1933, check the following box.

If this Form is filed to register additional securities for an offering pursuant to Rule 462(b) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

If this Form is a post-effective amendment filed pursuant to Rule 462(c) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

If this Form is a post-effective amendment filed pursuant to Rule 462(d) under the Securities Act, check the following box and list the Securities Act registration statement number of the earlier effective registration statement for the same offering.

If delivery of the prospectus is expected to be made pursuant to Rule 434, please check the following box.

CALCULATION OF REGISTRATION FEE

Title of each class of Securities to be Registered	Amount to be Registered(1)	Proposed Maximum Offering Price Per Share	Proposed Maximum Aggregate Offering Price(2)	Amount of Registration Fee(3)
Common Stock, \$0.001 par value	7,762,500	\$16	\$124,200,000	\$14,713

- (1) Includes shares subject to over-allotment option granted to the underwriters.
- (2) Estimated solely for the purpose of computing the amount of the registration fee pursuant to Rule 457 under the Securities Act of 1933, as amended.
- (3) The Registration previously paid \$9,503 in connection with the original filing of the registration statement.

THE REGISTRANT HEREBY AMENDS THIS REGISTRATION STATEMENT ON SUCH DATE OR DATES AS MAY BE NECESSARY TO DELAY ITS EFFECTIVE DATE UNTIL THE REGISTRANT SHALL FILE A FURTHER AMENDMENT WHICH SPECIFICALLY STATES THAT THIS REGISTRATION STATEMENT SHALL THEREAFTER BECOME EFFECTIVE IN ACCORDANCE WITH SECTION 8(A) OF THE SECURITIES ACT OF 1933 OR UNTIL THE REGISTRATION STATEMENT SHALL BECOME EFFECTIVE ON SUCH DATE AS THE COMMISSION, ACTING PURSUANT TO SAID SECTION 8(A), MAY DETERMINE.

The information in this prospectus is not complete and may be changed. We may not sell these securities until the registration statement filed with the Securities and Exchange Commission is effective. This prospectus is not an offer to sell these securities and it is not soliciting an offer to buy these securities in any state where the offer or sale is not permitted.

SUBJECT TO COMPLETION, DATED JULY 20, 2005

PROSPECTUS

6,750,000 Shares

Heartland Payment Systems, Inc.

Common Stock
\$ _____
per share

We are selling 2,622,046 shares of our common stock and the selling stockholders named in this prospectus are selling 4,127,954 shares. We will not receive any proceeds from the sale of the shares by the selling stockholders. We and the selling stockholders have granted the underwriters an option to purchase up to 1,012,500 additional shares of common stock to cover over-allotments.

This is the initial public offering of our common stock. We currently expect the initial public offering price to be between \$14.00 and \$16.00 per share. We have applied to list our common stock on the New York Stock Exchange under the symbol "HPY".

Investing in our common stock involves risks. See "Risk Factors" beginning on page 8.

Neither the Securities and Exchange Commission nor any state securities commission has approved or disapproved of these securities or determined if this prospectus is truthful or complete. Any representation to the contrary is a criminal offense.

	<u>Per Share</u>	<u>Total</u>
Public Offering Price	\$	\$
Underwriting Discount	\$	\$
Proceeds to Heartland Payment Systems (before expenses)	\$	\$
Proceeds to the selling stockholders (before expenses)	\$	\$

The underwriters expect to deliver the shares to purchasers on or about _____, 2005.

Citigroup

Credit Suisse First Boston

Robert W. Baird & Co.

William Blair & Company

KeyBanc Capital Markets

SunTrust Robinson Humphrey

, 2005

You should rely only on the information contained in this prospectus. We and the selling stockholders have not authorized anyone to provide you with different information. We and the selling stockholders are not making an offer of these securities in any state where the offer is not permitted.

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Until _____, 2005 (25 days after the date of this prospectus), all dealers that buy, sell or trade our common stock, whether or not participating in this offering, may be required to deliver a prospectus. This is in addition to the dealers' obligation to deliver a prospectus when acting as underwriters and with respect to their unsold allotments or subscriptions.

In this prospectus, we use the terms "Heartland," "we," "us" and "our" to refer to Heartland Payment Systems, Inc.

HEARTLAND PAYMENT SYSTEMS is our registered trademark. We have applied to register HPS Exchange as a trademark. This prospectus also contains trademarks and tradenames of other companies.

SPECIAL NOTE ABOUT FORWARD-LOOKING STATEMENTS

We have made forward-looking statements in this prospectus, including the sections entitled "Management's Discussion and Analysis of Financial Condition and Results of Operations" and "Business," that are based on our management's beliefs and assumptions and on information currently available to our management. Forward-looking statements include the information concerning our possible or assumed future results of operations, business strategies, financing plans, competitive position, industry environment, potential growth opportunities, the effects of future regulation and the effects of competition. Forward-looking statements include all statements that are not historical facts and can be identified by the use of forward-looking terminology such as the words "believe," "expect," "anticipate," "intend," "plan," "estimate" or similar expressions.

Forward-looking statements involve risks, uncertainties and assumptions. Actual results may differ materially from those expressed in the forward-looking statements. We do not have any intention or obligation to update forward-looking statements after we distribute this prospectus.

You should understand that many important factors, in addition to those discussed elsewhere in this prospectus, could cause our results to differ materially from those expressed in the forward-looking statements. These factors include, without limitation, our competitive environment, the business cycles and credit risks of our merchants, chargeback liability, merchant attrition, problems with our bank sponsor, our reliance on other bank card payment processors, our inability to pass increased interchange fees along to our merchants, the unauthorized disclosure of merchant data, economic conditions, system failures and government regulation.

SUMMARY

This summary highlights material information about our company and the common stock that we and the selling stockholders are offering. It does not contain all of the information that may be important to you. You should read this entire prospectus carefully, including the "Risk Factors" section and the financial statements and notes to those statements, which are included elsewhere in this prospectus.

Heartland Payment Systems, Inc.

Our Business

We provide bank card-based payment processing services to small-and medium-sized merchants in the United States and, according to The Nilson Report, in 2004 we were the seventh largest card acquirer in the United States ranked by purchase volume, which consists of both credit and debit Visa and MasterCard transactions. This ranking represented 1.8% of the total bank card processing market. As of June 30, 2005, we provided our payment processing services to approximately 101,500 active merchants located across the United States. Our processing volume for the six months ended June 30, 2005 was \$ billion, a % increase from the \$ billion processed during the same period in 2004.

Our revenue is recurring in nature as we typically enter into three-year service contracts that, in order to qualify for the agreed-upon pricing, require the merchant to achieve processing volume minimums. Most of our gross revenue is payment processing fees, which are a combination of a percentage of the dollar amount of each Visa and MasterCard transaction we process plus a flat fee per transaction. On average, our gross revenue from processing transactions equals approximately \$2.38 for every \$100 we process.

We sell and market our payment processing services through a nationwide direct sales force of approximately 800 sales professionals, known as Relationship Managers. Our sales force is responsible for both the initial sale to, and the ongoing relationship management with, our merchants. Our sales force is compensated solely with commissions, which are directly tied to the performance of the contract signed by the merchant. They are therefore compensated only for adding and retaining profitable processing volume. In 2004, our sales force generated over 42,500 merchant applications and installed over 39,000 new merchants.

We focus our sales efforts on low-risk merchants and have developed systems and procedures designed to minimize our exposure to potential losses. In 2002, 2003 and 2004, we experienced losses of \$0.6 million, \$0.6 million and \$0.9 million, respectively, each of which represented less than 0.4 basis points (0.004%) of payment processing volume. In the first quarter of 2005, we experienced losses of \$0.3 million, or 0.44 basis points. We cannot predict our future losses, and any future increases in the loss rate would reduce our income. We have developed expertise in industries that we believe present relatively low risks, as the customers are generally present and the products or services are generally delivered at the time the transaction is processed. These industries include restaurants, brick and mortar retailers, lodging establishments (hotels and motels), automotive repair shops, convenience and liquor stores and professional service providers. As of March 31, 2005, over 33% of our merchants were restaurants. We believe that restaurants represent an attractive merchant base as they typically have unique processing needs and have significant, predictable processing volume.

Our direct sales force and merchant services initiatives are supported by our technology platform. We use a number of proprietary Internet-based systems which allow us to increase our operating efficiencies and distribute our processing and merchant data to our three main constituencies: our sales force, our merchant base and our customer service staff. In 2001, we began using our internally-developed system, HPS Exchange, to provide authorization and data capture services, known as front-end processing, to our merchants. We believe that our proprietary systems provide a superior experience for both our Relationship Managers and merchants, which enhances the overall relationship.

We also believe that our front-end processing system allows us to offer superior service at a lower cost to us. During the years ended December 31, 2003 and 2004, and the quarter ended March 31, 2005, approximately 26%, 43% and 51% respectively, of our transactions were processed through HPS Exchange, and we anticipate that as this percentage increases our processing costs per transaction will continue to decline. We rely on third parties, primarily Vital Processing Services, Inc., to provide the remainder of our bank card authorization and data capture services, as well as all of our settlement and merchant accounting services.

Since 2002, our processing volume has increased 31.8% annually from approximately \$14.4 billion for the year ended December 31, 2002 to approximately \$25.0 billion for the year ended December 31, 2004. During the same period, our total net revenues increased from \$340.6 million in 2002 to \$602.7 million in 2004. We have achieved this growth entirely through internal expansion rather than through acquisitions or buying merchant contracts from others. In 2000 and 2001 we recorded net losses of \$9.4 million and \$17.4 million, respectively. In 2002, 2003 and 2004, we recorded net income of \$4.9 million, \$20.1 million and \$8.9 million, respectively. In 2004, our net income declined approximately 55.7% from 2003 primarily as the result of income tax benefits recorded in 2003.

Our Market Opportunity

According to The Nilson Report, total expenditures for all card type transactions, which include credit and debit purchases with American Express, Diners Club, Discover, MasterCard and Visa, by U.S. consumers grew from \$0.9 trillion in 1998, to \$1.9 trillion in 2004, and are expected to grow to \$2.8 trillion by 2008, representing a compound annual growth rate of 10% from 2004 levels. We believe that these increases are due to the benefits of bank card payment systems to both merchants and consumers and generational trends that have increased the size of the population that is comfortable with, and accustomed to, using bank cards as a payment medium. By accepting bank cards, merchants can access a broader universe of consumers and enjoy administrative conveniences that are not available with cash and check payments. For example, in recent years, state and local governments have begun accepting bank cards for government payments, such as motor vehicle fees, recreational services, parking fees and taxes, in order to reduce their costs for collecting and processing payments and to expedite the deposit of these payments into their own accounts. Also, we believe more businesses will accept bank card payments from other businesses. By using bank cards, consumers and businesses are able to make purchases more conveniently, while benefiting from loyalty programs, such as frequent flier miles or cash back, which are increasingly being offered by bank card issuers. Given the advantages of bank card payment systems to both merchants and bank card users, favorable generational trends and the resulting growth in bank card usage, we believe that the number of purchases processed using bank card payment systems and the number of merchants accepting bank card payments will continue to increase.

Our Competitive Strengths

Our principal competitive strengths are:

Large, experienced, efficient direct sales force. We believe that we have the largest direct sales force in the payment processing industry.

Recurring and predictable revenues. Our merchants typically sign three-year service contracts, and many continue their contracts with us for much longer.

Internal growth. All merchants on our platform were originally underwritten by us.

Strong position and substantial experience in our target markets. We believe that we are the largest payment processor that concentrates primarily on small- and medium-sized merchants.

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Industry expertise. Our locally-based sales professionals are trained to address the needs of specific industries, in particular the restaurant industry.

Merchant focused culture. Since inception, our corporate culture has focused on offering fully-disclosed pricing and providing superior customer service to our merchants.

Advanced technology. Since our inception, we have consistently invested in our technology and focused on bringing in-house formerly outsourced processes.

Scalable operating structure. The nature of our business, combined with the investment we have made in our technology, allow for lower incremental costs as we grow our processing volume.

Comprehensive underwriting and risk management system. Our underwriting process and experience in assessing risk, combined with our focus on low-risk merchants, has allowed us to maintain low loss levels.

Proven management team. Our senior management team has broad experience within the payment processing industry.

Challenges We Face

We face a number of challenges in executing our business strategy. Among the most important we face are:

Competition. The payment processing industry is very competitive, and includes large firms with substantial resources, including First Data Merchant Services Corporation, National Processing, Inc., a subsidiary of Bank of America Corporation, Global Payments, Inc., Fifth Third Bank and Nova Information Systems, Inc., a subsidiary of U.S. Bancorp.

General Economic Conditions. Any changes in economic conditions that adversely affect our customers could reduce the number of merchants or volume of transactions that we process.

Regulation. Our business is subject to numerous bank card association rules and practices that are subject to change and may impose significant costs or limitations on the way we conduct or expand our business.

Technology. We depend on various forms of technology systems to deliver our products and services. The failure of these systems could cause us to lose customers and increase our costs.

Reliance on Third Parties. We rely on third parties, including our bank sponsor, in order to conduct our business. If any of these relationships are terminated, and we cannot find alternate providers quickly, our business will be severely impacted.

Data Security. As a card processor, we must protect cardholder data from unauthorized use. A major compromise of our systems could subject us to significant fines and sanctions from Visa, MasterCard and/or governmental agencies.

Please see the section entitled "Risk Factors" for information on these and other risks related to our business and this offering.

Our Strategy

Our growth strategy is to increase our market share in the bank card payment processing services industry for small- and medium-sized merchants in the United States. Key elements of our strategy include:

Expanding our direct sales force.

Entering into new markets and further penetrating existing target markets.

Expanding our product and service offerings.

Leveraging our technology.

Enhancing merchant retention.

Pursuing strategic acquisitions.

Recent Event Processing Volume for the Three and Six Months Ended June 30, 2005

As of the date of this prospectus, we preliminarily estimate that our processing volume for the three months ended June 30, 2005 increased by % to \$ billion, compared to \$ billion for the three months ended June 30, 2004. Processing volume increased by %, from \$ billion to \$ billion, in the six months ended June 30, 2004 and 2005, respectively. The processing volume increases reflect the cumulative benefit of the net addition of new merchant accounts from 2004 to 2005, while the faster growth in revenues reflect interchange increases by Visa and MasterCard, which we pass through to our merchants. In June 2005, we processed transactions for 101,633 merchant locations, a 28.6% increase from the 79,022 merchant locations processed in June 2004.

Our History

Heartland Card Services LLC, a Missouri limited liability company and our predecessor, was formed on March 27, 1997, through a contribution of a merchant portfolio from Triad, LLC, a company founded and majority-owned by our chief executive officer, Robert O. Carr, and cash from Heartland Bank, through its subsidiary Heartland Card Company. It began actively processing transactions in July 1997, and in 1999 it changed its name to Heartland Payment Systems LLC. On May 8, 2000, Heartland Payment Systems LLC redeemed the 50% interest owned by Heartland Card Company for cash and part of the merchant portfolio, leaving Triad as the sole member. In connection with such transaction, Heartland Bank and Heartland Card Company acknowledged that we will continue to use the name "Heartland" in connection with our business. On June 16, 2000, we were formed as a Delaware corporation. Triad and Uhle and Associates, LLC were merged into us effective October 1, 2000 and Heartland Payment Systems LLC was merged into us effective January 1, 2001. In addition, on October 1, 2000, Heartland Payroll Company became our wholly-owned subsidiary. In June 2004, we merged Credit Card Software Systems, Inc., our wholly-owned subsidiary, which was acquired by us on December 14, 2000 pursuant to a settlement agreement approved by the United States Bankruptcy Court for the Middle District of North Carolina, into us.

Corporate Information

Our principal executive offices are located at 47 Hulfish Street, Suite 400, Princeton, New Jersey 08542 and our telephone number is (609) 683-3831. Our website address is www.heartlandpaymentsystems.com. Information contained on our website is not a prospectus and does not constitute part of this prospectus.

THE OFFERING

Common stock offered by us	2,622,046 shares
Common stock offered by selling stockholders	4,127,954 shares
Common stock outstanding after this offering	32,406,460 shares
Use of proceeds	We intend to use our estimated net proceeds from this offering to repay approximately \$2.9 million of outstanding indebtedness and to use the remainder for general corporate purposes, including to fund working capital and potential acquisitions. We will not receive any proceeds from the sale of shares by the selling stockholders. See "Use of Proceeds."
Proposed New York Stock Exchange symbol	"HPY"
Risk factors	See "Risk Factors" for a discussion of factors you should carefully consider before deciding to invest in shares of our common stock.

Except as otherwise noted, all information in this prospectus assumes:

a two-for-one split of our outstanding common stock immediately prior to completion of this offering;

the automatic conversion of all outstanding shares of our convertible participating preferred stock into 13,333,334 shares of common stock upon completion of this offering, assuming an initial public offering price of \$15.00 per share, the midpoint of the range on the cover of this prospectus; and

no exercise of the underwriters' over-allotment option.

As of March 31, 2005, we had 29,784,414 shares of common stock outstanding. The number of shares of common stock to be outstanding after this offering excludes:

9,261,002 shares of common stock issuable upon exercise of outstanding stock options as of March 31, 2005 at a weighted average exercise price of \$6.43 per share; and

168,904 shares of common stock issuable upon exercise of outstanding mandatorily redeemable warrants as of March 31, 2005 at an exercise price of \$0.005 per share.

SUMMARY HISTORICAL CONSOLIDATED FINANCIAL AND OTHER DATA

The following summary historical consolidated financial and other data should be read in conjunction with "Selected Historical Consolidated Financial Information and Other Data," "Capitalization," "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our consolidated financial statements and the related notes included elsewhere in this prospectus. Our summary balance sheet data as of March 31, 2005 and summary statement of operations data for the years ended December 31, 2002, 2003 and 2004 have been derived from our consolidated financial statements included elsewhere in this prospectus. The summary statement of operations data for the three months ended March 31, 2004 and 2005 are derived from our unaudited consolidated financial statements included elsewhere in this prospectus and include all adjustments that we consider necessary for a fair presentation of the financial position and results of operations for those periods. We have prepared the unaudited information on the same basis as the audited consolidated financial statements and have included all adjustments, consisting only of normal recurring adjustments, that we consider necessary for a fair presentation of our financial position at those dates and our results of operations for the periods ended.

The following unaudited pro forma balance sheet data give effect to the automatic conversion of all outstanding shares of our convertible participating preferred stock into common stock upon completion of this offering as if it had occurred as of March 31, 2005.

The following unaudited pro forma as adjusted balance sheet data give effect to the pro forma adjustments discussed in the preceding paragraph, our receipt of approximately \$32.1 million in estimated net proceeds from our sale of 2,622,046 shares of our common stock in this offering at an assumed initial public offering price of \$15.00 per share, the midpoint of the range on the cover of this prospectus, as if it had occurred as of March 31, 2005 and the application of our estimated net proceeds from this offering to repay approximately \$2.9 million of outstanding indebtedness. The unaudited pro forma and pro forma as adjusted consolidated financial data do not purport to represent what our financial condition would have been if the issuance of the common stock or the automatic conversion of all outstanding shares of our convertible participating preferred stock had occurred as of or on the dates indicated and do not purport to represent a projection of our future results.

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	Year Ended December 31,			Three Months Ended March 31,	
	2002	2003	2004	2004	2005
(in thousands, except share and per share data)					
				(unaudited)	(unaudited)
	(Restated*)	(Restated*)	(Restated*)	(Restated*)	
Statement of Operations Data:					
Revenue:					
Gross processing revenue	\$ 330,975	\$ 414,715	\$ 595,524	\$ 119,202	\$ 166,172
Other revenue, net	9,607	7,522	7,225	2,002	3,693
Total net revenue	340,582	422,237	602,749	121,204	169,865
Costs of services:					
Interchange	242,407	302,057	438,738	86,372	122,416
Dues and assessments	12,616	15,945	23,348	4,785	6,415
Processing and servicing	44,224	50,805	70,232	14,748	19,820
Customer acquisition costs	12,422	13,380	18,908	4,135	5,841
Depreciation and amortization	1,587	2,571	3,912	876	1,283
Total costs of services	313,256	384,758	555,138	110,916	155,775
Selling and administrative	20,786	25,751	31,501	7,233	8,989
Total expenses	334,042	410,509	586,639	118,149	164,764
Income from operations	6,540	11,728	16,110	3,055	5,101
Other income (expense):					
Interest income	171	124	182	38	110
Interest expense	(1,182)	(1,188)	(1,385)	(298)	(435)
Fair value adjustment for warrants with mandatory redemption provisions	(509)	(893)	(509)		(90)
Other, net	(62)	(740)	833	833	(3)
Total other income (expense)	(1,582)	(2,697)	(879)	573	(418)
Income before income taxes	4,958	9,031	15,231	3,628	4,683
Provision for (benefit from) income taxes	51	(11,102)	6,376	1,482	1,989
Net income	\$ 4,907	\$ 20,133	\$ 8,855	\$ 2,146	\$ 2,694
Accretion of Series A Senior Convertible Participating Preferred Stock	(6,509)				
Income allocated to Series A Senior Convertible Participating Preferred Stock		(9,843)	(4,263)	(1,037)	(1,295)
Net (loss) income attributable to common stock	\$ (1,602)	\$ 10,290	\$ 4,592	\$ 1,109	\$ 1,399
(Loss) earnings per share:					
Basic	\$ (0.10)	\$ 0.65	\$ 0.28	\$ 0.07	\$ 0.09
Diluted	\$ (0.10)	\$ 0.62	\$ 0.26	\$ 0.07	\$ 0.08
Weighted average number of shares outstanding:					
Basic	15,642,356	15,931,626	16,407,554	16,295,846	16,449,452

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	Year Ended December 31,			Three Months Ended March 31,	
	2004	2003	2002	2004	2003
Diluted	15,642,356	32,230,708	33,785,760	32,870,764	34,671,796

Other:

Number of active merchants (at period end)	53	67	89	72	94
Processing volume for period	\$ 14,391,628	\$ 17,914,893	\$ 24,986,790	\$ 5,125,939	\$ 6,877,850

March 31, 2005

	Actual	Pro Forma	Pro Forma As Adjusted
	(unaudited)	(in thousands)	
	(Restated*)		

Balance Sheet Data:

Cash and cash equivalents	\$ 12,706	\$ 12,706	\$ 41,965
Receivables	64,664	64,664	64,664
Total assets	136,392	136,392	165,651
Due to sponsor bank	45,465	45,465	45,465
Accounts payable	26,891	26,891	26,891
Total liabilities	127,562	127,562	124,709
Total stockholders' equity	8,830	8,830**	40,941

*

As discussed in Note 21 of the accompanying consolidated financial statements, the consolidated financial statements for 2002, 2003, 2004 and the three months ended March 31, 2004 and the consolidated balance sheet as of March 31, 2005 have been restated.

**

For details of the pro forma stockholder equity accounts, please see "Capitalization."

RISK FACTORS

An investment in our common stock involves a high degree of risk. You should consider carefully the following risks and other information contained in this prospectus before you decide whether to buy our common stock. If any of the events contemplated by the following discussion of risks should occur, our business, results of operations and financial condition could suffer significantly. As a result, the market price of our common stock could decline, and you may lose all or part of the money you paid to buy our common stock.

Risks Relating to Our Business

The payment processing industry is highly competitive and we compete with certain firms that are larger and that have greater financial resources. Such competition could increase, which would adversely influence our prices to merchants, and as a result, our operating margins.

The market for payment processing services is highly competitive. Other providers of payment processing services have established a sizable market share in the small- and medium-size merchant processing sector. Maintaining our historic growth will depend on a combination of the continued growth in electronic payment transactions and our ability to increase our market share. According to The Nilson Report, in 2004 the eight largest bank card acquirers accounted for approximately \$1.4 trillion of purchase volume (which we refer to as processing volume) on bank cards and the total purchase volume of all bank card acquirers was \$1.5 trillion. We accounted for approximately 1.8% of this total volume in 2004. This competition may influence the prices we are able to charge. If the competition causes us to reduce the prices we charge, we will have to aggressively control our costs in order to maintain acceptable profit margins. In addition, some of our competitors are financial institutions, subsidiaries of financial institutions or well-established payment processing companies, including First Data Merchant Services Corporation, National Processing, Inc., a subsidiary of Bank of America Corporation, Global Payments, Inc., Fifth Third Bank and Nova Information Systems, Inc., a subsidiary of U.S. Bancorp. Our competitors that are financial institutions or subsidiaries of financial institutions do not incur the costs associated with being sponsored by a bank for registration with the card associations and can settle transactions more quickly for their merchants than we can for ours. Some of these competitors have substantially greater financial, technology, management and marketing resources than we have. This may allow our competitors to offer more attractive fees to our current and prospective merchants, requiring us to keep a tighter control on costs in order to maintain current operating margins. We currently do not anticipate acquiring or merging with a financial institution in order to increase our competitiveness.

We are subject to the business cycles and credit risk of our merchants, which could negatively impact our financial results.

A recessionary economic environment could have a negative impact on our merchants, which could, in turn, negatively impact our financial results, particularly if the recessionary environment disproportionately affects some of the market segments that represent a larger portion of our processing volume, like restaurants. If our merchants make fewer sales of their products and services, we will have fewer transactions to process, resulting in lower revenue. In addition, we have a certain amount of fixed and semi-fixed costs, including rent, processing contractual minimums and salaries, which could limit our ability to quickly adjust costs and respond to changes in our business and the economy.

In a recessionary environment our merchants could also experience a higher rate of business closures, which could adversely affect our business and financial condition. During the last recession, we experienced a slowdown in the rate of same-store sales growth and an increase in business closures. In the event of a closure of a merchant, we are unlikely to receive our fees for any transactions processed by that merchant in its final month of operation.

While we service a broad range of merchants, restaurants represent a significant portion of our merchant base. The failure rate of restaurants is typically high, which increases our merchant attrition

and reject losses. A reduction in consumer spending, particularly at restaurants, would further increase our rate of merchant attrition and reject losses.

We have faced, and will in the future face, chargeback liability when our merchants refuse or cannot reimburse chargebacks resolved in favor of their customers, and reject losses when our merchants go out of business. We cannot assure you that we will accurately anticipate these liabilities, which may adversely affect our results of operations and financial condition.

In the event a billing dispute between a cardholder and a merchant is not resolved in favor of the merchant, the transaction is normally "charged back" to the merchant and the purchase price is credited or otherwise refunded to the cardholder. If we or our clearing banks are unable to collect such amounts from the merchant's account, or if the merchant refuses or is unable, due to closure, bankruptcy or other reasons, to reimburse us for the chargeback, we bear the loss for the amount of the refund paid to the cardholder. The risk of chargebacks is typically greater with those merchants that promise future delivery of goods and services rather than delivering goods or rendering services at the time of payment. There can be no assurance that we will not experience significant losses from chargebacks in the future. Any increase in chargebacks not paid by our merchants may adversely affect our financial condition and results of operations.

Reject losses arise from the fact that we collect our fees from our merchants on the first day after the monthly billing period. This results in the build-up of a substantial receivable from our customers, which significantly exceeds the receivables of any of our competitors which assess their fees on a daily basis. If a merchant has gone out of business during the billing period, we may be unable to collect such fees. In addition, if our sponsor bank is unable, due to system disruption or other failure, to collect our fees from our merchants, we would face a substantial loss.

We incurred charges relating to chargebacks and reject losses of \$561,928, \$605,256, \$939,500 and \$299,714 in the years ended December 31, 2002, 2003 and 2004 and the quarter ended March 31, 2005, respectively.

We have faced, and will in the future face, merchant fraud, which could have an adverse effect on our operating results and financial condition.

We have potential liability for fraudulent bank card transactions initiated by merchants. Merchant fraud occurs when a merchant knowingly uses a stolen or counterfeit bank card or card number to record a false sales transaction, processes an invalid bank card or intentionally fails to deliver the merchandise or services sold in an otherwise valid transaction. Examples of merchant fraud we have faced include a manager of a franchised motel who applied for a merchant account that proved to be a second account for that motel, and processed duplicate charges in his office, and an antique repair service owner who continued accepting deposits on cards for repairs, but stopped doing the repairs. We have established systems and procedures designed to detect and reduce the impact of merchant fraud, but we cannot assure you that these measures are or will be effective. It is possible that incidents of fraud could increase in the future. Failure to effectively manage risk and prevent fraud would increase our chargeback liability. Increases in chargebacks could have an adverse effect on our operating results and financial condition.

Increased merchant attrition that we cannot anticipate or offset with increased processing volume or new accounts would cause our revenues to decline.

We experience attrition in merchant processing volume in the ordinary course of business resulting from several factors, including business closures, transfers of merchants' accounts to our competitors and account closures that we initiate due to heightened credit risks relating to, and contract breaches by, merchants. During 2003, 2004 and the first quarter of 2005, we experienced average attrition of less than 1% of total processing volume per month. Substantially all of our processing contracts may be terminated by either party on relatively short notice. Increased attrition in merchant processing volume may have an adverse effect on our financial condition and results of operations. We cannot predict the

level of attrition in the future. If we are unable to establish accounts with new merchants or otherwise increase our processing volume in order to counter the effect of this attrition, our revenues will decline.

We rely on a bank sponsor, which has substantial discretion with respect to certain elements of our business practices, including sponsorship in the bank card associations, in order to process bank card transactions. If this sponsorship is terminated and we are unable to secure new bank sponsors, we will not be able to conduct our business.

Substantially all of our revenue is derived from Visa and MasterCard bank card transactions. Because we are not a bank, we are not eligible for membership in the Visa and MasterCard associations and are, therefore, unable to directly access the bank card association networks, which are required to process Visa and MasterCard transactions. Visa and MasterCard operating regulations require us to be sponsored by a bank in order to process bank card transactions. We are currently registered with Visa and MasterCard through KeyBank National Association, which has maintained that registration since 1999. If we or our bank sponsor fail to comply with the applicable requirements of the Visa and MasterCard bank card associations, Visa or MasterCard could suspend or terminate our registration. The bank card associations frequently amend their requirements. If we or our sponsoring bank were unable to comply with any such amended requirements, Visa or MasterCard could suspend or terminate our registration. On occasion, we have received notices of non-compliance, which have typically related to excessive chargebacks for a merchant or data security failures on the part of a merchant.

The termination of our registration, or any changes in the Visa or MasterCard rules that would impair our registration, could require us to stop providing Visa and MasterCard payment processing services, which would make it impossible for us to conduct our business. In addition, if our sponsorship is terminated and we are unable to secure another bank sponsor or sponsors, we will not be able to process Visa and MasterCard transactions. Furthermore, our agreement with KeyBank gives it substantial discretion in approving certain aspects of our business practices, including our solicitation, application and qualification procedures for merchants, the terms of our agreements with merchants and our customer service levels. We cannot guarantee that KeyBank's actions under this agreement will not be detrimental to our operations.

Current or future bank card association rules and practices could adversely affect our business.

We are registered with the Visa and MasterCard associations through our bank sponsor as an Independent Sales Organization with Visa and a Member Service Provider with MasterCard. In addition, we are a sales agent for Discover, American Express and Diners Club. The rules of the bank card associations are set by member banks and, in the case of Discover, American Express and Diners Club, by the card issuers, and some of those banks and issuers are our competitors with respect to these processing services. Many banks directly or indirectly sell processing services to merchants in direct competition with us. These banks could attempt, by virtue of their membership in the associations, to alter the associations' rules or policies to the detriment of non-members like us. Discover, American Express and Diners Club also sell processing services for their cardholders to merchants. We cannot assure you that the bank card associations or issuers will maintain our registrations or arrangements or that the current bank card association or issuer rules allowing us to market and provide payment processing services will remain in effect. The termination of our registration or our status as an Independent Sales Organization or Member Service Provider, or any changes in card association or issuer rules that limit our ability to provide payment processing services, could have an adverse effect on our processing volumes, revenues or operating costs. In addition, if we were precluded from processing Visa and MasterCard bank card transactions, we would lose substantially all of our revenues.

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Our systems and our third-party providers' systems may fail due to factors beyond our control, which could interrupt our service, cause us to lose business and increase our costs.

We depend on the efficient and uninterrupted operation of our computer network systems, software, data center and telecommunications networks, as well as the systems of third parties. Our systems and operations or those of our third-party providers could be exposed to damage or interruption from, among other things, fire, natural disaster, power loss, telecommunications failure, unauthorized entry and computer viruses. Our property and business interruption insurance may not be adequate to compensate us for all losses or failures that may occur. Defects in our systems or those of third parties, errors or delays in the processing of payment transactions, telecommunications failures or other difficulties could result in:

loss of revenues;

loss of merchants, although our contracts with merchants do not expressly provide a right to terminate for business interruptions;

loss of merchant and cardholder data;

harm to our business or reputation;

exposure to fraud losses or other liabilities;

negative publicity;

additional operating and development costs; and/or

diversion of technical and other resources.

We rely on other payment processors and service providers; if they no longer agree to provide their services, our merchant relationships could be adversely affected and we could lose business.

We rely on agreements with several other large payment processing organizations to enable us to provide bank card authorization, data capture, settlement and merchant accounting services and access to various reporting tools for the merchants we serve. These organizations include First Data Corporation, Paymentech Network Services, Inc. and Global Payments Inc. who also directly or indirectly sell payment processing services to merchants in competition with us. We rely primarily on Vital Processing Services, which provides all of our back-end and the majority of our front-end processing needs under a contract that expires in 2006. We also rely on third parties to whom we outsource specific services, such as organizing and accumulating daily transaction data on a merchant-by-merchant and card issuer-by-card issuer basis and forwarding the accumulated data to the relevant bank card associations. Some of these organizations and service providers are our competitors and, with the exception of Vital, we do not have any long-term contracts with them. Typically, our contracts with these third parties are for one-year terms, have automatic one-year renewals and are subject to cancellation upon limited notice by either party.

The termination by our service providers of their arrangements with us or their failure to perform their services efficiently and effectively may adversely affect our relationships with our merchants and, if we cannot find alternate providers quickly, may cause those merchants to terminate their processing agreements with us.

Adverse conditions in markets in which we obtain a substantial amount of our processing volume, such as our three largest markets of California, New York and Florida, could negatively affect our results of operations.

Adverse economic or other conditions in California, New York and Florida would negatively affect our revenue and could materially and adversely affect our results of operations. In March 2005, merchants in California represented 15.8%, in New York represented 6.2%, and in Florida represented 6.8% of our total processing volume. As a result of this geographic concentration of our merchants in these markets, we are particularly exposed to the risks of downturns in these local economies and to

other local conditions, which could adversely affect the operating results of our merchants in these markets.

If we lose key personnel or are unable to attract additional qualified personnel as we grow, our business could be adversely affected.

We are dependent upon the ability and experience of a number of our key personnel who have substantial experience with our operations, the rapidly changing payment processing industry and the selected markets in which we offer our services. It is possible that the loss of the services of one or a combination of our senior executives or key managers, particularly Robert O. Carr, our Chief Executive Officer, would have an adverse effect on our operations. None of our senior executives or key managers have entered into employment agreements with us. Our success also depends on our ability to continue to attract, manage and retain other qualified middle management and technical and clerical personnel as we grow. We cannot assure you that we will continue to attract or retain such personnel.

If we are unable to attract and retain qualified sales people, our business and financial results may suffer.

Unlike many of our competitors who rely on Independent Sales Organizations or salaried salespeople and telemarketers, we rely on a direct sales force whose compensation is entirely commission-based. Through our direct sales force of approximately 800 Relationship Managers, we seek to increase the number of merchants using our products and services. We intend to significantly increase the size of our sales force. Our success partially depends on the skill and experience of our sales force. If we are unable to retain and attract sufficiently experienced and capable Relationship Managers, our business and financial results may suffer.

If we cannot pass increases in bank card association interchange fees along to our merchants, our operating margins will be reduced.

We pay interchange fees set by the bank card associations to the card issuing bank for each transaction we process involving their bank cards. From time to time, the bank card associations increase the interchange fees that they charge payment processors and the sponsoring banks. For example, in 2004, Visa increased its interchange fees for retail transactions by 0.11%. At its sole discretion, our sponsoring bank has the right to pass any increases in interchange fees on to us and it has consistently done so in the past. We are allowed to, and in the past we have been able to, pass these fee increases along to our merchants through corresponding increases in our processing fees. However, if we are unable to do so in the future, our operating margins will be reduced.

Any acquisitions or portfolio buyouts that we make could disrupt our business and harm our financial condition.

We expect to evaluate potential strategic acquisitions of complementary businesses, products or technologies. We may not be able to successfully finance or integrate any businesses, products or technologies that we acquire. Furthermore, the integration of any acquisition may divert management's time and resources from our core business and disrupt our operations. To date, we have not acquired any significant companies or products. We may spend time and money on projects that do not increase our revenue. To the extent we pay the purchase price of any acquisition in cash, it would reduce our cash reserves, including the proceeds from this offering available to us for other uses, and to the extent the purchase price is paid with our stock, it could be dilutive to our stockholders. While we from time to time evaluate potential acquisitions of businesses, products and technologies, and anticipate continuing to make these evaluations, we have no present understandings, commitments or agreements with respect to any acquisitions.

We also regularly buy out the residual commissions of our Relationship Managers and sales managers, at multiples that typically amount to 2 to 2¹/₂ years of such commissions. If the merchants included in the portfolios we purchase do not generate sufficient incremental margin after the purchase, we will not achieve a positive return on the cash expended.

Unauthorized disclosure of merchant and cardholder data, whether through breach of our computer systems or otherwise, could expose us to liability and protracted and costly litigation.

We collect and store sensitive data about merchants, including names, addresses, social security numbers, driver's license numbers and checking account numbers. In addition, we maintain a database of cardholder data relating to specific transactions, including bank card numbers, in order to process the transactions and for fraud prevention. In the last twelve months we have been notified by Visa or MasterCard of six possible compromises of cardholder information retained by our merchants. Two of those incidents resulted in fines to us, each of which was recovered from our merchants. In each of those two incidents, less than 1,400 accounts may have been compromised, and we are unaware of any fraudulent activity resulting from either merchant data compromise. Any significant incidents of loss of cardholder data by us or our merchants could result in significant fines and sanctions by Visa, MasterCard or governmental bodies, which could have a material adverse effect upon our financial position and/or operations. In addition, a significant breach could result in our being prohibited from processing transactions for Visa and MasterCard.

We cannot guarantee that our computer systems will not be penetrated by hackers. If a breach of our system occurs, we may be subject to liability, including claims for unauthorized purchases with misappropriated bank card information, impersonation or other similar fraud claims. We could also be subject to liability for claims relating to misuse of personal information, such as unauthorized marketing purposes. These claims also could result in protracted and costly litigation. In addition, we could be subject to penalties or sanctions from the Visa and MasterCard associations.

Although we generally require that our agreements with our service providers who have access to merchant and customer data include confidentiality obligations that restrict these parties from using or disclosing any customer or merchant data except as necessary to perform their services under the applicable agreements, we cannot assure you that these contractual measures will prevent the unauthorized use or disclosure of data. In addition, our agreements with financial institutions require us to take certain protective measures to ensure the confidentiality of merchant and consumer data. Any failure to adequately enforce these protective measures could result in protracted and costly litigation.

Governmental regulations designed to protect or limit access to consumer information could adversely affect our ability to effectively provide our services to merchants.

Governmental bodies in the United States and abroad have adopted, or are considering the adoption of, laws and regulations restricting the transfer of, and safeguarding, non-public personal information. For example, in the United States, all financial institutions must undertake certain steps to ensure the privacy and security of consumer financial information. While our operations are subject to certain provisions of these privacy laws, we have limited our use of consumer information solely to providing services to other businesses and financial institutions. We limit sharing of non-public personal information to that necessary to effect the services necessary to complete the transactions on behalf of the consumer and the merchant and to that permitted by federal and state laws. In connection with providing services to the merchants and financial institutions that use our services, we are required by regulations and contracts with our merchants to provide assurances regarding the confidentiality and security of non-public consumer information. These contracts require periodic audits by independent companies regarding our compliance with industry standards and best practices established by regulatory guidelines. The compliance standards relate to our infrastructure, components, and operational procedures designed to safeguard the confidentiality and security of non-public consumer personal information shared by our clients with us. Our ability to maintain compliance with these standards and satisfy these audits will affect our ability to attract and maintain business in the future. The cost of such systems and procedures may increase in the future and could adversely affect our ability to compete effectively with other similarly situated service providers.

We face uncertainty about additional financing for our future capital needs, which may prevent us from growing our business.

We may need to raise additional funds to finance our future capital needs and operating expenses. We may need additional financing earlier than we anticipate if we:

expand faster than our internally generated cash flow can support;

purchase portfolio equity (the portion of our commissions that we have committed to our sales force for as long as the merchant processes with us, which we may buy out at an agreed multiple) from a large number of Relationship Managers or sales managers;

add new merchant accounts faster than expected;

need to reduce pricing in response to competition; or

acquire complementary products, businesses or technologies.

If we raise additional funds through the sale of equity or debt securities, these transactions may dilute the value of our outstanding common stock. We may also decide to issue securities, including debt securities, that have rights, preferences and privileges senior to our common stock. We cannot assure you that we will be able to raise additional funds on terms favorable to us or at all. If financing is not available or is not available on acceptable terms, we may be unable to fund our future needs. This may prevent us from increasing our market share, capitalizing on new business opportunities or remaining competitive in our industry.

We have sustained losses in the past and may not be able to achieve or sustain profitability in the future.

Our predecessor began operations in March 1997. In 2000 and 2001, we recorded operating losses of \$4.7 million and \$12.3 million, respectively. We also recorded net losses of \$9.4 million and \$17.4 million in 2000 and 2001, respectively. We cannot assure you that we will operate profitably in the future. In addition, we may experience significant quarter-to-quarter variations in operating results. We are pursuing a growth strategy focused on expanding our sales force, penetrating existing target markets and entering into new markets and expanding our product and service offerings. We may also pursue strategic acquisitions. Our growth strategy may involve, among other things, increased marketing expenses, significant cash expenditures, debt incurrence and other expenses that could negatively impact our profitability on a quarterly and annual basis.

Risks Relating to This Offering

Our executive officers, directors and principal stockholders have substantial control over our business, which could lead to conflicts of interest with other stockholders and could limit your ability to influence corporate matters.

Following this offering, our Chairman and Chief Executive Officer, Robert O. Carr, will beneficially own approximately 33.0% of our outstanding common stock. Mr. Carr and our other executive officers and directors will collectively own approximately 71.5% of our outstanding common stock after this offering. Greenhill Capital Partners, L.P. and its affiliated investment funds and LLR Equity Partners, L.P. and its affiliated investment fund will own in the aggregate approximately 36.6% of our outstanding common stock after this offering. Accordingly, these stockholders, acting individually or together, will have significant influence over all matters requiring stockholder approval, including the election and removal of directors and any merger, consolidation or sale of all or substantially all of our assets. In addition, these stockholders may dictate the day-to-day management of our business. This concentration of ownership could limit your ability to influence corporate matters and could have the effect of delaying, deferring or preventing a change in control, or impeding a merger or consolidation, takeover or other business combination or a sale of all or substantially all of our assets. In addition, the significant concentration of stock ownership may adversely affect the trading price of our common stock due to investors' perception that conflicts of interest may exist or arise.

Future sales of our common stock, or the perception in the public markets that these sales may occur, could depress our stock price.

Sales of substantial amounts of our common stock in the public market, or the perception in the public markets that these sales may occur, could cause the market price of our common stock to decline. This could also impair our ability to raise additional capital through the sale of our equity securities. Upon completion of this offering, we will have 32,406,460 shares of our common stock outstanding. In addition, as of March 31, 2005, we had outstanding options to purchase a total of 9,261,002 shares under our 2000 Incentive Stock Option Plan and 2002 PEPSHares Plan, of which 7,524,904 were vested. We intend to file a Form S-8 registration statement to register all the shares of common stock issuable under our option plans. Our current stockholders and holders of shares of our convertible participating preferred stock, options and warrants to acquire our common stock, on a fully-diluted basis assuming exercise of all outstanding options and warrants and automatic conversion of the convertible participating preferred stock, are expected to own 93.7% of the outstanding shares of our common stock, or 91.5% if the underwriters' over-allotment option is exercised in full. Following the expiration of a 180-day "lock-up" period to which all of our outstanding shares and shares issuable upon the exercise of outstanding options and warrants are subject, the holders of those shares will generally be entitled to freely transfer those shares. Moreover, Citigroup may, in its sole discretion and at any time without notice, release those holders from the sale restrictions on their shares. In addition to the adverse effect a price decline could have on holders of our common stock, such a decline could impede our ability to raise capital or to make acquisitions through the issuance of additional shares of our common stock or other equity securities.

After this offering, the holders of approximately 30,485,160 shares of our common stock, including shares to be issued upon the automatic conversion of the convertible participating preferred stock immediately prior to this offering, will have rights to demand the registration of their shares or include their shares in registration statements that we may file on our behalf or on behalf of other stockholders. By exercising their registration rights and selling a large number of shares, these holders could cause the price of our common stock to decline, which could impede our ability to make acquisitions through the issuance of additional shares of our common stock. Furthermore, if we file a registration statement to offer additional shares of our common stock and have to include shares held by those holders, it could impair our ability to raise needed capital by depressing the price at which we could sell our common stock.

Provisions in our charter documents and Delaware law could discourage a takeover you may consider favorable or could cause current management to become entrenched and difficult to replace.

Provisions in our amended and restated certificate of incorporation, in our bylaws and under Delaware law could make it more difficult for other companies to acquire us, even if doing so would benefit our stockholders. Our amended and restated certificate of incorporation and bylaws contain the following provisions, among others, which may inhibit an acquisition of our company by a third party:

advance notification procedures for matters to be brought before stockholder meetings;

a limitation on who may call stockholder meetings;

a prohibition on stockholder action by written consent; and

the ability of our board of directors to issue up to 10 million shares of preferred stock without a stockholder vote.

If any shares of preferred stock are issued that contain an extraordinary dividend or special voting power, a change in control could be impeded.

We are also subject to provisions of Delaware law that prohibit us from engaging in any business combination with any "interested stockholder," meaning, generally, that a stockholder who beneficially owns more than 15% of our stock cannot acquire us for a period of three years from the date this person became an interested stockholder unless various conditions are met, such as approval of the transaction by our board of directors. Any of these restrictions could have the effect of delaying or preventing a change in control.

Our common stock has not been publicly traded, and we expect that the price of our common stock will fluctuate substantially.

Before this offering, there has been no public market for our common stock. An active public trading market may not develop after completion of this offering or, if developed, may not be sustained. The initial public offering price for our shares will be determined by negotiations between us and the representatives of the underwriters and may not be indicative of the market price of our common stock after this offering. The market price for our common stock after this offering will be affected by a number of factors, including:

quarterly variations in our or our competitors' results of operations;

changes in earnings estimates, investors' perceptions, recommendations by securities analysts or our failure to achieve analysts' earning estimates;

the announcement of new products or service enhancements by us or our competitors;

announcements related to litigation;

developments in our industry; and

general market conditions and other factors unrelated to our operating performance or the operating performance of our competitors.

You will suffer immediate and substantial dilution.

The initial public offering price per share is substantially higher than the net tangible book value per share immediately after the offering. As a result, you will pay a price per share that substantially exceeds the book value of our assets after subtracting our liabilities. Assuming an offering price of \$15.00, the midpoint of the range set forth on the cover of this prospectus, you will incur immediate and substantial dilution of \$13.74 in the net tangible book value per share of the common stock from the price you paid. We also have outstanding mandatorily redeemable warrants to purchase 168,904 shares of our common stock at an exercise price of \$0.005 per share and stock options to purchase 9,261,002 shares of our common stock at a weighted average exercise price of \$6.43 per share. To the extent these warrants or options are exercised, there will be further dilution.

We do not intend to pay cash dividends on our common stock in the foreseeable future.

We currently anticipate that we will retain all future earnings, if any, to finance the growth and development of our business and do not anticipate paying cash dividends on our common stock in the foreseeable future. Any payment of cash dividends will depend upon our financial condition, capital requirements, earnings and other factors deemed relevant by our board of directors.

USE OF PROCEEDS

We will receive estimated net proceeds from this offering of approximately \$32.1 million, or \$34.0 million if the underwriters exercise their over-allotment option in full, after deducting estimated underwriting discounts and commissions and offering expenses payable by us and assuming an initial public offering price of \$15.00 per share, the midpoint of the range on the cover of this prospectus.

We will not receive any of the proceeds from the sale of shares by the selling stockholders.

We are undertaking this offering in order to access the public capital markets and to increase our liquidity.

At March 31, 2005, the outstanding balance under our Revolver and Advance Facility with KeyBank National Association was \$2,068,897. The entire principal balance plus all accrued interest and fees is due on August 31, 2005, or on demand if there were to be a default. The principal balance due under the Revolver accrues interest at a rate equal to the prime rate, which was 5.75% at March 31, 2005. At March 31, 2005, the outstanding principal balance under our Ability Line of Credit Facility with KeyBank National Association was \$784,165. This amount plus all accrued interest and fees is due upon demand and accrues interest at the prime rate.

We intend to use our net proceeds from this offering to repay this outstanding indebtedness to KeyBank National Association and to use the remainder for general corporate purposes, including to fund working capital and potential acquisitions. However, we currently do not have a specific plan relating to the expenditure of our remaining proceeds from this offering. Pending the use of such net proceeds, we intend to invest these funds in investment-grade, short-term interest bearing securities.

DIVIDEND POLICY

We have never declared or paid any cash dividends on our common stock and do not anticipate paying any cash dividends in the foreseeable future. We currently intend to retain future earnings to fund the development and growth of our business.

CAPITALIZATION

The following table sets forth our capitalization as of March 31, 2005:

on an actual basis;

on a pro forma basis to give effect to a two-for-one split of our outstanding common stock immediately prior to this offering and the automatic conversion of all outstanding shares of our convertible participating preferred stock into 13,333,334 shares of common stock upon the completion of this offering, assuming an initial public offering price of \$15.00 per share, the midpoint of the range on the cover of this prospectus; and

on a pro forma as adjusted basis to give effect to the pro forma adjustments described above, our receipt of approximately \$32.1 million in estimated net proceeds from our sale of 2,622,046 shares of our common stock in this offering assuming an initial public offering price of \$15.00 per share, the midpoint of the range on the cover of this prospectus, and the application of our estimated net proceeds from this offering to repay approximately \$2.9 million of outstanding indebtedness.

The number of shares of common stock to be outstanding after this offering excludes:

9,261,002 shares of common stock issuable upon exercise of outstanding stock options as of March 31, 2005 at a weighted average exercise price of \$6.43 per share; and

168,904 shares of common stock issuable upon exercise of outstanding mandatorily redeemable warrants as of March 31, 2005 at a weighted average exercise price of \$0.005 per share.

You should read this table in conjunction with the "Selected Historical Consolidated Financial Information and Other Data," "Management's Discussion and Analysis of Financial Condition and Results of Operations," our consolidated financial statements and the related notes included elsewhere in this prospectus.

	As of March 31, 2005		
	Actual	Pro Forma	Pro Forma As Adjusted
	(in thousands, except share data)		
Borrowings, financing arrangements and mandatorily redeemable warrants	\$ 14,206	\$ 14,206	\$ 11,353
Stockholders' equity:			
Series A Senior Convertible Participating Preferred Stock, \$80 million liquidation preference, \$.001 par value, 10,000,000 shares authorized, 7,619,048 shares issued and outstanding actual, no shares issued and outstanding pro forma and pro forma as adjusted	8		
Common stock, par value \$.001 per share, 100,000,000 shares authorized, 16,451,080 shares issued and outstanding actual, 29,784,414 shares issued and outstanding pro forma and 32,406,460 shares issued and outstanding pro forma as adjusted	8	30	32
Additional paid in capital	41,110	41,096	73,205
Accumulated other comprehensive income and deficit	(32,296)	(32,296)	(32,296)
Total stockholders' equity	8,830	8,830	40,941
Total capitalization	\$ 23,036	\$ 23,036	\$ 52,294

DILUTION

Our pro forma net tangible book value as of March 31, 2005, was \$8.7 million, or \$0.29 per share of common stock, after giving effect to the automatic conversion of all outstanding shares of convertible participating preferred stock into shares of common stock upon the completion of this offering. Pro forma net tangible book value per share represents the amount of our total tangible assets less total liabilities, divided by the pro forma number of shares of our outstanding common stock. After giving effect to our sale of common stock in this offering at an assumed initial public offering price of \$15.00 per share, the midpoint of the range on the cover of this prospectus, our receipt of approximately \$32.1 million in estimated net proceeds from this offering, and an estimated repayment of approximately \$2.9 million of outstanding indebtedness, our pro forma net tangible book value as of March 31, 2005 would have been \$40.8 million, or \$1.26 per share, representing an immediate increase in the pro forma net tangible book value of \$0.97 to existing stockholders and an immediate dilution of \$13.74 per share to new investors purchasing our common stock in this offering. The following table summarizes this per share dilution:

Assumed initial public offering price per share		\$	15.00
Pro forma net tangible book value per share as of March 31, 2005		\$	0.29
Increase in pro forma net tangible book value per share attributable to new investors			0.97
			<u>1.26</u>
Pro forma net tangible book value per share after this offering			1.26
			<u>1.26</u>
Dilution per share to new investors		\$	13.74
			<u>13.74</u>

The following table summarizes, on the pro forma basis described above as of March 31, 2005, the difference between the number of shares of common stock purchased from us, the total consideration paid to us, and the average price per share paid by existing stockholders and new investors at an assumed initial public offering price of \$15.00 per share, the midpoint of the range on the cover of this prospectus, before deducting estimated underwriting discounts and commissions and estimated offering expenses payable by us.

	Shares Purchased		Total Consideration	
	Number	Percentage	Amount	Average Price Per Share
Existing stockholders	29,784,414	92%	\$ 8,828,688	\$ 0.30
New investors	2,622,046	8	39,330,690	15.00
	<u>32,406,460</u>	<u>100%</u>	<u>\$ 48,159,378</u>	<u>\$ 1.49</u>

The tables and calculations above assume no exercise by the underwriters of their over-allotment option and no exercise of stock options outstanding on March 31, 2005. As of March 31, 2005, there were 29,784,414 shares of common stock outstanding (assuming the conversion of 13,333,334 shares of convertible participating preferred stock, assuming an initial public offering price of \$15.00 per share, the midpoint of the range on the cover of this prospectus), which includes:

9,261,002 shares of common stock issuable upon exercise of outstanding stock options as of March 31, 2005 at a weighted average exercise price of \$6.43 per share; and

168,904 shares of common stock issuable upon exercise of outstanding mandatorily redeemable warrants as of March 31, 2005 at a weighted average exercise price of \$0.005 per share.

To the extent any of these options and warrants are exercised, there will be further dilution to new investors. If all of these outstanding options and warrants had been exercised as of March 31, 2005, our pro forma net tangible book value per share after this offering would be \$2.40 and total dilution per share to new investors would be \$12.60 per share.

SELECTED HISTORICAL CONSOLIDATED FINANCIAL INFORMATION AND OTHER DATA

The following table sets forth our selected historical consolidated financial information and other data for the years ended December 31, 2002, 2003 and 2004 and for the three months ended March 31, 2004 and 2005, which are derived from our consolidated financial statements included elsewhere in this prospectus. Historical consolidated financial information for 2000 and 2001 are derived from our consolidated financial statements for those years. We have prepared the unaudited information for the three months ended March 31, 2004 and 2005, on the same basis as the annual consolidated financial statements and have included all adjustments, consisting only of normal recurring adjustments, that we consider necessary for a fair presentation of our financial position at those dates and our results of operations for the periods ended. All outstanding common shares, average number of 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 split of our outstanding common stock in connection with this offering.

The information in the following table should be read together with "Capitalization," "Management's Discussion and Analysis of Financial Condition and Results of Operations" and our consolidated financial statements and the related notes included elsewhere in this prospectus.

	Year Ended December 31,					Three Months Ended March 31,	
	2000	2001	2002	2003	2004	2004	2005
	(in thousands, except share and per share data)						
	(unaudited)						
	(Restated**)	(Restated**)	(Restated*)	(Restated*)	(Restated*)	(Restated*)	
Statement of Operations Data:							
Revenue:							
Gross processing revenue	\$ 193,110	\$ 265,468	\$ 330,975	\$ 414,715	\$ 595,524	\$ 119,202	\$ 166,172
Other revenue, net	10,334	17,588	9,607	7,522	7,225	2,002	3,693
Total net revenue	203,444	283,056	340,582	422,237	602,749	121,204	169,865
Costs of services:							
Interchange	144,134	193,460	242,407	302,057	438,738	86,372	122,416
Dues and assessments		10,223	12,616	15,945	23,348	4,785	6,415
Processing and servicing	27,247	52,677	44,224	50,805	70,232	14,748	19,820
Customer acquisition costs	2,387	21,692	12,422	13,380	18,908	4,135	5,841
Depreciation and amortization	4,949	1,256	1,587	2,571	3,912	876	1,283
Total costs of services	178,717	279,308	313,256	384,758	555,138	110,916	155,775
Selling and administrative	29,443	16,074	20,786	25,751	31,501	7,233	8,989
Total expenses	208,160	295,382	334,042	410,509	586,639	118,149	164,764
(Loss) income from operations	(4,716)	(12,326)	6,540	11,728	16,110	3,055	5,101
Other income (expense):							
Interest income		120	171	124	182	38	110
Interest expense	(4,525)	(4,185)	(1,182)	(1,188)	(1,385)	(298)	(435)
Fair value adjustment for warrants with mandatory redemption provisions		(104)	(509)	(893)	(509)		(90)
Loss on settlement of financing arrangement	(223)						
Other, net	64	(861)	(62)	(740)	833	833	(3)

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	Year Ended December 31,				Three Months Ended March 31,			
Total other income (expense)	(4,684)	(5,030)	(1,582)	(2,697)	(879)	573	(418)	
(Loss) income before income taxes	(9,400)	(17,356)	4,958	9,031	15,231	3,628	4,683	
Provision for (benefit from) income taxes		17	51	(11,102)	6,376	1,482	1,989	
Net (loss) income	\$ (9,400)	\$ (17,373)	\$ 4,907	\$ 20,133	\$ 8,855	\$ 2,146	\$ 2,694	
Accretion of Series A Senior Convertible Participating Preferred Stock		1,390	6,509					
Income allocated to Series A Senior Convertible Participating Preferred Stock				(9,843)	(4,263)	(1,037)	(1,295)	
Net (loss) income attributable to common stock	\$ (9,400)	\$ (18,763)	\$ (1,602)	\$ 10,290	\$ 4,592	\$ 1,109	\$ 1,399	

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As discussed in Note 21 of the accompanying consolidated financial statements, 2002, 2003, 2004 and the three months ended March 31, 2004 have been restated.

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2000 and 2001 have been restated for the matters discussed in Note 21 of the accompanying consolidated financial statements.

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	Year Ended December 31,					Three Months Ended March 31,	
	2000	2001	2002	2003	2004	2004	2005
	(in thousands, except share and per share data)					(unaudited)	
	(Restated**)	(Restated**)	(Restated*)	(Restated*)	(Restated*)	(Restated*)	
(Loss) earnings per share:							
Basic	\$ (0.55)	\$ (1.12)	\$ (0.10)	\$ 0.65	\$ 0.28	\$ 0.07	\$ 0.09
Diluted	\$ (0.55)	\$ (1.12)	\$ (0.10)	\$ 0.62	\$ 0.26	\$ 0.07	\$ 0.08
Weighted average number of shares outstanding:							
Basic	17,000,000	16,696,552	15,642,356	15,931,626	16,407,554	16,295,846	16,449,452
Diluted	17,000,000	16,696,552	15,642,356	32,230,708	33,785,760	32,870,764	34,671,796
Other:							
Number of owned and serviced active merchants (at period end)							
	38	46	53	67	89	72	94
Owned and serviced processing volume for period							
	\$ 8,954,931	\$ 12,084,441	\$ 14,391,628	\$ 17,914,893	\$ 24,986,790	\$ 5,125,939	\$ 6,877,850
	December 31,					March 31,	
	2000	2001	2002	2003	2004	2005	
	(in thousands)					(unaudited)	
	(Restated**)	(Restated**)	(Restated*)	(Restated*)	(Restated*)	(Restated*)	
Balance Sheet Data:							
Cash and cash equivalents	\$ 2,304	\$ 13,047	\$ 8,073	\$ 13,004	\$ 13,237	\$ 12,706	
Receivables	24,488	27,406	33,435	44,934	64,325	64,664	
Total assets	41,134	55,743	65,596	100,742	133,926	136,392	
Due to sponsor bank		20,755	26,319	34,225	45,153	45,465	
Accounts payable	23,979	14,087	14,712	17,923	27,103	26,891	
Total liabilities	81,428	80,453	84,630	98,656	127,827	127,562	
Series A Senior Convertible Participating Preferred Stock (classified as mezzanine equity)	7	36,892	43,401	43,401	6,099	8,830	
Total stockholders' (deficit) equity	(40,301)	(61,601)	(62,435)	(41,315)	6,099	8,830	

The Statement of Operations Data for the years ended December 31, 2000 and 2001 are presented as reflected in the audited financial statements for those years, except that the restatement to reflect the change in the treatment of the 1999 and 2000 portfolio sales has the effect of reducing deferred gain included in other revenue, net and increasing gross processing revenue to reflect the processing activities of merchants that had previously been treated as sold. Costs of services increased to reflect: interchange and dues and assessments on the merchant contracts that had previously been treated as sold; the elimination of the rental equipment inventory; merchant portfolio purchases being expensed as customer acquisition costs; and, increased amortization of signing bonuses related to sold contracts that had previously been written off. In addition, interest expense has been increased to reflect the establishment of the financing arrangements, and a loss has been recorded on the settlement of debt in 2000 related to one of the financing arrangements. Further, the 2000 presentation is not consistent with the presentation for subsequent years. Costs of services for the periods ended December 31, 2001, and thereafter reflect a more detailed breakout than 2000. In addition, 2000 data includes our service center costs in selling and administrative expenses, whereas in the periods ended December 31, 2001 and thereafter the service center costs directly related to revenue generation are included in processing and servicing.

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As discussed in Note 21 of the accompanying consolidated financial statements, the consolidated financial statements for 2002, 2003, 2004 and the three months ended March 31, 2004 and the consolidated balance sheet as of March 31, 2005 have been restated.

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2000 and 2001 have been restated for the matters discussed in Note 21 of the accompanying consolidated financial statements.

**MANAGEMENT'S DISCUSSION AND ANALYSIS OF
FINANCIAL CONDITION AND RESULTS OF OPERATIONS**

The following discussion and analysis of our financial condition and results of operations should be read in conjunction with "Selected Historical Consolidated Financial Information and Other Data" and our consolidated financial statements and the related notes included elsewhere in this prospectus.

As discussed in Note 21 to the Consolidated Financial Statements, our previously audited financial statements for the years ended December 31, 2001, 2002 and 2003 have been restated. The accompanying management's discussion and analysis of financial condition and results of operations gives effect to that restatement.

Overview

We provide bank card-based payment processing services to merchants in the United States. As of June 30, 2005, we provided our payment processing services to approximately 101,500 active merchants located across the United States. Using June processing data, as adjusted by our estimate of seasonal purchasing patterns for June, we estimate that the annualized processing volume of our merchant contracts at June 30, 2005 was approximately \$32.9 billion. This "run rate" estimate is not an indicator of the actual volumes we expect for 2005, which could be more or less than this amount.

Our revenue is recurring in nature, as we typically enter into three-year service contracts that, in order to qualify for the agreed-upon pricing, require the merchant to achieve processing volume minimums. Most of our gross revenue is payment processing fees, which are a combination of a fee equal to a percentage of the dollar amount of each Visa or MasterCard transaction we process plus a flat fee per transaction. We make mandatory payments of interchange fees to card-issuing banks and dues and assessment fees to Visa and MasterCard. Our business volume, and consequently gross processing revenue, is largely driven by the cumulative growth in the number of merchants with whom we have processing contracts. This in turn is the result of the number of merchants that we install during a period, offset by the number of merchants who cease processing with us during that period. We also generally benefit from consumers' increasing use of bank cards in place of cash and checks.

Since our inception in 1997, our success at signing new merchants has generally led to significant annual gross processing revenue increases. However, our limited capital resources and our desire to buy out the equity of our former 50% owner led us to economically transfer approximately two-thirds of our merchant contracts in late 1999 and early 2000 to National Processing Company and Heartland Bank. In October 2001, we raised an aggregate of \$40 million from Greenhill Capital Partners, L.P. and its affiliated investment funds and LLR Equity Partners, L.P. and its affiliated investment fund in exchange for a significant interest in our company. These additional financial resources allowed us to begin the rapid growth of our sales force, a process that was accelerated in late 2002 by a restructuring of our sales management structure. This restructuring included the creation of eight regions (now 12), with the sales managers in these regions being compensated based on their success in growing the sales force and increasing the merchant base in their regions. The result has been a significant increase in the number of new Relationship Managers and new merchants installed, with the number of new merchants growing by approximately 42% from 19,687 in 2002 to 27,911 in 2003, and by approximately 41% to 39,403 in 2004. In order to continue to increase our gross processing revenue, we intend to increase both the size and productivity of our sales force. As a result of our commission-only compensation system for our sales force, which is required to work exclusively for us, we are able to increase the size of our sales force with minimal upfront costs. However, since we pay signing bonuses and commissions approximating 92% of the gross margin generated by a merchant in its first year, growth in merchant accounts consumes significant capital, as it typically takes approximately 11 months of processing to cover the signing bonus and commission outlays. During 2003 and 2004 we also experienced an improvement in our same store sales statistics, which represent the change in processing

volume for all merchants that were processing with us in the same month a year earlier. Same store sales grew 5.0% on average in 2003, and grew 7.5% on average in 2004; this same store sales growth declined somewhat to 6.9% on average in the first quarter of 2005. This same store sales growth resulted from the combination of the increasing use by consumers of bank cards for the purchase of goods and services at the point of sale, and sales growth experienced by our retained merchants, some of which was likely the result of an improving economy.

Critical Accounting Policies

The discussion and analysis of our financial condition and results of operations are based on our financial statements, which have been prepared in accordance with accounting principles generally accepted in the United States. The preparation of these financial statements requires us to make estimates and judgments that affect the reported amounts of assets, liabilities, revenue and expenses. Our significant accounting policies are more fully described in note 2 to our consolidated financial statements included elsewhere in this prospectus. The critical accounting policies described here are those that are most important to the depiction of our financial condition and results of operations, including those whose application requires management's most subjective judgment in making estimates about the effect of matters that are inherently uncertain.

Revenue

Nearly 75% of our reported gross processing revenue is paid by us as interchange fees to the card issuing banks. Certain of our competitors report their revenue net of interchange fees. This is because the issuing banks make their payments to these competitors net of those interchange fees, and these acquirers pay this reduced amount to their merchants. We do not offset gross processing revenue and interchange fees because our business practice is to arrange for our banks to advance the interchange fees to most of our merchants when settling their transactions (thus paying the full amount of the transaction to the merchant), and then to collect our full discount fees from our merchants on the first business day of the next month. We believe this policy aids in new business generation, as our merchants benefit from bookkeeping simplicity. However, it results in our carrying a large receivable from our merchants at each period-end, and a corresponding but smaller payable to the banks, both of which are settled on the first business day after the period-end. As we are at risk for the receivables, we record the associated revenues on a gross processing revenue basis in our income statements.

Capitalized Customer Acquisition Costs

Capitalized customer acquisition costs consist of (1) up-front signing bonus payments made to Relationship Managers and sales managers for the establishment of new merchant relationships, and (2) deferred acquisition cost representing the cost of buying out the commissions of vested Relationship Managers and sales managers. 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 paid is based on the estimated gross margin for the first year of the merchant contract. The signing bonuses paid during 2002, 2003 and 2004, and in the three months ended March 31, 2005 were \$8.4 million, \$13.1 million, \$21.6 million and \$4.6 million, respectively. The signing bonus paid, amount capitalized, and related amortization are adjusted at the end of the first year to reflect the actual gross margin generated by the merchant contract during that year. The deferred acquisition cost is accrued over the first year of merchant processing, consistent with the build-up in the accrued buyout liability.

The amount of signing bonus paid which remained subject to adjustment at December 31, 2002, 2003 and 2004 and at March 31, 2005 was \$8.4 million, \$13.1 million, \$21.6 million and \$21.9 million,

respectively. The net signing bonus adjustments made during the years ended December 31, 2002, 2003 and 2004, and the quarter ended March 31, 2005, were \$(0.4) million, \$(0.8) million, \$(1.4) million and \$(0.6) million, respectively. Negative signing bonus adjustments result from the overpayment of signing bonuses previously paid, which are recovered from the relevant salesperson.

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. We have not recognized an impairment loss for the years ended December 31, 2002, 2003 and 2004 and the three months ended March 31, 2005.

Accrued Buyout Liability

Two changes in our agreements with our Relationship Managers and sales managers in 2001 resulted in the creation of an accrued buyout liability. These changes included:

1. A portion, typically 25%, of the residual commissions we owed to our Relationship Managers and sales managers was deemed to be a servicing fee, and our Relationship Managers and sales managers had no obligation to perform services for the remainder of their residual commissions (referred to as the "owned" portion of such commissions, or "portfolio equity") for so long as the merchant continued processing with us; and
2. Our vested Relationship Managers and sales managers had the contractual right to sell (this right was eliminated in May, 2004) their portfolio equity to us at a fixed multiple of their owned commissions. In addition, we retained the right to buy them out at the same multiple at any time. Relationship Managers and sales managers become vested once they have established merchant relationships that generate the equivalent of \$2,000 of monthly residual commissions. Vested status entitles the salesperson to his or her residual commissions for as long as the merchant processes with us, even if the salesperson is no longer employed by us.

As the Relationship Managers and sales managers were not required to perform any additional services to earn the owned portion of the residual commissions, and had the right to require us to purchase their portfolio equity, we recorded a liability representing the current settlement cost of buying out all vested and expected-to-vest Relationship Managers and sales managers on each presented balance sheet date. As noted above, as we build the buyout liability during the first year after a merchant is installed, we also record a deferred acquisition cost asset related to those buyouts, and amortize that asset as an expense over the initial 3-year contract term.

The accrued buyout liability is based on the merchants we have under contract at the balance sheet date, the gross margin (calculated by deducting interchange fees, dues and assessments and all costs incurred in underwriting, processing and reviewing an account from gross processing revenue) we generated from those accounts in the prior twelve months, and the fixed 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.

For unvested Relationship Managers and sales managers, the accrued buyout liability is accrued over the expected vesting period; however, no deferred acquisition cost is capitalized as future services are required in order to vest. In calculating the accrued buyout liability for unvested Relationship Managers and sales managers, we have assumed that 31% of the unvested Relationship Managers and sales managers will vest in the future, which represents our historical vesting rate. A 5% increase to 36% in the expected vesting rate would have increased the accrued buyout liability for unvested

Relationship Managers and sales managers by \$28,075 at December 31, 2002, \$56,974 at December 31, 2003, \$201,139 at December 31, 2004, and \$195,713 at March 31, 2005.

Buyout payments made to Relationship Managers and sales managers reduce the outstanding liability. Given our view of the duration of the cash flows associated with a pool of merchant contracts, we believe that the benefits of such buyouts significantly exceed the cost, which typically represents 2 to 2^{1/2} years of commissions. If the cash flows associated with a pool of bought out contracts does not exceed this cost, we will incur a loss on the transaction. In 2002, 2003, 2004 and the first quarter of 2005 we made buyout payments of approximately \$7.5 million, \$4.7 million, \$2.2 million and \$3.3 million, respectively. Buyout payments were greater in 2002, reflecting the Welsch Financial Merchant Services, Inc. buyout. In 2004, we processed fewer buyouts as a result of the contract modifications and initial public offering process. We expect to make significant buyout payments in the future, as such buyouts reduce the monthly payments we will have to make to our Relationship Managers and sales managers for such merchants in the future.

Chargebacks, Reject Losses and Merchant Deposits

Disputes between a cardholder and a merchant periodically arise as a result of, among other things, the cardholder's dissatisfaction with merchandise quality or merchant services. Such disputes may not be resolved in the merchant's favor. In these cases, the transaction is "charged back" to the merchant, which means the purchase price is refunded to the customer by the card-issuing bank and charged to the merchant. If the merchant is unable to fund the refund, we must do so. If the Relationship Manager who installed the merchant is still employed by us, that Relationship Manager bears a portion of this loss through a reduction in our payment of residual commissions or signing bonuses to such Relationship Manager. We also bear the risk of reject losses arising from the fact that we collect our fees from our merchants on the first day after the monthly billing period. If the merchant has gone out of business during such period, we may be unable to collect such fees. We maintain cash deposits or require the pledge of a letter of credit from certain merchants, generally those with higher average transaction size where the card is not present when the charge is made or the product or service is delivered after the charge is made, in order to offset potential contingent liabilities such as chargebacks and reject losses that would arise if the merchant went out of business. The owners of the serviced portfolios bear the credit risk for their merchants. At December 31, 2002, 2003 and 2004 and March 31, 2005, we held merchant deposits totaling \$4.4 million, \$4.2 million, \$6.7 million and \$7.7 million, respectively. Most chargeback and reject losses are charged to processing and servicing as they are incurred. However, we also maintain a loss reserve against losses including major fraud losses, which are both less predictable and involve larger amounts. The loss reserve was established using historical loss rates, applied to recent processing volume. At March 31, 2005, our loss reserve totaled \$470,944. Aggregate merchant losses, including losses charged to operations and the loss reserve, were \$561,928, \$605,256 and \$939,500 for the years ending December 31, 2002, 2003 and 2004, respectively, and \$299,714 for the quarter ended March 31, 2005.

Stock Options

We account for our stock options using the intrinsic value method, with no compensation expense being recognized for the stock-based compensation plan because the options are granted at an exercise price that in most cases was higher than, and in all cases was at least equal to, the estimated fair value at the grant date. As a company with no established market for our common stock, and consistent with existing accounting literature, prior to the initial filing of our registration statement with the Securities and Exchange Commission in August 2004, we assumed a volatility factor of 0%. As a result, had the compensation been determined based on the fair value method, our net income would remain unchanged. For those periods after the filing of our initial registration statement, a 50% volatility assumption was used in estimating the fair value of options. As a result of applying the 50% volatility

assumption, had compensation expense been determined based on the fair value method, reported net income for the year ended December 31, 2004 would have been reduced by \$5.5 million, or \$0.16 per diluted share, and reported net income for the three months ended March 31, 2005 would have been reduced \$1.4 million, or \$0.04 per diluted share. The 50% volatility assumption was determined by referencing the average volatility assumed by six of our public company peers.

Our principal approach to determining the fair value of the stock in the 2002 to 2003 period was our value as a potential acquisition candidate. Consequently, we used the portfolio purchase multiple established in our portfolio transfer to National Processing Company at year-end 1999, as adjusted for net working capital and a separate multiple of revenue for our payroll operations. This resulted in steadily increasing share values, which were all at least 15% below the \$5.00 and \$6.25 per share exercise price we set for virtually all options issued in the period. This valuation method generated results that were consistent with, and in fact higher than, valuations performed by valuation specialists engaged for other stock value purposes for periods ending as recently as March 2003. We have not typically employed valuation specialists to value our stock for purposes of establishing the exercise price of options, particularly since we grant options on a quarterly basis and such valuations are costly and divert our management's time and resources from our core business. In addition, our board of directors, which is comprised of several individuals with experience in valuing companies, determined that the results of a valuation specialist would not likely result in higher exercise prices than those established by our board of directors.

We believe that these judgments have been validated by certain recent transactions in our stock. In July 2003, our board of directors raised the exercise price for option grants to \$6.25 per share after six months of additional growth. In December 2003 and January 2004, the first two transactions with third parties since the sale of preferred stock in 2001 occurred. In one transaction, an institutional investor purchased 90,000 shares of our common stock from certain of our executives, senior managers and consultants, at a price of \$6.25 per share. In the second, BHC Interim Funding, L.P. redeemed 168,906 of our warrants pursuant to a contractual "put" option at their fair value, which they agreed was \$6.25 per share. Recognizing our intention to go public, and the potential that the stock could have a higher value in the public marketplace, we raised that exercise price by 20% to \$7.50 for options issued in April 2004. During our fiscal third quarter of 2004, this exercise price was raised again to \$9.28 per share. This represented a 30% discount to the estimated value of our common stock if we could have gone public at that time, and so reflects a private company discount that is typically applied by valuation specialists to private companies. In October, our former President and Chief Operating Officer sold 129,000 shares of common stock back to us at a price of \$9.28 per share. In November, our CEO sold an aggregate of 108,000 shares of common stock to Greenhill Capital Partners, L.P., LLR Equity Partners, L.P., and their affiliated investment funds at a price of \$9.28 per share. We believe that these transactions support our board of directors' determination that \$9.28 is the fair value of our common stock at December 31, 2004. During our fiscal first quarter of 2005, this price was raised to \$9.80 per share, again reflecting a 30% private company discount to the estimated value of our common stock as indicated by the proposed underwriters of the offering.

Financing Arrangements

In 1999, we transferred certain merchant contracts to National Processing Company in exchange for \$23.0 million and subject to revenue guaranties and servicing agreements. Consistent with EITF 87-34, EITF 90-21 and EITF 95-5, we concluded that we should not recognize the transfers of individual merchant contracts as sales until the revenue guaranties were satisfied and servicing was transferred to the buyer. Pursuant to EITF 88-18, we recognized the transfer as a financing arrangement included under Borrowings and Financing Arrangements on the consolidated balance sheet, until such time as the conditions for recognizing the transfers of individual merchant contracts as sales were met. Payments we make to National Processing Company represent principal repayment and

interest on the financing arrangement. Payments include all cash flows, net of servicing fees and chargeback losses, associated with specific lists of merchant contracts that were committed to the arrangement. Until the efforts to convert merchants to the transferee's processing systems ceased in 2002, payments also included the estimated fair value of merchant contracts that had converted. We have calculated an imputed interest rate of 4.26% on this financing arrangement, based on the expected cash flows resulting from these contracts. The expected cash flows were based on the actual historical cash flows of the merchant 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. In this later stage of the life of this financing arrangement, the calculation of the interest cost, and remaining balance, of the financing arrangement is relatively insensitive to changes in portfolio attrition. If that attrition declined to 10% for 2005 and thereafter, the expected interest cost for 2005 would increase from \$24,000 to \$29,000 reflecting an interest rate for future payments of approximately 4.8%. If the attrition rate increases from the projected 15%, the interest rate would decline from the current 4.26%.

In 2000, we transferred certain merchant contracts to Certegy Inc., a third party, subject to a 10-year servicing agreement, in exchange for \$22 million. Consistent with EITF 87-34, EITF 90-21 and EITF 95-5, we concluded that we should not recognize the transfer as a sale due to the duration of the servicing agreement and Certegy Inc.'s limited ability to exercise ownership control of the contracts. In accordance with EITF 88-18, the proceeds of \$22 million are classified as a financing arrangement and included with Borrowings and Financing Arrangements on our balance sheets. Payments we make to Certegy Inc. represent principal repayment and interest on the financing arrangement. We have calculated an imputed interest rate of 2.53%, based on the expected cash flows resulting from these contracts. The expected cash flows were based on the actual historical cash flows of the merchant contracts, reduced by an expected annual volume attrition rate of 15.0%. Any significant differences between actual future payments and expected payments will result in a change to that interest rate, which will be applied prospectively. The calculation of the interest cost, and remaining balance, of the financing arrangement is relatively sensitive to changes in portfolio attrition. If that attrition declined to 10% for 2005 and thereafter, the expected interest cost for 2005 would increase from \$0.2 million to \$0.7 million, reflecting an interest rate for future payments of approximately 8.4%. If the attrition rate increases from the projected 15%, the interest rate would decline from the current 2.53%.

We have included our estimated future payments under both financing arrangements in the "Contractual Obligations" table included under Commitments.

Income Taxes

We account for income taxes pursuant to the provisions of Statement of Financial Accounting Standards No. 109, *Accounting for Income Taxes*. Under this method, deferred tax assets and liabilities are recorded to reflect the future tax consequences attributable to the effects of differences between the carrying amounts of existing assets and liabilities for financial reporting and for income tax purposes. Judgments are required in determining the amount and probability of future taxable income, which in turn is critical to a determination of whether a valuation reserve against the deferred tax asset or liability is appropriate.

We released the income tax valuation allowance at year ended 2003 as evidence indicated that it was more likely than not that we would realize on our deferred tax assets. This conclusion was made in 2003 based on the fact that we generated taxable income of \$1 million and \$6.5 million in 2002 and 2003, respectively, and were able to utilize the same amounts of net operating losses to reduce taxable income to zero. Our projections for the next three years reflected substantial taxable income which would completely exhaust the small amount of remaining net operating losses in 2004. The net operating losses were exhausted in 2004.

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In addition, none of our net operating losses have expired unused, there are no anticipated losses in future years and no unsettled circumstances, that if unfavorably resolved, would adversely affect our future operations and taxable income levels in future years.

Based on the above estimates and facts, our judgment was to release the valuation allowance as of the year ended 2003.

Components of Revenue and Expenses

Revenue

Our revenues fall into two categories, gross processing revenue and other revenue, net. Our gross processing revenue primarily consists of discount, per-transaction and periodic (primarily monthly) fees from the processing of bank card transactions, primarily Visa and MasterCard transactions, for merchants. These fees are negotiated by our Relationship Managers with each merchant. Gross processing revenue also includes fees charged by Heartland Payroll Company for payroll processing services. Gross processing revenue is recorded as services are performed.

Other revenue, net includes American Express and Discover fees, customer service fees, fees for processing chargebacks, fees for the sale, rental, leasing and deployment of bank card terminals, termination fees on terminated contracts, 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. Most of these other fees and revenue items will tend to grow with our merchant growth.

Expenses

Our most significant expense is interchange fees, which are set by the Visa and MasterCard card associations, and are paid to the card issuing banks. Interchange fees are calculated as a percentage of the dollar volume processed plus a per transaction fee. We also pay Visa and MasterCard association dues and assessments, which are calculated as a percentage of the dollar volume processed. Interchange fees and dues and assessments are recognized at the time transactions are processed. It is our policy to pass along to our merchants any changes in interchange fees and card association dues and assessments. Consequently, after Visa and MasterCard decreased their debit interchange rates in August 2003, both our discount and our interchange fees as a percentage of processing volume decreased by approximately 0.1%, with both income and expense decreasing by approximately the same amount. Our income from operations was therefore not affected by the reduction in debit interchange fee rates. Since the card associations have recently implemented significant increases in those rates, our gross processing revenue will increase, but all the benefit will be paid to the card issuing banks and our income from operations will not be affected.

Costs of services also include processing and servicing costs, customer acquisition costs, and depreciation and amortization. Processing and servicing costs include:

residual commission payments to our Relationship Managers, sales managers and trade associations, agent banks and value-added resellers, which are a percentage of the gross margin we generated from our merchant contracts during the accounting period;

processing costs, which are either paid to third parties, or represent the cost of our own authorization/capture system. During 2004, third party costs represented about 77% of our processing costs, with internal costs representing the remainder. Approximately 72% of our third-party processing costs were paid to Vital; and

miscellaneous items, including telecommunications costs, personnel costs, occupancy costs, losses due to merchant defaults, bank sponsorship costs and other direct merchant servicing expenses.

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Customer acquisition costs reflect the amortization over the initial three-year contract term of the cash signing bonus paid, the deferred acquisition costs for vested Relationship Managers and sales managers, and changes in the accrued buyout liability, which reflect the impact of buyouts and volume attrition.

Depreciation and amortization expenses are primarily recognized on a straight-line basis over the estimated useful life of the asset. We have made significant capital expenditures for computer hardware and software and such costs are generally depreciated over three years.

Selling and administrative expenses include salaries and wages and other administrative expenses. The two most significant elements in these expenses are our information technology infrastructure costs and our marketing expenses.

Other income (expense) consists of interest income on cash and investments, the interest cost on our borrowings, the gains or losses on the disposal of property, plant and equipment and other non-recurring income or expense items. Other income (expense) also includes the adjustment to the fair value of our outstanding warrants with mandatory redemption provisions.

Results of Operations

Three Months Ended March 31, 2004 and 2005

The following table shows certain financial data as a percentage of revenue for the periods indicated (in thousands of dollars):

	Three Months Ended March 31, 2004	% of Total Net Revenue	Three Months Ended March 31, 2005	% of Total Net Revenue	Change	
	(unaudited)		(unaudited)		Amount	%
Revenue:						
Gross processing revenue	\$ 119,202	98.3 %	\$ 166,172	97.8 %	\$ 46,970	39.4 %
Other revenue, net	2,002	1.7 %	3,693	2.2 %	1,691	84.5 %
Total net revenue	121,204	100.0 %	169,865	100.0 %	48,661	40.1 %
Costs of services:						
Interchange	86,372	71.3 %	122,416	72.1 %	36,044	41.7 %
Dues and assessments	4,785	3.9 %	6,415	3.8 %	1,630	34.1 %
Processing and servicing	14,748	12.2 %	19,820	11.7 %	5,072	34.4 %
Customer acquisition costs	4,135	3.4 %	5,841	3.4 %	1,706	41.3 %
Depreciation and amortization	876	0.7 %	1,283	0.8 %	407	46.5 %
Total costs of services	110,916	91.5 %	155,775	91.7 %	44,859	40.4 %
Selling and administrative	7,233	6.0 %	8,989	5.3 %	1,756	24.3 %
Total expenses	118,149	97.5 %	164,764	97.0 %	46,615	39.5 %
Income from operations	3,055	2.5 %	5,101	3.0 %	2,046	67.0 %
Other income (expense):						
Interest income	38	0.0 %	110	0.1 %	72	189.5 %
Interest expense	(298)	(0.2) %	(435)	(0.3) %	(137)	(46.0) %
Fair value adjustment for warrants with mandatory redemption provisions		0.0 %	(90)	(0.1) %	(90)	(100.0) %
Other, net	833	0.7 %	(3)	0.0 %	(836)	(100.4) %
Total other income (expense)	573	0.5 %	(418)	(0.2) %	(991)	(172.9) %
Income before income taxes	3,628	3.0 %	4,683	2.8 %	1,055	29.1 %
Provision for income taxes	1,482	1.2 %	1,989	1.2 %	507	34.2 %

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				Change	
Net income	\$ 2,146	1.8 %	\$ 2,694	1.6	548 25.5 %
		29		%	\$

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Revenue Total net revenue increased 40.1% from \$121.2 million for the three months ended March 31, 2004 to \$169.9 million for the three months ended March 31, 2005, primarily as a result of a 39.4% increase in our gross processing revenue from \$119.2 million for the three months ended March 31, 2004 to \$166.2 million for the three months ended March 31, 2005. These gross processing revenue and dollar volume increases were primarily attributable to a net increase in merchant accounts, with the number of merchant accounts growing by 30.0% from 72,196 as of March 31, 2004 to 93,825 as of March 31, 2005. The increase in new merchant accounts during this period was primarily the result of the growth in our sales force, combined with improved production from our existing sales force. The sales force grew by 12.4% from 769 at March 31, 2004 to 864 at March 31, 2005. Gross processing revenue also includes payroll processing fees, which increased by 20.0% from \$1.0 million for the three months ended March 31, 2004 to \$1.2 million for the three months ended March 31, 2005.

Total net revenue also includes other revenue, net which increased by 84.5% from \$2.0 million for the three months ended March 31, 2004 to \$3.7 million for the three months ended March 31, 2005. The increase was primarily due to increases in annual fees, and equipment related income.

Costs of services. Costs of services increased 40.4% from \$110.9 million for the three months ended March 31, 2004 to \$155.8 million for the three months ended March 31, 2005 due primarily to an increase in interchange fees, which resulted from higher processing volume. Cost of services represented 91.5% and 91.7% of total net revenue for the three months ended March 31, 2004 and 2005, respectively. Interchange fees represented 71.3% of total net revenue for the three months ended March 31, 2004 and 72.1% of total net revenue for the three months ended March 31, 2005. The incremental deterioration in the ratio of interchange fees to total net revenue is primarily the result of interchange increases from Visa and Master Card, which we pass through to our merchants without mark-up. Dues and assessments as a percentage of total net revenue declined from 3.9% to 3.8% for the three months ended March 31, 2004 and 2005, respectively, as the rate paid for dues and assessments did not change, but interchange increased. Processing and servicing increased by \$5.1 million, or 34.4%, and as a percentage of total net revenue declined from 12.2% for the three months ended March 31, 2004 to 11.7% for the three months ended March 31, 2005. The increase in processing and servicing was due primarily to costs associated with increased volume, the addition of 56 sales, risk and underwriting support personnel in the service center, and a \$1.8 million increase in residual commission payments to our Relationship Managers and sales management related to their portion of the growth in our gross margin. Since our sales organization is 100% commission-based, increases in processing income directly impact commissions in cost of services. Processing and servicing as a percentage of total net revenue decreased primarily due to improved merchant pricing, leveraging the lower costs, as compared to third party processors, of our internally developed front-end processing system, HPS Exchange, and growth in our services center staff that was slower than our revenue growth. Over 58% of new merchants each month were installed on HPS Exchange during the three months ended March 31, 2005, and we have completed some conversions from other front-end processors, so that HPS Exchange represented approximately 41% of our total volume for the three months ended March 31, 2005, up significantly from 29% for the three months ended March 31, 2004. We expect the increasing share of HPS Exchange in our total merchant base to continue in the future. Included in processing and servicing was \$353,151 of payroll processing costs for the three months ended March 31, 2004, which increased 9.5% to \$386,788 for the three months ended March 31, 2005.

Customer acquisition costs increased 41.3% from \$4.1 million for the three months ended March 31, 2004 to \$5.8 million for the three months ended March 31, 2005. The amortization of signing bonuses increased from \$2.6 million to \$3.7 million for the three months ended March 31, 2004 and 2005, respectively, while the accrued buyout cost amortization grew from \$1.6 million for the three months ended March 31, 2004 to \$2.3 million in the same period in 2005. Increases in new account generation activity, reflected by the increase in signing bonus payments from \$4.2 million for the three

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months ended March 31, 2004 to \$4.6 million for the three months ended March 31, 2005, were responsible for increases in the amortization of both the accrued buyout costs and signing bonuses.

Depreciation and amortization expenses increased 46.5% from \$0.9 million for the three months ended March 31, 2004 to \$1.3 million for the three months ended March 31, 2005. The increase was primarily due to the purchase of information technology equipment to support the network and the development of HPS Exchange. Additionally, we capitalized salaries and fringe benefits and other expenses incurred by employees that worked on internally developed software projects. Amortization does not begin on the internally developed software until the project is complete and placed in service, at which time we begin to amortize the asset over three years. The capitalized amounts increased from \$224,490 for the three months ended March 31, 2004 to \$434,074 for the three months ended March 31, 2005. The total amount of capitalized projects placed in service for the three months ended March 31, 2004 and 2005 was \$0 and \$61,888, respectively.

Selling and administrative. Selling and administrative expenses increased 24.3% from \$7.2 million for the three months ended March 31, 2004 to \$9.0 million for the three months ended March 31, 2005. The increase was primarily due to added costs necessary to continue building our corporate and marketing infrastructure to meet our sales initiatives. Selling and administrative expenses as a percentage of total net revenue declined from 6.0% for the three months ended March 31, 2004 to 5.3% for the three months ended March 31, 2005, as revenue growth outpaced the increase in expenses. The payroll operation's selling and administrative expenses increased by 0.2% from \$454,463 for the three months ended March 31, 2004 to \$455,518 for the three months ended March 31, 2005.

Income from operations. For the reasons described above, income from operations improved from \$3.1 million for the three months ended March 31, 2004 to \$5.1 million for the three months ended March 31, 2005.

Interest Income. Interest income increased from \$38,000 to \$110,000 in the first three months of 2004 and 2005, respectively, due primarily to increased interest rates.

Interest Expense. Interest expense increased from \$0.3 million for the three months ended March 31, 2004 to \$0.4 million for the three months ended March 31, 2005. Most of our interest expense arises from the fact that our banks advance interchange fees to most of our merchants, and we pay those banks prime rate on those balances. Those balances were higher for the three months ended March 31, 2005 due to increased processing volume. This was partially offset by a decrease in interest expense resulting from repayments of the principal of the financing arrangements as the outstanding balance declined from \$12.2 million as of March 31, 2004 to \$9.7 million as of March 31, 2005.

Fair value adjustment for warrants with mandatory redemption provisions. The fair value put option associated with warrants that had been issued in 2001 became exercisable in 2003. We recognized expense of \$0.1 million in 2005 to adjust the warrants' value to \$9.80 per share, the estimated fair value.

Other net. Other, net decreased from \$0.8 million of income for the three months ended March 31, 2004 to \$3,000 of expense for the three months ended March 31, 2005. This decrease was attributable to a payment we received in connection with a legal settlement in the first quarter of 2004.

Income Tax. Income taxes for the three months ended March 31, 2005 were \$2.0 million using an effective tax rate of 42.5%. This represented an increase from the 40.8% effective rate for the first quarter of 2004 which resulted in taxes of \$1.5 million.

Net income. As a result of the above factors, net income increased from \$2.1 million for the three months ended March 31, 2004 to \$2.7 million for the three months ended March 31, 2005.

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Years Ended December 31, 2003 and 2004

The following table shows certain financial data as a percentage of revenue for the periods indicated (in thousands of dollars):

	2003	% of Total Net Revenue	2004	% of Total Net Revenue	Change	
					Amount	%
Revenue:						
Gross processing revenue	\$ 414,715	98.2 %	\$ 595,524	98.8 %	\$ 180,809	43.6 %
Other revenue, net	7,522	1.8 %	7,225	1.2 %	(297)	(3.9)%
Total net revenue	422,237	100.0 %	602,749	100.0 %	180,512	42.8 %
Costs of services:						
Interchange	302,057	71.5 %	438,738	72.8 %	136,681	45.3 %
Dues and assessments	15,945	3.8 %	23,348	3.9 %	7,403	46.4 %
Processing and servicing	50,805	12.0 %	70,232	11.7 %	19,427	38.2 %
Customer acquisition costs	13,380	3.2 %	18,908	3.1 %	5,528	41.3 %
Depreciation and amortization	2,571	0.6 %	3,912	0.6 %	1,341	52.2 %
Total costs of services	384,758	91.1 %	555,138	92.1 %	170,380	44.3 %
Selling and administrative	25,751	6.1 %	31,501	5.2 %	5,750	22.3 %
Total expenses	410,509	97.2 %	586,639	97.3 %	176,130	42.9 %
Income from operations	11,728	2.8 %	16,110	2.7 %	4,382	37.4 %
Other income (expense):						
Interest income	124	0.0 %	182	0.0 %	58	46.8 %
Interest expense	(1,188)	(0.3)%	(1,385)	(0.2)%	(197)	(16.6)%
Fair value adjustment for warrants with mandatory redemption provisions	(893)	(0.2)%	(509)	(0.1)%	384	43.0 %
Other, net	(740)	(0.2)%	833	0.1 %	1,573	212.6 %
Total other (expense) income	(2,697)	(0.6)%	(879)	(0.1)%	1,818	67.4 %
Income before income taxes	9,031	2.1 %	15,231	2.5 %	6,200	68.7 %
(Benefit) provision for income taxes	(11,102)	(2.6)%	6,376	1.1 %	17,478	157.4 %
Net income	\$ 20,133	4.8 %	\$ 8,855	1.5 %	\$ (11,278)	(56.0)%

Revenue. Total net revenue increased 42.8% from \$422.2 million in 2003 to \$602.7 million in 2004, primarily as a result of a 43.6% increase in our gross processing revenue from \$414.7 million in 2003 to \$595.5 million in 2004. Gross processing revenue increased due to a 39.7% increase in the dollar volume of transactions we processed, to \$25.0 billion in 2004 from \$17.9 billion in 2003. These gross processing revenue and dollar volume increases were primarily attributable to a net increase in merchant accounts, with the number of merchant accounts growing by 32.2% from 67,271 as of December 31, 2003 to 88,900 as of December 31, 2004, as well as increases in interchange rates, which are passed through to our merchants. New merchants installed during the year grew by 41.2%, from 27,911 in 2003 to 39,403 in 2004. The increase in new merchant accounts during this period was primarily the result of the rapid growth in our sales force, which was accompanied by improvements in services provided by the Service Center, improvements in the training of our sales force and changes in and enhancements to our incentive programs. In addition, we believe our decision to pass through to our merchants the August 2003 reduction in debit interchange had a significant impact on our new account generation commencing in September 2003. The sales force grew by 24.0% from 671 at December 31, 2003 to 832 at December 31, 2004. Gross processing revenue also includes payroll processing fees, which increased by 33.3% from \$2.7 million in 2003 to \$3.6 million in 2004.

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Total net revenue also includes other revenue, net which decreased by 3.9% from \$7.5 million in 2003 to \$7.2 million in 2004.

Costs of services. Costs of services increased 44.3% from \$384.8 million in 2003 to \$555.1 million in 2004 due primarily to an increase in interchange fees, which resulted from higher processing volume.

Costs of services represented 91.1% of total net revenue in 2003 and 92.1% of total net revenue in 2004. Interchange fees represented 71.5% of total net revenue in 2003 and 72.8% of total net revenue in 2004, with the increase resulting from higher interchange rates. Dues and assessments as a percentage of total net revenue grew from 3.8% to 3.9% in 2003 and 2004, respectively, due to an increase in Visa's dues and assessments. Processing and servicing increased by \$19.4 million, or 38.2%, and as a percentage of total net revenue declined from 12.0% in 2003 to 11.7% in 2004. The increase in processing and servicing was due primarily to costs associated with increased processing volume, the addition of 116 sales, risk and underwriting support personnel in the service center, and a \$7.1 million increase in residual commission payments to our Relationship Managers and sales managers related to their portion of the growth in our gross margin. Since our sales organization is 100% commission-based, increases in processing income directly impact commissions in processing and servicing. Processing and servicing as a percentage of total net revenue decreased primarily due to leveraging the lower costs, as compared to third party processors, of HPS Exchange, and growth in our service center staff that was slower than our revenue growth. Over 55% of new merchants each month were installed on HPS Exchange during 2004, and we have completed some conversions from other front-end processors, so that HPS Exchange represented approximately 35% of our total volume in 2004, up from 20% in 2003. We expect the increasing share of HPS Exchange in our total merchant base to continue in the future. Included in processing and servicing was \$0.8 million of payroll processing costs in 2003, which increased 75.0% to \$1.4 million in 2004.

Customer acquisition costs increased 41.3% from \$13.4 million to \$18.9 million in 2003 and 2004, respectively. The amortization of signing bonuses increased from \$8.6 million in 2003 to \$12.0 million in 2004, while the accrued buyout cost amortization grew from \$4.3 million in 2003 to \$7.7 million in 2004. Increases in new account generation activity, reflected by the increase in signing bonus payments from \$13.1 million to \$21.6 million in 2003 and 2004, respectively, were responsible for increases in the amortization of both the accrued buyout costs and signing bonuses.

Depreciation and amortization expenses increased 52.2% from \$2.6 million in 2003 to \$3.9 million in 2004. The depreciation expense increased primarily from the purchase of information technology equipment to support the network and the development of HPS Exchange. Additionally, we capitalized salaries and fringe benefits and other expenses incurred by employees that worked directly on internally developed software projects. Amortization does not begin on the internally developed software until the project is complete and ready for its intended use, at which time we begin to amortize the asset on a straight line basis over three years. The capitalized amounts increased from \$0.8 million in 2003 to \$1.5 million in 2004. The total amount of capitalized projects placed in service in 2003 and 2004 was \$0.3 million and \$0.8 million, respectively.

Selling and administrative. Selling and administrative expenses increased 22.3% from \$25.8 million in 2003 to \$31.5 million in 2004. The increase was primarily due to added costs necessary to continue building our corporate and marketing infrastructure to meet our sales initiatives. Selling and administrative expenses as a percentage of total net revenue declined from 6.1% in 2003 to 5.3% in 2004, as revenue growth outpaced the increase in expenses. The payroll operation's selling and administrative expenses increased by 11.8% from \$1.7 million in 2003 to \$1.9 million in 2004.

Income from operations. For the reasons described above, income from operations improved from \$11.7 million in 2003 to income of \$16.1 million in 2004.

Interest income. Interest income increased from \$0.1 million to \$0.2 million in 2003 and 2004, respectively. This was the result of an increase in interest-bearing deposits and investments.

Interest expense. Interest expense increased from \$1.2 million in 2003 to \$1.4 million in 2004. Most of our interest expense arises from the fact that our banks advance interchange fees to most of our merchants, and we pay those banks prime rate on those balances. Those balances were higher in

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2004 due to increased processing volume. This was partially offset by a decrease in interest expense resulting from a reduction in the principal of the financing arrangements, from \$12.9 million as of December 31, 2003 to \$10.2 million as of December 31, 2004.

Fair value adjustment for warrants with mandatory redemption provisions. The fair value put option associated with warrants that had been issued in 2001 became exercisable in 2003. We recognized expense of \$0.9 million in 2003 to adjust the warrants' value to \$6.25 per share, the estimated fair value. During 2004, the warrants were further adjusted to the current fair value of \$9.28 per share.

Other, net. Other, net improved from expense of \$0.7 million in 2003 to income of \$0.8 million in 2004. Most of the expense in 2003 was attributable to the purchase of Welsch Financial Merchant Services, Inc. in which the purchase agreement called for an earnout valued at \$0.3 million. Subsequently, the earnout was paid in the amount of \$1.0 million, based on specific incentive clauses in the purchase agreement, resulting in a loss of \$0.7 million. Most of this income in 2004 was attributable to a payment we received in connection with the settlement of a suit we had initiated to collect on an insurance policy we had in 1998.

Income tax. Income taxes for the year ended December 31, 2004 were \$6.4 million using an effective tax rate of 41.9%. During 2003, management determined that our deferred tax assets were more likely than not to be realized, and the valuation allowance of \$11.1 million was released at that time.

Net income. As a result of the above factors, in particular changes in taxes, net income decreased from \$20.1 million in 2003 to \$8.9 million in 2004.

Years Ended December 31, 2002 and 2003

The following table shows certain financial data as a percentage of revenue for the periods indicated (in thousands of dollars):

	2002	% of Total Net Revenue	2003	% of Total Net Revenue	Change	
					Amount	%
Revenue:						
Gross processing revenue	\$ 330,975	97.2 %	\$ 414,715	98.2 %	\$ 83,740	25.3 %
Other revenue, net	9,607	2.8 %	7,522	1.8 %	(2,085)	(21.7)%
Total net revenue	340,582	100.0 %	422,237	100.0 %	81,655	24.0 %
Costs of services:						
Interchange	242,407	71.2 %	302,057	71.5 %	59,650	24.6 %
Dues and assessments	12,616	3.7 %	15,945	3.8 %	3,329	26.4 %
Processing and servicing	44,224	13.0 %	50,805	12.0 %	6,581	14.9 %
Customer acquisition costs	12,422	3.6 %	13,380	3.2 %	958	7.7 %
Depreciation and amortization	1,587	0.5 %	2,571	0.6 %	984	62.0 %
Total costs of services	313,256	92.0 %	384,758	91.1 %	71,502	22.8 %
Selling and administrative	20,786	6.1 %	25,751	6.1 %	4,965	23.9 %
Total expenses	334,042	98.1 %	410,509	97.2 %	76,467	22.9 %
Income from operations	6,540	1.9 %	11,728	2.8 %	5,188	79.3 %
Other income (expense):						
Interest income	171	0.1 %	124	0.0 %	(47)	(27.5)%
Interest expense	(1,182)	(0.3)%	(1,188)	(0.3)%	(6)	(0.5)%

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					<u>Change</u>	
Fair value adjustment for warrants with mandatory redemption provisions	(509)	(0.1)%	(893)	(0.2)	(384)	(75.4)%
Other, net	(62)	0.0 %	(740)	(0.2)%	(678)	(1,093.5)%
	<u> </u>		<u> </u>		<u> </u>	
Total other income (expense)	(1,582)	(0.5)%	(2,697)	(0.6)%	(1,115)	(70.5)%
	<u> </u>		<u> </u>		<u> </u>	
Income before income taxes	4,958	1.5 %	9,031	2.1 %	4,073	82.2 %
Provision for (benefit from) income taxes	51	0.0 %	(11,102)	(2.6)%	(11,153)	(21,868.6)%
	<u> </u>		<u> </u>		<u> </u>	
Net income	\$ 4,907	1.4 %	\$ 20,133	4.8 %	\$ 15,226	310.3 %
	<u> </u>		<u> </u>		<u> </u>	

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Revenue. Total net revenue increased 24.0% from \$340.6 million in 2002 to \$422.2 million in 2003 primarily as a result of a 25.3% increase in our gross processing revenue from \$331.0 million in 2002 to \$414.7 million in 2003. Gross processing revenue increased due to a 24.3% increase in the dollar volume of transactions we processed, from \$14.4 billion in 2002 to \$17.9 billion in 2003. These gross processing revenue and dollar volume increases were primarily attributable to a net increase in merchant accounts, from 52,624 at December 31, 2002 to 67,271 at December 31, 2003, which was the result of the number of newly installed merchants growing by 41.8% from 19,687 in 2002 to 27,911 in 2003. The increase in merchant accounts in 2003 was primarily the result of the rapid growth in our sales force, the impact of changes to the sales management structure that were made in the second half of 2002, and the beneficial impacts on sales of our decision to pass the August, 2003 debit interchange reduction on to our merchants. The sales force grew by 60.9% from 417 people at year-end 2002 to 671 people at year-end 2003. Gross processing revenue also includes payroll processing fees, which increased by 42.1% from \$1.9 million in 2002 to \$2.7 million in 2003.

Total net revenue also includes other revenue, net, which decreased by 21.7% from \$9.6 million in 2002 to \$7.5 million in 2003. The decrease was attributable primarily to a decrease in gains on sales of merchant contracts, as in 2002 we recognized \$2.2 million of gain from the National Processing Company portfolio transfer, partially offset by increases in chargeback processing and other service fee income.

Costs of services. Costs of services increased 22.8% from \$313.3 million in 2002 to \$384.8 million in 2003, primarily due to an increase in interchange fees resulting from higher processing volume. Costs of services represented 92.0% of total net revenue in 2002 and 91.1% of total net revenue in 2003. Interchange fees represented 71.2% of total net revenue in 2002, and increased to 71.5% in 2003. Dues and assessments increased from 3.7% in 2002 to 3.8% of total net revenue in 2003. Processing and servicing increased by \$6.6 million, or 14.9%, and as a percentage of total net revenue declined from 13.0% in 2002 to 12.0% in 2003. The increase in processing and servicing was due primarily to costs associated with new merchant accounts and increased processing volume, the addition of 19 sales support and technical personnel in our service center, and a \$2.5 million increase in commission payments to our Relationship Managers and sales management related to the growth in our gross margin. Since our sales force is 100% commission-based, increases in processing income directly impact commissions in processing and servicing. Processing and servicing as a percentage of total net revenue decreased primarily due to improving merchant pricing, leveraging the lower costs, as compared to third-party processors, of HPS Exchange, and growth in our service center staff that was slower than our total net revenue growth. Over 55% of our new merchants in 2003 were installed on HPS Exchange, and we have completed some conversions from other front-end processors, so that HPS Exchange represented approximately 20% of our total volume in 2003, up significantly from 6% in 2002. Included in processing and servicing was \$0.5 million of payroll processing costs in 2002, which increased to \$0.8 million in 2003.

Customer acquisition costs increased 7.7% from \$12.4 million in 2002 to \$13.4 million in 2003. The amortization of signing bonuses grew from \$6.3 million in 2002 to \$8.7 million in 2003, while the accrued buyout cost amortization increased from \$1.8 million in 2002 to \$4.3 million in 2003. Signing bonus payments of \$13.1 million (\$12.3 million after signing bonus adjustments of \$0.8 million) in 2003 represented an increase of 56.0% over signing bonus payments of \$8.4 million (\$8.0 million after signing bonus adjustments of \$0.4 million) in 2002, and resulted in an increase in amortization expense. These increases were partially offset by a decline in the accrued buyout liability due to merchant attrition.

Depreciation and amortization expenses increased 62.0% from \$1.6 million in 2002 to \$2.6 million in 2003. The depreciation expense increased primarily from the purchase of information technology equipment to support the network, the development of HPS Exchange and to upgrade and maintain the telecommunication systems at our service center. Additionally, we capitalized salaries, fringe

benefits and other expenses incurred by employees that worked on internally developed software projects. The capitalized amounts increased from \$1.6 million in 2002 to \$2.4 million in 2003. The total amount of capitalized software development projects placed in service in 2002 and 2003 was \$0.9 million and \$0.5 million, respectively.

Selling and administrative. Selling and administrative expenses increased 23.9% from \$20.8 million in 2002 to \$25.8 million in 2003. The increase was primarily due to added costs necessary to continue building our corporate and marketing infrastructure to support our sales initiatives. Selling and administrative expenses as a percentage of total net revenue remained unchanged at 6.1% in 2002 and 2003. The payroll operation's selling and administrative expenses increased by 21.4% from \$1.4 million in 2002 to \$1.7 million in 2003.

Interest income. Interest income decreased by 27.5%, from 2002 to 2003. The decrease was due to the significant decline in interest rates that occurred between 2002 and 2003, as evidenced by the decline in 3-month bank CDs from an average of 1.73% in 2002 to 1.15% in 2003.

Interest expense. Interest expense increased by 0.5% from \$1.18 million in 2002 to \$1.19 million in 2003. Our balances for bank-advanced interchange fees increased during 2003 in line with our processing volume, but the increase in interest expense was lower than the processing volume increase due to the decline in the prime rate. In addition, the interest paid on the financing arrangement declined due to principal payments that had been made, which reduced the obligation from \$16.0 million at December 31, 2002 to \$12.9 million at December 31, 2003.

Fair market adjustment for warrants with mandatory redemption provisions. The fair value put option associated with warrants that had been issued in 2001 became exercisable in 2003. We recognized expense of \$0.9 million in 2003 to adjust their value to \$6.25 per share, the estimated fair value. We also recognized expense of \$0.5 million in 2002 to adjust their value to \$3.61 per share, the estimated fair value.

Other, net. Other, net expense increased from \$0.1 million in 2002 to \$0.7 million in 2003. The expense in 2003 was attributable to the purchase of Welsch Financial Merchants Services, Inc. in which the purchase agreement called for an earnout valued at \$0.3 million. Subsequently the earnout was paid in the amount of \$1.0 million, based on specific incentive clauses in the purchase agreement, resulting in a loss of \$0.7 million. In 2002, the expense was the result of the disposition of point-of-sale terminals, plus other miscellaneous adjustments.

Income tax. Prior to 2003, we provided deferred tax asset valuation allowances because the historic variability in our profitability made the realization on our operating loss carryforwards questionable. During 2003, we concluded, based on current and forecasted taxable income, that our deferred tax assets are more likely than not to be realized. As a result, we realized a tax benefit of \$11.1 million, since the valuation allowance that had previously been maintained was released during the year. The income tax provision in 2002 related only to state taxes payable.

Net income. As a result of the above factors, in particular the release of the tax valuation allowance, net income increased from \$4.9 million in 2002 to \$20.1 million in 2003.

Liquidity and Capital Resources

At March 31, 2005, we had cash and cash equivalents totaling \$12.7 million, and at December 31, 2003 and 2004, we had cash and cash equivalents totaling \$13.0 million and \$13.2 million, respectively. Net cash provided by operating activities was \$12.0 million in 2003, \$17.9 million in 2004 and \$2.3 million for the three months ended March 31, 2005. Key sources of operating cash flows in all periods were net income as adjusted for changes in deferred taxes, plus depreciation and amortization. Contained within changes in operating assets and liabilities are the increase in receivables, which is essentially offset by changes in accounts payable. This is because the largest receivable is from our merchants, the majority of which is

associated with the interchange that we cause Key Bank to advance to our merchants, while the largest payable is to Key Bank for the interchange. These amounts tend to rise and fall together, depending on our processing activity in the final month of the period in question. The other major determinants of operating cash flow are increases in capitalized customer acquisition costs, which consume increasing amounts of operating cash as our new merchant installation activity rises, and payouts on the accrued buyout liability, which represent the costs of buying out residual commissions owned by our Relationship Managers and sales managers. Included in the amount of cash consumed by increases in capitalized customer acquisition costs are signing bonus payments of \$8.4 million, \$13.1 million, \$21.6 million and \$4.6 million, respectively, in 2002, 2003, 2004 and the first quarter of 2005. In 2002, 2003, 2004 and the first quarter of 2005, we reduced the accrued buyout liability by making buyout payments of \$7.5 million, \$4.7 million, \$2.2 million and \$3.3 million. While our working capital, defined as current assets less current liabilities, was negative at March 31, 2005 and December 31, 2003 and 2004, we do not require cash from the proceeds of this offering to supplement our working capital because as described above, we historically have generated sufficient cash flow from our operating activities and we expect to continue to do so.

Net cash used in investing activities was \$3.5 million for the year ended December 31, 2003, \$8.9 million for the year ended December 31, 2004, and \$2.4 million for the three months ended March 31, 2005. During each of those periods, most of the cash used in investing activities was used to fund capital expenditures. Total capital expenditures for the year ended December 31, 2003 were \$3.7 million, an increase of \$0.1 million from the \$3.6 million invested in 2002. Total capital expenditures for the year ended December 31, 2004 were \$9.1 million, up 145.9% from 2003. Total capital expenditures for the three months ended March 31, 2005 were \$2.1 million. In 2003, 2004, and the three months ended March 31, 2005, these expenditures were primarily related to continued building of our technology infrastructure, primarily for hardware and software needed for the expansion of HPS Exchange and our own back-end processing system. We anticipate that these expenditures may increase as we further develop our technology. In addition, beginning in 2002 we started investing a portion of the cash balances held at our subsidiary, Heartland Payroll Company, in securities that are classified on our balance sheet as investments. We invest in federal, federal agency and corporate debt obligations with maturities of up to four years and no less than a single-A rating.

Net cash used in financing activities was \$2.9 million, \$3.6 million, \$8.8 million and \$0.5 million for the years ended December 31, 2002, 2003, 2004 and the three months ended March 31, 2005, respectively. In 2002, we issued \$3.6 million of debt to fund buyouts of future residual commissions and the purchase of \$0.2 million of our common stock. We expect to make significant buyout payments in the future. Although we will determine to make such payments on a case-by-case basis, we anticipate that in 2005, such payments will exceed the \$7.5 million we spent in 2002. On May 15, 2002, we issued a promissory note to Welsch Financial Merchant Services, Inc. in the principal amount of \$2.0 million with simple interest payable monthly in arrears on the principal amount outstanding at a rate equal to the prime rate as reported in the Wall Street Journal, as adjusted on a daily basis. In 2002 and 2003, we repaid \$750,000 of our debt to Welsch in two \$375,000 payments, and \$1.0 million, in four \$250,000 payments. In January 2004, we made the final payment of \$250,000 to Welsch. On January 8, 2004, a warrant holder elected to exercise their put, and we redeemed half of the holder's warrants, or 168,906 shares, at the deemed fair value of \$6.25 per share. The exercise price of the warrants was \$0.005 per warrant and net consideration paid by us was \$1.1 million. The remaining warrants to purchase 168,904 shares of our common stock expire on July 25, 2006, and the holder can exercise their fair value put at any time. Upon the closing of this offering, we expect to exercise our option to require the holder to exercise all of the remaining warrants. On September 28, 2004, we redeemed six warrants totalling 2,000,000 shares of our common stock for net consideration of \$5.25 million. During 2004, several employees exercised their employee stock options in the aggregate amount of \$1.6 million.

On August 28, 2002, we signed a loan and security agreement with KeyBank National Association for two loan instruments, which was amended on November 6, 2003, June 23, 2004, and May 26, 2005. The agreement was amended twice to reflect changes we have made in our accounting policies. The

loan and security agreement contains covenants requiring an operating cash flow to total fixed charges ratio of not less than 1.2 to 1, and a measure of total funded debt to EBITDA of less than 2 to 1. The first instrument is a revolver advance facility, which is to be used solely to fund the buyouts of future residual commissions from former Relationship Managers or Independent Sales Organizations. We may draw down on the revolver up to an aggregate unpaid principal amount of \$3.5 million. As of March 31, 2005, \$2.1 million was outstanding under the revolver. The entire principal balance plus all accrued interest and fees are due on May 31, 2005 (subsequently extended to August 31, 2005) or on demand if we are in default. The second instrument is a purpose and ability line of credit totaling \$3.0 million, which is payable on demand. As of March 31 2005, we had \$784,165 of outstanding indebtedness under this line of credit. Borrowings under the two lines of credit bear interest at the prime rate, which was 5.75% at March 31, 2005 and are secured by a lien on our assets. They contain customary covenants, including the provision of financial reports, maintenance of insurance, payment of taxes and provision of notice of any default, and events of default, including failure to pay principal or interest, cross-default, and insolvency covenants. We are currently in compliance with all covenants, and have been since the instruments were established.

On May 26, 2005, we entered into an amendment to our loan and security agreement with KeyBank National Association, which extended the scheduled maturity date from May 31, 2005 to August 31, 2005.

We believe that our current cash and investment balances, cash generated from operations and existing lines of credit will provide sufficient liquidity to meet our anticipated needs for capital for at least the next 12 months.

Commitments

The Visa and MasterCard associations generally allow chargebacks up to four months after the later of the date the transaction is processed or the delivery of the product or service to the cardholder. As the majority of our transactions involve the delivery of the product or service at the time of the transaction, a good estimate of our exposure to chargebacks is the last four months' processing volume on our portfolio, which was \$5.0 billion, \$6.6 billion, \$9.0 billion and \$9.4 billion for the four months ended December 31, 2002, 2003 and 2004 and March 31, 2005, respectively. However, for the four months ended December 31, 2002, 2003 and 2004 and March 31, 2005, we were presented with \$4.5 million, \$5.4 million, \$5.6 million and \$5.5 million, respectively, of chargebacks by issuing banks. In the years ended December 31, 2002, 2003 and 2004 and the quarter ended March 31, 2005, we incurred merchant credit losses of \$561,928, \$605,256, \$939,500 and \$299,714, respectively, on total dollar volume processed of \$14.4 billion, \$17.9 billion, \$25.0 billion and \$6.9 billion, respectively. These credit losses are included in "cost of services" in our consolidated statements of operations.

The following table reflects our significant contractual obligations as of March 31, 2005:

Cash Payments Due By Period as of March 31, 2005

	Total	Less than One Year	1-3 Years	4-5 Years	After 5 Years
(In thousands)					
Contractual Obligations:					
Processing providers	\$ 10,896	\$ 7,089	\$ 2,727	\$ 1,080	\$
Financing arrangement (expected payments, including interest)	10,265	2,598	4,123	2,837	707
Telecommunications providers	5,783	2,610	3,173		
Office and equipment leases	6,647	1,315	2,885	1,497	950
Revolver advance	2,069	2,069			
Line of credit	784	784			
	\$ 36,444	\$ 16,465	\$ 12,908	\$ 5,414	\$ 1,657

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In addition, we record a payable to KeyBank each month in conjunction with our monthly processing activities. This amount was \$45.5 million as of March 31, 2005. This amount is repaid on the first business day of the following month out of the fees collected from our merchants.

Qualitative and Quantitative Disclosure About Market Risk

Our primary market risk exposure is to changes in interest rates. During each month, KeyBank advances interchange fees to most of our merchants so that during the month we build up a significant payable to KeyBank, bearing interest at the prime rate. At March 31, 2005, our payable to KeyBank was approximately \$45.5 million. This advance is repaid on the first business day of the following month out of fee collections from our merchants. During the quarter ended March 31, 2005 the average daily balance of that loan was approximately \$21.6 million and was directly related to our processing volume. We also had outstanding \$2.9 million in other loans at March 31, 2005, which also bear interest at the prime rate. A hypothetical 100 basis point change in short-term interest rates would result in a change of approximately \$245,000 in annual pre-tax income.

While the bulk of our cash and cash-equivalents are held in checking accounts or money market funds, we do hold certain fixed-income investments with maturities of up to three years. At March 31, 2005, a hypothetical 100 basis point increase in short-term interest rates would result in an increase of approximately \$11,500 in annual pre-tax income from money market fund holdings, but a decrease in the value of fixed-rate investments of approximately \$18,000. A hypothetical 100 basis point decrease in short-term interest rates would result in a decrease of approximately \$11,500 in annual pre-tax income from money market funds, but an increase in the value of fixed-rate instruments of approximately \$18,000.

We do not hold or engage in the trading of derivative financial, commodity or foreign exchange instruments. All of our business is conducted in U.S. dollars.

New Accounting Standards

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. We do not believe adoption of Statement 153 will have a material effect on our 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. We will adopt this statement when effective, and continue to assess its impact.

BUSINESS

Overview

We provide bank card payment processing services to merchants in the United States. We facilitate the exchange of information and funds between merchants and cardholders' financial institutions, providing end-to-end electronic payment processing services to merchants, including merchant set-up and training, transaction authorization and electronic draft capture, clearing and settlement, merchant accounting, merchant assistance and support and risk management. We also provide additional services to our merchants, such as gift and loyalty programs, paper check authorization and payroll processing, and we sell and rent point-of-sale devices and supplies.

Our revenue is recurring in nature, as we typically enter into three-year service contracts that, in order to qualify for the agreed-upon pricing, require the achievement of agreed processing volume minimums from our merchants. Most of our gross revenue is payment processing fees, which are a combination of a percentage of the dollar amount of each Visa and MasterCard transaction we process plus a flat fee per transaction. We pay interchange fees to card issuing banks and dues and assessments to Visa and MasterCard, and we retain the remainder. For example, the allocation of funds resulting from a \$100 transaction is depicted below.

We sell and market our payment processing services through a nationwide direct sales force of approximately 800 sales professionals, known as Relationship Managers. We establish a local sales and servicing presence, which we believe provides for enhanced referral opportunities and helps mitigate merchant attrition. We pay our sales force through commissions only, based solely upon the performance of their merchant accounts. We believe that our sales force and our experience and knowledge in providing payment processing services to small- and medium-size merchants gives us the ability to effectively evaluate and manage the payment processing needs and risks that are unique to these merchants. In 2004, our sales force generated over 42,500 merchant applications and installed over 39,000 new merchants.

We focus our sales efforts on low-risk merchants and have developed systems and procedures designed to minimize our exposure to potential losses. In 2003 and 2004, we experienced losses of 0.34 basis points (0.0034%) and 0.38 basis points (0.0038%) of payment processing volume, respectively, and in the first quarter of 2005, we experienced losses of 0.44 basis points (0.0044%). We have developed significant expertise in industries that we believe present relatively low risks as the customers are generally present and the products or services are generally delivered at the time the transaction is processed. These industries include restaurants, brick and mortar retailers, lodging establishments, automotive repair shops, convenience and liquor stores and professional service providers. As of March 31, 2005, approximately 33.2% of our merchants were restaurants, approximately 21.2% were brick and mortar retailers, approximately 10.6% were convenience and liquor stores, approximately 7.8% were automotive sales and repair shops, approximately 6.5% were professional service providers and approximately 4.5% were lodging establishments. We believe that the restaurant industry will continue to provide us with growth opportunities. According to a report by the National Restaurant Association, restaurant industry sales are expected to reach approximately \$476 billion in 2005, which

would represent the fourteenth consecutive year of real sales growth, as adjusted for inflation. This steady growth profile, combined with the industry's low seasonality, makes restaurant merchant processing volume very stable and predictable. In addition, the incidence of chargebacks is very low among restaurants, as the service is provided before the card is used. Our industry focus not only differentiates us from other payment processors, but also allows us to forge relationships with key trade associations that attract merchants to our business. Our industry focus also allows us to better understand a merchant's needs and tailor our services accordingly.

Since our inception, we have used a number of proprietary Internet-based systems to increase our operating efficiencies and distribute our processing and merchant data to our three main constituencies: our sales force, our merchant base and our customer service staff. In 2001, we began providing authorization and data capture services to our merchants through our own front-end processing system, HPS Exchange. During the years ended December 31, 2003 and 2004 and the quarter ended March 31, 2005, approximately 26%, 43% and 51%, respectively, of our transactions were processed through HPS Exchange, which has decreased our operating costs per transaction. We rely on third parties to provide the remainder of our bank card authorization and data capture services, as well as all of our settlement and merchant accounting services. We are developing our own back-end processing system for the clearing and settlement of transactions, which will enable us to customize these services to the needs of our Relationship Managers and merchants.

Industry Overview

The payment processing industry provides merchants with credit, debit, gift and loyalty card and other payment processing services, along with related information services. The industry has grown rapidly in recent years as a result of wider merchant acceptance, increased same store sales, increased consumer use of bank cards and advances in payment processing and telecommunications technology. According to The Nilson Report, total expenditures for all card type transactions by U.S. consumers were \$1.9 trillion in 2004, and are expected to grow to \$2.8 trillion by 2008. From 1998 to 2004, the compound annual growth rate of card payments was 13%, but this rate is expected to slow modestly to 10% for 2004 to 2008. The proliferation of bank cards has made the acceptance of bank card payments a virtual necessity for many businesses, regardless of size, in order to remain competitive. This use of bank cards, enhanced technology initiatives, efficiencies derived from economies of scale and the availability of more sophisticated products and services to all market segments has led to a highly competitive and specialized industry.

We believe that the card-based payment processing industry will continue to benefit from the following trends:

Growth in Card Transactions

The proliferation in the uses and types of cards, the rapid growth of the Internet, significant technological advances in payment processing and financial incentives offered by issuers have

contributed greatly to wider merchant acceptance and increased consumer use of such cards. The following chart illustrates the growth for card transactions for the periods indicated.

Source: The Nilson Report. Card purchase volume includes VISA / MasterCard (debit and credit), American Express, Discover and Diners Club.

Note: Percentages inside bar represent year-over-year growth.

According to the Nilson Report and the New York State Forum for Information Resource Management, sources of increased bank card payment volume include:

continued displacement of cash and checks at the point of sale;

increasing consumer acceptance of alternative forms of electronic payments; and

increasing acceptance of electronic payments by merchants who previously did not do so, such as government agencies and businesses that provide goods and services to other businesses.

Increased Bank Card Acceptance by Small Businesses

Small businesses are a vital component of the U.S. economy and are expected to contribute to the increased use of bank cards. The lower costs associated with bank card payment methods, as opposed to checks, are making payment processing services more affordable to a larger segment of the small business market. In addition, we believe these businesses are experiencing increased pressure to accept bank card payments in order to remain competitive and to meet consumer expectations. As a result, many of these small businesses are seeking to provide customers with the alternative to pay for merchandise and services using bank cards, including those in industries that have historically accepted only cash and checks.

Bank Card Acceptance by Government and Business-to-Business Industry

State and local governments and the business-to-business industry have recently begun to provide customers with the ability to pay for merchandise and services using bank cards. For example, state and local governments have begun accepting bank cards for government payments, such as motor vehicle fees, recreational services, parking fees and taxes, in order to reduce their costs of collecting and processing payments and to expedite the deposit of these payments into their own accounts. We believe that the growth in bank card payments between businesses and the historically low acceptance of bank cards as a payment method by governments and the business-to-business industry represent an attractive market opportunity for us.

Technology

At present, many large payment processors provide customer service and applications via legacy systems that are difficult and costly to alter or otherwise customize. In contrast to these systems, recent advances in scalable and networked computer systems, such as distributed application architecture, often referred to as "client-server" systems, and relational database management systems, provide payment processors with the opportunity to deploy less costly technology that has improved flexibility and responsiveness. In addition, the use of fiber optic cables and advanced switching technology in telecommunications networks and competition among long-distance carriers further enhance the ability of payment processors to provide faster and more reliable service at lower per-transaction costs than previously possible.

Advances in personal computers and point-of-sale terminal technology, including integrated cash registers and networked systems, have increasingly allowed access to a greater array of sophisticated services at the point of sale and have contributed to the demand for such services. These trends have created the opportunity for payment processors to leverage technologies by developing business management and other software application products and services.

Segmentation of Merchants and Service Providers

The payment processing industry is dominated by a small number of large, fully-integrated payment processors that handle the processing needs of the nation's largest merchants. Large national merchants (i.e., those with multiple locations and high volumes of bank card transactions) typically demand and receive the full range of payment processing services at low per-transaction costs.

Payment processing services are generally sold to the small- and medium-sized merchant market segment through banks and Independent Sales Organizations that generally procure most of the payment processing services they offer from large payment processors. It is difficult, however, for banks and Independent Sales Organizations to customize payment processing services for the small- and medium-sized merchant on a cost-effective basis or to provide sophisticated value-added services. Accordingly, services to the small- and medium-sized merchant market segment historically have been characterized by basic payment processing without the availability of the more customized and sophisticated processing, information-based services or customer service that is offered to large merchants. The growth in bank card transactions and the transition from paper-based to electronic payment processing is expected to cause small- and medium-sized merchants to increasingly value sophisticated payment processing and information services similar to those provided to large merchants.

The following table sets forth the typical range of services provided directly (in contrast to using outsourced providers) by fully integrated transaction processors, traditional Independent Sales Organizations and us.

Consolidation

During the last decade, the payment processing industry has undergone significant consolidation. The costs to convert from paper to electronic processing, merchant requirements for improved customer service, and the demand for additional customer applications have made it difficult for community and regional banks to remain competitive. Many of these providers are unwilling or unable to invest the capital required to meet these evolving demands, and are increasingly exiting the payment processing business or otherwise seeking partners to provide payment processing for their customers. Despite this consolidation, the industry remains fragmented with respect to the number of entities offering payment processing services, particularly to small- and medium-sized merchants.

Favorable Demographics

Consumers are beginning to use card-based and other electronic payment methods for purchases at an earlier age. According to Nellie Mae:

the number of college students who have credit cards has grown from 67% in 1998 to 83% in 2001;

the prevalence of credit cards among college students is also reflected in the increased average number of cards held, from 3 cards in 2000 to 4.3 cards in 2001; and

there is increased card usage between the ages of 18 and 24, with 18-year-old students having the lowest card usage rate and debt levels and 24-year-old students typically having the highest.

As these consumers who have experience with card products, technology and the Internet enter the work force, we expect that purchases using card-based payment methods will comprise an increasing percentage of total consumer spending. This will represent the continuation of a trend that has been in place for the last decade.

We also expect to benefit from the increased spending of baby boomers. According to the Bureau of Labor Statistics' 2003 Consumer Expenditure Survey, households headed by 45- to 54-year-olds spent, on average, \$2,688 on food away from home, compared to \$2,211 for all households. They also had the highest average pre-tax income in 2003 (\$68,028) compared to all other age groups. Research from the National Restaurant Association shows that this group goes to casual dining restaurants more frequently than other groups. Since a significant percentage of our processing volume comes from restaurant merchants, we believe these trends will have a positive impact on our growth and future performance.

Our Competitive Strengths

We believe our competitive strengths include the following:

Large, Experienced, Efficient Direct Sales Force

While many of our competitors rely on Independent Sales Organizations that typically generate merchant accounts for multiple payment processing companies simultaneously, we market our services throughout the United States through our direct sales force of approximately 800 Relationship Managers who work exclusively for us. Our Relationship Managers have local merchant relationships and industry-specific knowledge that allow them to effectively compete for merchants. Our Relationship Managers are compensated solely on commissions, receiving signing bonuses and ongoing residual commissions for generating new merchant accounts. These commissions are based upon the gross margin we estimate that we will receive from their merchants, calculated by deducting interchange fees, dues and assessments and all of our costs incurred in underwriting, processing, servicing and managing the risk of the account from gross processing revenue. Our Relationship Managers have considerable latitude in pricing a new account, but we believe that the shared economics motivate them to sign attractively priced contracts with merchants generating significant processing volume. At the same time, our Relationship Managers share in any losses we incur on their merchant accounts, which we believe causes them to avoid riskier merchants. The residual commissions our Relationship Managers receive from their merchant accounts give them an incentive to maintain a continuing dialogue and servicing presence with their merchants. We believe that our

compensation structure is atypical in our industry and contributes to building profitable, long-term relationships with our merchants. Our sales compensation structure and marketing activities focus on recruiting and supporting our direct sales force, and we believe that the significant growth we have achieved in our merchant portfolio and processing volume are directly attributable to their efforts.

Recurring and Predictable Revenue

We generate recurring revenue through our payment processing services. Our revenue is recurring in nature because we typically enter into three-year service contracts that require minimum volume commitments from our merchants to qualify for the agreed-upon pricing. Our recurring revenue grows as the number of transactions or dollar volume processed for a merchant increases or as our number of merchants increases. In 2004, approximately 80% of our processing volume came from merchants we installed in 2003 and earlier.

Internal Growth

While many of our competitors in the payment processing industry have relied on acquisitions to expand their operations and improve their profitability, we have grown our business entirely through internal expansion by generating new merchant contracts submitted by our own direct sales force and, primarily before 2000, sales agents affiliated with us. Every merchant we currently process was originally underwritten by our staff, and we have substantial experience responding to their processing needs and the risks associated with them. We believe this both enhances our merchant retention and reduces our risks. We believe that internally generated merchant contracts are of a higher quality and are more predictable than, and the costs associated with such contracts are lower than the costs associated with, contracts acquired from third parties.

Strong Position and Substantial Experience in Our Target Markets

As of June 30, 2005, we were providing payment processing services to approximately 101,500 active small- and medium-sized merchants located across the United States. We believe our understanding of the needs of small- and medium-sized merchants and the risks inherent in doing business with them, combined with our efficient direct sales force, provides us with a competitive advantage over larger service providers that access this market segment indirectly. We also believe that we have a competitive advantage over service providers of a similar or smaller size that may lack our extensive experience and resources and which do not benefit from the economies of scale that we have achieved.

Industry Expertise

We have focused our sales efforts on merchants who have certain key attributes and on industries in which we believe our direct sales model is most effective and the risks associated with processing are relatively low. These attributes include owners who are typically on location, interact with customers in person, value a local sales and servicing presence and often consult with trade associations and other civic groups to help make purchasing decisions. Although we have historically focused our sales and marketing efforts on the restaurant industry, our merchant base now also includes a broad range of brick and mortar retailers, lodging establishments, automotive repair shops, convenience and liquor stores and professional service providers. To further promote our products and services, we have entered into sponsoring arrangements with various trade associations, with an emphasis on state restaurant and hospitality groups. We believe that these sponsorships have enabled us to gain exposure and credibility within the restaurant industry and have provided us with opportunities to market our products to new merchants. In March 2005, the restaurant industry represented approximately 43% of our processing volume and over 59% of our transactions. We believe that the restaurant industry will continue to represent a significant portion of our processing volume as the industry continues to experience sales growth and we continue to generate new restaurant merchants. According to the National Restaurant Association, restaurant sales are expected to reach approximately \$476 billion in 2005, which will represent the fourteenth consecutive year of real sales growth, as adjusted for inflation.

This steady growth profile, together with the industry's low seasonality, makes restaurant merchant processing volume relatively stable and predictable. Our focus on small- and medium-sized merchants and on certain industries has diversified our merchant portfolio and we believe has reduced the risks associated with revenue concentration. In 2004, no single merchant represented more than 0.3% of our total processing volume. We intend to build upon our success in the restaurant industry by applying similar strategies to new target markets through targeted marketing efforts that leverage our local sales force.

Merchant Focused Culture

We have built a culture and established practices that we believe improve the quality of services and products we provide to our merchants. This culture spans from our sales force, which maintains a local market presence to provide rapid, personalized customer service, through our technology organization, which has developed a customer management interface and information system that alerts our Relationship Managers to any problems a merchant has reported and provides them with detailed information on the merchants in their portfolio. Additionally, we believe that we are one of the few companies that discloses our pricing policies to merchants. In 2004, Visa increased its interchange fees for retail transactions by 0.11%. We believe that we were one of the few companies that did not raise their fees by more than the amount of Visa's increase to small- and medium-sized merchants. We believe that our culture and practices allow us to maintain strong merchant relationships and differentiate ourselves from our competitors in obtaining new merchants.

Scalable Operating Structure

Our scalable operating structure allows us to expand our operations without proportionally increasing our fixed and semi-fixed support costs. Our sales force's commission-only compensation structure ties our sales compensation to the growth in merchant profitability. In addition, our technology platform, in particular HPS Exchange, was designed with the flexibility to support significant growth and drive economies of scale with relatively low incremental costs. Most of our operating costs are related to the number of individuals we employ. We have in the past used, and expect in the future to use, technology to leverage our personnel, which should cause our personnel costs to increase at a slower rate than our processing volume.

Advanced Technology

We employ information technology systems that use a distributed application architecture, often referred to as "client-server" systems, and which use the Internet to improve management reporting, enrollment processes, customer service, sales management, productivity, merchant reporting and problem resolution. In 2001, we began providing authorization and data capture services to our merchants through our internally-developed front-end processing system, HPS Exchange. This system incorporates patent-pending real time reporting tools for, and interactive point-of-sale database maintenance via, the Internet. These tools enable merchants, and our employees, to change the messages on credit card receipts and to view sale and return transactions entered into the point-of-sale device with a several second delay on any computer linked to the Internet. During the year ended December 31, 2003, approximately 26% of our transactions were processed through this system, and this percentage increased to 43% of our transactions in 2004, and 51% of our transactions in the first quarter of 2005. HPS Exchange and our other technology efforts have contributed to a reduction of our cost of services as a percentage of our gross processing revenue and to a reduction of our per-transaction processing costs. Although many existing merchants will remain on Vital's system and those of our other third-party processors, we intend to install the majority of our new merchants on HPS Exchange. Our Internet-based systems allow all of our merchant relationships to be documented and monitored in real time, which maximizes management information and customer service responsiveness. We believe that these systems help attract both new merchants and Relationship Managers and provide us with a competitive advantage over many of our competitors who rely on less flexible legacy systems.

Comprehensive Underwriting and Risk Management System

Through our experience and cumulative knowledge in assessing risks associated with providing payment processing services to small- and medium-size merchants, we have developed procedures and systems that provide risk management and fraud prevention solutions designed to minimize losses. Our underwriting processes help us to evaluate merchant applications and balance the risks of accepting a merchant against the benefit of the charge volume we anticipate the merchant will generate. We believe our systems and procedures enable us to identify potentially fraudulent activity and other questionable business practices quickly, thereby minimizing both our losses and those of our merchants. As evidence of our ability to manage these risks, we experienced losses of less than 0.40 basis points of processing volume for each of the years ended December 31, 2002, 2003 and 2004. This loss increased to 0.44 basis points of processing volume in the first quarter of 2005.

Proven Management Team

We have a strong senior management team, each with at least 18 years of financial services and payment processing experience. Our Chief Executive Officer, Robert O. Carr, was a founding member of the Electronic Transactions Association, the leading trade association of the bank card acquiring industry. Our management team has developed extensive contacts in the industry and with banks and value-added resellers. As of March 31, 2005, we had referral relationships with over 900 trade associations, banks and value-added resellers. We believe that the strength and experience of our management team has helped us to attract additional sales professionals and add additional merchants, thereby significantly contributing to our growth.

Strategy

Our current growth strategy is to increase our market share as a provider of bank card payment processing services to small- and medium-size merchants in the United States. We believe that the increasing use of bank cards, combined with our sales and marketing approaches, will continue to present us with significant growth opportunities. Key elements of our strategy include:

Expand Our Direct Sales Force

Unlike many of our competitors who rely on Independent Sales Organizations or salaried salespeople and telemarketers, we have built a direct sales force. We have grown our sales force from 417 Relationship Managers and sales managers as of December 31, 2002 to 671 as of December 31, 2003, 832 Relationship Managers and sales managers as of December 31, 2004 and 864 Relationship Managers and Sales Managers as of March 31, 2005. We anticipate significantly increasing the size of our sales force in the next few years in order to increase our share of our target markets. We have implemented a geographic sales model that divides the United States into 12 primary regions overseen by Regional Directors, who are primarily responsible for hiring Relationship Managers and increasing the number of installed merchants in their territory. Our Regional Directors' commission-only compensation is directly tied to the compensation of the Relationship Managers in their territory, providing a significant incentive for them to grow the number and productivity of Relationship Managers in their territory. In addition, we believe that our commission-based compensation structure will continue to succeed in attracting new Relationship Managers to our company.

Further Penetrate Existing Target Markets and Enter Into New Markets

We believe that we have an opportunity to grow our business by further penetrating the small- and medium-sized merchant market through our direct sales force and alliances with local trade organizations, banks and value-added resellers. During 2004, according to The Nilson Report, we processed approximately 1.8% of the dollar volume of all Visa and MasterCard transactions in the United States, up from approximately 1.4% in 2003, 1.1% in 2002, 0.9% 2001 and 0.6% in 2000. In March 2005, the restaurant industry represented approximately 43% of our processing volume and over

59% of our transactions. Our merchant base also includes a wide range of merchants, including brick and mortar retailers, lodging establishments, automotive repair shops, convenience and liquor stores and professional service providers. We believe that our sales model, combined with our community-based strategy that involves our Relationship Managers building relationships with various trade groups and other associations in their territory, will enable our Relationship Managers to continuously add new merchants. We intend to further expand our sales efforts into new target markets with lower risk characteristics, including markets that have not traditionally accepted electronic payment methods. These markets include governments, schools and the business-to-business market.

Expand Our Product and Service Offerings

In recent years, we have focused on offering a broad set of payment-related products to our customers. In addition to payroll processing services, our current product offerings include check verification and guarantee services that allow merchants to accept paper checks with guaranteed payment assurance and gift and loyalty card product solutions. We also intend to develop products that will help our merchants reduce their costs and grow their businesses, such as age verification services that track driver's license data to verify an individual's age and identity. We may develop these new products and services internally, enter into arrangements with third-party providers of these products or selectively acquire new technology and products. Many of these new service offerings are designed to work on the same point-of-sale devices that are currently in use, enabling merchants to purchase a greater volume of their services from us and eliminating their need to purchase additional hardware. We believe that these new products and services will enable us to leverage our existing infrastructure and create opportunities to cross-sell our products and services among our various merchant bases, as well as enhance merchant retention and increase gross processing revenue.

Leverage Our Technology

We intend to continue to leverage our technology to increase our operating efficiencies and provide real-time processing and account data to our merchants, Relationship Managers and customer service staff. Since our inception, we have been developing Internet-based systems to improve and streamline our information systems, including detailed customer-use reporting, management reporting, enrollment, customer service, sales management and risk management reporting tools. We have also made significant investments in our payment processing capabilities, which we believe will allow us to offer a differentiated payment processing product that is faster and less expensive than many competing products. We also intend to introduce our own processing system for the clearing and settlement of transactions, known as back-end processing. This will allow us to become a fully integrated bank card payment processor, providing end-to-end electronic payment processing services to our merchants.

Enhance Merchant Retention

By providing our merchants with a consistently high level of service and support, we strive to build merchant retention and limit merchant attrition. While increased bank card use helps maintain our stable and recurring revenue base, we recognize that our ability to maintain strong merchant relationships is key to our continued growth. We believe that our practice of fully disclosing our pricing policies to our merchants creates goodwill. For example, in 2003, we believe we were one of the few companies that passed along to small- and medium-sized customers a reduction in debit interchange fees that resulted from the settlement of the so-called Wal-Mart lawsuit against Visa and MasterCard. We are developing a customer management interface that alerts our Relationship Managers to any problems a merchant has reported and provides them with detailed information on the merchants in their portfolio. In addition, we believe that the development of a more flexible back-end processing capability will allow us to tailor our services to the needs of our Relationship Managers and merchants, which we believe will further enhance merchant retention. The back-end processing system will also allow us to offer new services to our merchants.

Pursue Strategic Acquisitions

Although we intend to continue to grow through the efforts of our direct sales force, we may also expand our merchant base or gain access to other target markets by acquiring complementary businesses, products or technologies, including other providers of payment processing services and, possibly, portfolios of merchant accounts. We may also consider portfolio acquisitions, especially from commercial banks, which, in an effort to focus on their core competencies, often sell or outsource their payment processing operations.

Services and Products

As noted above, we derive the majority of our revenues from fee income relating to Visa and MasterCard payment processing, which is primarily comprised of a percentage of the dollar amount of each transaction we process, as well as a flat fee per transaction. The percentage we charge varies and depends upon several factors, including the transaction amount and whether the transaction processed is a swipe transaction or a non-swipe transaction. On average, the gross revenue we generate from processing a Visa or MasterCard transaction equals approximately \$2.38 for every \$100 we process. We also receive fees from American Express, Discover, Diners Club and JCB for facilitating their transactions with our merchants.

We receive net revenues as compensation for providing bank card payment processing services to merchants, including merchant set-up and training, transaction authorization and electronic draft capture, clearing and settlement, merchant accounting, merchant support and chargeback resolution, as well as payroll services. We arrange for certain of these services, particularly merchant accounting, clearing and settlement and a majority of our authorization and electronic draft capture services, to be performed by third-party processors (primarily Vital), while we perform the remaining services in-house. In addition, we sell and rent point-of-sale devices and supplies and provide additional services to our merchants, such as gift and loyalty programs, paper check authorization and chargeback processing. These services and products are described in more detail below:

Merchant Set-up and Training

After we establish a contract with a merchant, we create the software configuration that is downloaded to the merchant's existing, newly purchased or rented point-of-sale terminal, cash register or computer. This configuration includes the merchant identification number, which allows the merchant to accept Visa and MasterCard as well as any other bank cards, such as American Express, Discover, JCB and Diners Club, provided for in the contract. The configuration might also accommodate check verification, gift and loyalty programs and allow the terminal or computer to communicate with a pin-pad or other device. Once the download has been completed by the Relationship Manager, we conduct a training session on use of the system. We also offer our merchants flexible low-cost financing options for point-of-sale terminals, including installment sale and monthly rental programs.

Authorization and Draft Capture

We provide electronic payment authorization and draft capture services for all major bank cards. Authorization generally involves approving a cardholder's purchase at the point of sale after verifying that the bank card is not lost or stolen and that the purchase amount is within the cardholder's credit or account limit. The electronic authorization process for a bank card transaction begins when the merchant "swipes" the card through its point-of-sale terminal and enters the dollar amount of the purchase. After capturing the data, the point-of-sale terminal transmits the authorization request through HPS Exchange or the third-party processor to the card-issuing bank for authorization. The transaction is approved or declined by the card-issuing bank and the response is transmitted back through HPS Exchange or the third-party processor to the merchant. At the end of each day, and, in

certain cases, more frequently, the merchant will "batch out" a group of authorized transactions, transmitting them through us to Visa and MasterCard for payment.

We introduced HPS Exchange, our internally developed front-end processing system, in August 2001. In 2003, 2004 and the first quarter of 2005 we processed approximately 26%, 43% and 51%, respectively, of our transactions through HPS Exchange. The remainder of our front-end processing is outsourced to third-party processors, primarily Vital, but also including First Data Merchant Services Corporation, Paymentech Network Services, Inc. and Global Payments Inc. Although we will continue to install new merchants on Vital's and other third-party processors' systems, we anticipate that the percentage of transactions that are outsourced to third-party processors will decline as we install a majority of new merchants on HPS Exchange.

Clearing and Settlement

Clearing and settlement processes represent the "back-end" of a transaction. Once a transaction has been "batched out" for payment, the payment processor transfers the merchant data to Visa or MasterCard. This is typically referred to as "clearing". After a transaction has been cleared, the transaction is "settled" by Visa or MasterCard and the merchant is compensated for the value of the purchased goods or services. We currently outsource these clearing and settlement services to Vital. We are developing the technology necessary to perform these services internally since a majority of the data provided to merchants by back-end providers already resides in our databases. We anticipate offering these services to some of our merchants in 2005.

Merchant Accounting

We organize our merchants' transaction data into various files for merchant accounting purposes. Merchant accounting services allow merchants to monitor sales performance, control expenses, disseminate information and track profitability through the production and distribution of detailed statements summarizing their bank card payment processing activity. We also provide exception item processing. We use this data to provide merchants with information, such as volume, discounts, fees, chargebacks, qualification levels and funds held for reserves to help them track their account activity. Merchants may access this archived information through our customer service representatives or online through our Internet-based customer service system.

Merchant Support Services

We provide merchants with ongoing service and support for their processing needs. Customer service and support includes answering billing questions, responding to requests for supplies, resolving failed payment transactions, troubleshooting and repair of equipment, educating merchants on Visa and MasterCard compliance and assisting merchants with pricing changes and purchases of additional products and services. We maintain a toll-free help-line 24 hours a day, seven days a week, which is staffed by our customer service representatives and during 2004 answered an average of approximately 70,000 customer calls per month. The information access and retrieval capabilities of our Internet-based systems provide our customer service representatives prompt access to merchant account information and call history. This data allows them to quickly respond to inquiries relating to fees, charges and funding of accounts, as well as technical issues.

Chargeback Services

In the event of a billing dispute between a cardholder and a merchant, we assist the merchant in investigating and resolving the dispute as quickly and accurately as possible with the bank card associations or card issuers, which determine the outcome of the dispute. In most cases, before we process a debit to a merchant's account for the chargeback, we provide the merchant with the opportunity to demonstrate to the bank card association or the card issuer that the transaction was valid. If the merchant is unable to demonstrate that the transaction was valid and the dispute is

resolved by the bank card association or the card issuer in favor of the cardholder, the transaction is charged back to the merchant. We typically charge our merchants a \$25 fee for each chargeback they incur. However, in 2004 we initiated a new policy in which we do not charge our merchants a fee for their first three chargebacks in a year. We believe this policy has been well received by merchants who were unhappy with their occasional chargeback fees.

Payroll Services

Through our wholly-owned subsidiary, Heartland Payroll Company, we operate a full-service nationwide payroll processing service. Our payroll services include check printing, direct deposit and related tax payments. In addition, we offer a "Payday" card, which provides employees who do not have bank accounts with the opportunity to have their payroll deposited to a Visa debit card account. In order to improve operating efficiencies and ease-of-use for our customers and to decrease our own processing costs, we have implemented electronic and paperless payroll processing that allows an employer to submit its periodic payroll information to us via the Internet or through a personal computer-based, direct-connect option. If a customer chooses either of these online options, all reports and interactions between the employer and us can be managed electronically, eliminating the need for cumbersome paperwork. Over 42% of our payroll clients currently submit their information electronically. However, if a merchant chooses not to submit its payroll data online, it may submit such information via phone or facsimile. We recently enhanced our payroll processing service offerings by adding a time-and-attendance application, which enables employees to clock in and out using a point-of-sale terminal. This added functionality facilitates our collection of a merchant's payroll data.

Sales

The following graphic sets forth the number of Relationship Managers we employed by state as of March 31, 2005.

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We sell and market our products and services to merchants through our Relationship Managers. As of March 31, 2005, we employed 864 Relationship Managers and sales managers in 48 states. We have implemented a geographic sales model that divides the United States into 12 primary regions overseen by Regional Directors, who are primarily responsible for hiring Relationship Managers and increasing the number of installed merchants in their territory. Regional Directors may manage their territories through Division Managers and Territory Managers. Division Managers do not sell our products and services. Instead, their sole responsibility is to hire, train and manage Relationship Managers in their territory. In contrast, Territory Managers are Relationship Managers who are also responsible for hiring and training a small number of Relationship Managers in their territory. Our Relationship Managers employ a community-based strategy that involves cold calling, obtaining referrals from existing merchants and building relationships with various trade groups, banks and value-added resellers to create referral opportunities.

Our compensation structure is designed to motivate our Relationship Managers to establish profitable long-term relationships with low-risk merchants and create a predictable and recurring revenue stream. Compensation for Relationship Managers is entirely commission-based and sales are measured in terms of the gross margin we estimate we will receive from their merchant accounts, calculated by deducting interchange fees, dues and assessments and all of our costs incurred in underwriting, processing and reviewing an account from gross processing revenues. Relationship Managers are permitted to price accounts as they deem appropriate, subject to minimum and maximum gross margin objectives. The expected volume and pricing are entered into an online margin calculator, which calculates the estimated annual gross margin on the account.

We pay our Relationship Managers, Division Managers, Territory Managers, and Regional Directors a percentage of the gross margin we derive from the payments we process for the merchant accounts they or, in the case of Division Managers, Territory Managers and Regional Directors, the Relationship Managers in their territory generate and service. When a new merchant account is signed at an acceptable estimated gross margin level, the Relationship Manager will be paid a signing bonus equal to 50% of the first 12 months' estimated gross margin. The Relationship Manager will also receive 20% of the gross margin generated from the merchant each month, for as long as the merchant remains our customer, with 5% being paid for the Relationship Manager's continued servicing of the account, and 15% being paid for fulfilling an ongoing account relationship responsibility. For example, if a merchant account has \$1,000 of estimated annual gross margin, the Relationship Manager is paid \$500, the Division Manager is paid \$125 and the Regional Director is paid \$31.25 as a signing bonus. If the same merchant account generates \$83.33 in monthly margin, the Relationship Manager would be paid \$16.67, the Division Manager would be paid \$4.17 and the Regional Director would be paid \$1.04. In certain cases, no signing bonus will be paid, but the total residual commission is 35% of the ongoing monthly gross margin generated by such merchant. When a Relationship Manager's monthly residual commissions with respect to all merchants he or she installed exceeds \$2,000, he or she will be deemed to have a vested equity interest (known as portfolio equity), and will be guaranteed the "owned" portion (all but the 5% servicing portion) of the ongoing monthly gross margin generated by such merchants for as long as the Relationship Manager's account management responsibilities are fulfilled. At the end of the first 12 months of processing for a new merchant, we compare the actual gross margin generated from that merchant with the estimated gross margin used to calculate the signing bonus. If the merchant was more profitable than expected, we increase the signing bonus amount paid to the Relationship Manager. However, if the merchant was less profitable than anticipated, the Relationship Manager must return a pro-rata portion of his or her signing bonus to us. In addition, up to 26% of any significant loss on a merchant account will be reimbursed to us by any Relationship Manager and their sales manager(s) receiving a commission with respect to such account. Relationship Managers are entitled to smaller bonuses upon their successful renewal of a merchant contract.

In addition to our commission-based compensation structure, we use various sales contests to reward strong sales performance. The awards granted in connection with these contests include stock

options and company-paid trips. Options are awarded to Regional Directors, Division Managers, Territory Managers and Relationship Managers that achieve significant, targeted growth in the realized gross margin in their territory. During the year ended December 31, 2004, our board of directors authorized and issued options to purchase an aggregate of 1,984,550 shares of our common stock to some of our Regional Directors, Division Managers, Territory Managers and Relationship Managers as part of these contests, or 4.7% of our common stock on a fully diluted basis after giving effect to this offering and 62.8% of the options awarded in 2004.

Marketing

We focus our marketing efforts on industries in which we believe our direct sales model is most effective and on merchants with certain key attributes. These attributes include owners that are typically on location, interact with customers, value a local sales presence, and who often consult with trade associations and other civic groups to make purchasing decisions. We also determine which additional markets to enter into based on the following criteria:

average potential customer revenue;

number of locations to be serviced;

underwriting risk; and

required technological upgrades.

Since 1999, we have primarily focused on the hospitality industry and, in particular, independent restaurants. The number of independent restaurants to which we sell our products and services has increased from 6,360 as of December 31, 1999 to 31,169 as of March 31, 2005 and, in March 2005 the restaurant industry represented approximately 43% of our processing volume and over 59% of our transactions. In addition to restaurants, our merchant base includes brick and mortar retailers, lodging establishments, automotive repair shops, convenience and liquor stores, and professional service providers.

We have historically had success in marketing our products and services through relationships with key trade associations, agent banks and value-added resellers.

Trade Associations

As of March 31, 2005, we had entered into endorsement agreements with more than 100 trade associations, the majority of which are in the hospitality industry. Of these endorsements, 27 are state restaurant associations. These associations include the Arizona, California, Florida, Minnesota, Oklahoma, Washington and Wisconsin restaurant associations, which together represent in excess of 45,000 merchants. Our agreements with trade associations typically require us to pay a small upfront fee to the association and to sponsor certain association events or advertise in their publications. In exchange for their endorsement of our products and services, upon the installation of a new merchant that is a member of their association we pay trade associations a portion of the signing bonus or residual payments that otherwise would be paid to the Relationship Manager responsible for such merchant. In some cases, we have sold association memberships to prospective merchants and our Relationship Managers have received commissions for such sales.

Agent Banks

We have developed a sales channel within our direct sales force that services the community bank market. Many community banks find it difficult to provide their merchant servicing personnel with the training and support they need to serve their customer base and to properly assess transaction risk. As a result, some of these banks enter into arrangements with payment processors to service their merchant portfolios. We currently provide these services to over 200 community banks in the United States. In exchange for their endorsement of our products and services, upon the installation of a new

merchant referred by the bank we pay the bank a portion of the signing bonus or residual payment that otherwise would be paid to the Relationship Manager responsible for such merchant.

Value-Added Resellers and Third-Party Software Providers

In order to further market our products and services, we enter into arrangements with value-added resellers and third-party software developers. Value-added resellers typically sell complementary products and services, such as hardware and software applications and point-of-sale hardware, software and communication network services to merchants in markets similar to ours. Our agreements with value-added resellers provide that, in exchange for their endorsement of our products and services and upon the installation of a new merchant referred by them we will pay the value-added reseller a portion of the signing bonus and residual payment that otherwise would be paid to the Relationship Manager responsible for such merchant. As we continue to expand our product offerings, we intend to introduce capabilities that will allow our systems to be compatible with those of our value-added resellers and other third-party software developers and will enable them to embed our payment modules within their systems. As of March 31, 2005, we had entered into arrangements with approximately 680 value-added resellers, including agreements with many third-party developers in the hospitality industry. From time to time, we have also entered into direct alliances with original equipment manufacturers and vendors.

Relationships with Sponsors and Processors

In order to provide payment processing services for Visa and MasterCard transactions, we must be sponsored by a financial institution that is a principal member of the Visa and MasterCard associations. The sponsor bank must register us with Visa as an Independent Sales Organization and with MasterCard as a Member Service Provider. We also contract with third-party processors to provide critical payment processing services.

Sponsoring Bank

We currently have an agreement with KeyBank to sponsor us for membership in the Visa and MasterCard associations. Under this agreement, KeyBank also funds our daily interchange expenses and settles bank card transactions for our merchants. Either KeyBank or we can terminate the agreement if the other party materially breaches the agreement, including non-payment of fees due for processing our monthly settlement of transactions. The agreement may also be terminated if the other party enters bankruptcy or files for bankruptcy, if either party is required to discontinue performing its services under the agreement based upon a final order of a state or federal court or regulatory body or if there is a change in the majority ownership of the other party. This initial public offering will not constitute a change in our majority ownership. KeyBank may terminate the agreement with us if we breach the by-laws and regulations of Visa or MasterCard, if either our registration or KeyBank's membership with Visa or MasterCard terminates, if any federal or state regulatory authority requests that the agreement be terminated or that KeyBank terminate its services or if applicable laws or regulations change to prevent KeyBank from performing its services under the agreement. Upon termination of the agreement for any reason, we will have 180 days to convert to another sponsor bank. Although we expect that we would be able to secure a new sponsor bank, the cost of entering into a new sponsorship agreement may be different than under our current agreement with KeyBank. We entered into the agreement with KeyBank on April 1, 1999 and it expires in 2009. Prior to March 31, 2004, FleetBoston Financial Corporation was our sponsor with respect to a small number of merchants that were using First Data Resources, Inc. as their back-end processor. This contract was terminated by us when we consolidated our processing onto the Vital system for operational efficiency, which eliminated the need for the FleetBoston sponsorship.

Third-Party Processors

We have agreements with several third-party processors to provide to us on a non-exclusive basis payment processing and transmittal, transaction authorization and data capture services, and access to various reporting tools. These third-party processors include Vital Processing Services, First Data Resources, Inc., Paymentech Network Services, Inc. and Global Payments, Inc. Our agreements with third-party processors require us to submit a minimum monthly number of transactions or volume for processing. If we submit a number of transactions or volume that is lower than the minimum, we are required to pay them the fees that they would have received if we had submitted the required minimum number or volume of transactions. The majority of our agreements with third-party processors may be terminated by the third-party processors if we materially breach certain sections of the agreements, including our failure to pay fees due, and we do not cure the breach within 30 days, if our registration with Visa or MasterCard terminates, or if we enter bankruptcy or file for bankruptcy. Our agreement with Vital expires on March 31, 2006 and then automatically renews for consecutive one-year periods until terminated. Either Vital or we can terminate our agreement at the end of the initial term or any renewal term upon 270 days' prior written notice. Vital may terminate the agreement if we fail to make or adequately and timely provide for the payment of undisputed fees and expenses, but only if Vital gives us written notice of such failure and we fail to remedy it within 30 days after receipt of such notice. We may terminate the agreement at any time during the initial term or any renewal term by giving at least 270 days' prior written notice to Vital and by paying a termination fee.

Our Merchant Base

We have a diverse merchant base. As of June 30, 2005, we provided payment processing services to approximately 101,500 active small- and medium-sized merchant locations across the United States, an increase of 8% from the approximately 94,000 merchant locations as of March 30, 2005. We consider merchants that generate annual Visa and MasterCard processing volume between \$50,000 and \$5,000,000 to be small- and medium-sized merchants. While restaurants represent a significant portion of our merchant base, we also provide payment processing services to a wide variety of merchants, primarily those merchants whose typical customer is present when using a bank card to pay for products or services.

Processing Volume by Merchant Category

No single merchant accounted for more than 0.3% of our total processing volume in 2004, and during 2004, our top 25 merchants represented only 2.9% of our processing volume and 2.5% of our gross processing revenue. In March 2005, merchants in California represented 15.8%, in New York

represented 6.2% and in Florida represented 6.8% of our total processing volume. Our geographic concentration tends to reflect the states with the highest economic activity, including California, New York, Florida and Texas, as well as certain states where we have historically maintained a stronger sales force, including North Carolina and Minnesota. This merchant and geographic diversification makes us less sensitive to changing economic conditions in the industries or regions in which our merchants operate. We believe that the loss of any single merchant would not have a material adverse effect on our financial condition or results of operations.

Generally, our agreements with merchants are for three years and automatically renew for additional one-year periods unless otherwise terminated. Our sponsoring bank is also a party to these agreements. The merchants are obligated to pay for all chargebacks, fines, assessments, and fees associated with their account, and in some cases, annual fees. Our sponsoring bank may terminate a merchant agreement for any reason on 30 days' notice, and the merchant may terminate the agreement at any time without notice, subject to the payment of any applicable early termination fees. Typically, the agreement may also be terminated immediately upon a breach by the merchant of any of its terms. The agreement may not be assigned by the merchant without the prior written consent of the sponsoring bank and us.

Risk Management

We believe that we have significant experience in assessing the risks associated with providing payment processing services to small- and medium-sized merchants. These risks include the limited operating history of many of the small- and medium-sized merchants we serve and the risk that these merchants could be subject to a higher rate of insolvency, which could adversely affect us financially. We apply varying levels of scrutiny in our application evaluation and underwriting of prospective merchant accounts, ranging from basic due diligence for merchants with a low risk profile to a more thorough and detailed review for higher risk merchants.

Merchant attrition is expected in the payment processing industry in the ordinary course of business. During 2003 and 2004 we experienced an average monthly attrition of less than 1% of our total processing volume. Much of our attrition is related to business closures.

As a result of our exposure to potential liability for merchant fraud, chargebacks, reject and other losses created by our merchant services business, we view our risk management and fraud avoidance practices as integral to our operations and overall success. We believe that the risks associated with our merchant base are generally not significant as our merchants consist primarily of companies conducting card-present transactions and whose chargeback levels are generally not significant as a percentage of their sales volume. As a result of their low risk profile, we can employ underwriting and set-up procedures that are less extensive than if these merchants had higher risk profiles and can typically ensure that these merchants will be approved and set up on our systems within 24 hours of our receiving their application.

As of March 31, 2005, we had a staff of 53 employees dedicated to our risk management operations, which encompasses underwriting new accounts, monitoring and investigating merchant account activity for suspicious transactions or trends and avoiding or recovering losses. Effective risk management helps us minimize merchant losses for the mutual benefit of our merchants and ourselves. Our risk management procedures also help protect us from fraud perpetrated by our merchants. We believe our knowledge and experience in dealing with attempted fraud has resulted in our development and implementation of effective risk management and fraud prevention systems and procedures. In 2003 and 2004, we experienced losses of less than 0.40 basis points of our processing volume, which increased to 0.44 basis points in the first quarter of 2005.

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We employ the following systems and procedures to minimize our exposure to merchant and transaction fraud:

Underwriting

Our Relationship Managers send new applications to our underwriting department for review and screening. Our underwriting department's review of these applications serves as the basis for our decision whether to accept or reject a merchant account. The review also provides the criteria for establishing cash deposit or letter of credit requirements, processing limits, average transaction amounts and pricing, which assist us in monitoring merchant transactions for those accounts that exceed those pre-determined thresholds. The criteria set by our underwriting department also assist our risk management staff in advising merchants with respect to identifying and avoiding fraudulent transactions. Depending upon their experience level, our underwriting staff has the authority to render judgment on new applications or to take additional actions such as adjusting processing limits, average charge per transaction or cash deposit/letter of credit requirements for new and existing merchants. Our underwriting department reports to our credit committee, consisting of our Chief Financial Officer, Chief Services Officer, Director of Policy and Audit and Director of Loss Prevention. Approval of a merchant by the credit committee is required for all higher risk merchant accounts, and our Chief Financial Officer reviews all accounts with processing volume that exceed certain thresholds.

Merchant Monitoring

We employ several levels of merchant account monitoring to help us identify suspicious transactions and trends. Daily merchant activity is obtained from two internet-based systems, HPS Exchange (where the information is downloaded from HPS Exchange to our monitoring systems) and Vital (where the information is downloaded from our third-party processors onto Vital's risk system and then accessed by us on the Internet), and is sorted into a number of customized reports by our systems. Our risk management team reviews any unusual activity highlighted by these reports, such as larger than normal transactions or credits, and monitors other parameters that are helpful in identifying suspicious activity. We have a daily window of 10:00 a.m. to 6:00 p.m. Eastern time to decide if any transactions should be held for further review, which provides us time to interview a merchant or issuing bank to determine the validity of suspicious transactions. We have also developed a fraud management system for HPS Exchange that is fully integrated with our internal customer relationship management software and has detailed review capabilities to further streamline our monitoring of those transactions.

Investigation and Loss Prevention

If a merchant exceeds any parameters established by our underwriting and/or risk management staff or violates regulations established by the applicable bank card association or the terms of our agreement with the merchant, one of our investigators will identify the incident and take appropriate action to reduce our exposure to loss and the exposure of our merchant. This action may include requesting additional transaction information, instructing a third party to retrieve, withhold or divert funds, verifying delivery of merchandise or even deactivating the merchant account.

Collateral

We require some of our merchants to establish cash deposits or letters of credit that we use to offset against liabilities we may incur. We hold such cash deposits or letters of credit for as long as we are exposed to a loss resulting from a merchant's payment processing activity. As of March 31, 2005, these cash deposits and letters of credit totaled approximately \$4.7 million. In addition, we maintain a 5-day delayed deposit policy on transactions processed by most of our Internet merchants to allow for additional risk monitoring.

Technology

We have developed a number of Internet-based systems that are designed to improve the effectiveness of our sales force, customer service and the management of our business. In 2002, 2003 and 2004 we spent \$1,105,774, \$753,467 and \$1,390,237, respectively, on capitalized software development costs. Each of the following systems is available through www.e-hps.com and is being constantly updated, with new releases of software scheduled every six weeks:

Portfolio Manager

Portfolio Manager is designed to allow each of our Relationship Managers to manage many aspects of his or her business, including portfolio monitoring and management, compensation review, training and professional development and the ability to communicate with others within our company. Portfolio Manager consists of a set of merchant relationship management tools. These tools include detailed merchant data, such as historical processing volume, updates on merchant contracts that will soon expire, losses, merchants who may have attrited and data that can be used by our Relationship Managers to assist merchants in understanding interchange fee structures and the risks associated with certain types of transactions. Portfolio Manager also includes an estimated gross margin calculator and a merchant profitability analysis that allows Relationship Managers to optimize gross margin generated from a new merchant account. In addition, Portfolio Manager provides our Relationship Managers with the ability to view their residual commission stream from their merchant portfolio, track their productivity and compare their sales statistics with those of other Relationship Managers.

Merchant Center

Merchant Center is designed to improve our merchants' efficiency, cash management and dispute resolution by providing them with real-time access to their transaction data, including clearinghouse records, deposits and transactions. We offer Merchant Center as a fee-based data enhancement tool that can replace paper merchant statements and provide automated customer self-service. Over 17% of our merchants, as of March 31, 2005, had signed up for this product. Merchant Center also provides similar information tools to our strategic relationships, such as trade associations, banks and value-added resellers.

Merchant Manager

Information regarding all of our interactions with our merchants and all of their documents and transaction records are immediately available to our customer service department and management through Merchant Manager. Each new account is entered into this database during the initial application and underwriting process, and all documents regarding a merchant are scanned into the database. Subsequently, all of a merchant's transactions and statements, and records of all calls to our customer service representatives as well as their resolution are maintained in the database. Merchant Manager is also the tool by which we make any pricing adjustments and manage any equipment-related transactions. We believe that integrating many of our customer management tools into one database provides all of our employees with the same information regarding a merchant, which enables us to provide consistent, rapid problem resolution and optimal customer service. We also believe that reliance on the system has allowed considerable productivity gains in recent years.

HPS Exchange

Our front-end system, HPS Exchange, provides us greater control of the electronic transaction process, allows us to offer our merchants (through our Relationship Managers) a differentiated product offering, and offers economies of scale that we expect will increase our long-term profitability. As of March 31, 2005, approximately 51% of our merchants used HPS Exchange, and nearly 58% of all merchant accounts established in 2004 were placed on the system. When a merchant uses HPS Exchange on certain hardware platforms, including the Ingenico 510 and Hypercom T-7 series point-of-

sale processing terminals, the resulting authorization speed can be six seconds or less, which we believe is faster than industry norms for comparable terminals. This increased speed not only benefits the merchant but also reduces the telecommunications costs we incur in connection with a transaction.

HPS Exchange enables us to provide more customized solutions to small- and medium-size merchants, target larger merchants that demand customized front-end solutions and take advantage of new terminal hardware platforms as they become available. HPS Exchange is customized for each merchant and allows us to provide our merchants with differentiating value-added features, including the following:

Merchant/Cardholder Selected Debit or Credit. Merchants have the ability to convert a Visa Check or Master Money card to a pin-based debit transaction, which is typically less expensive for the merchant.

Electronic Receipt Capture. Electronic Receipt Capture enables certain merchant terminals to capture a cardholder's receipt and signature electronically and to display and print the receipt on demand. In particular, this feature adds value to merchants with high-ticket items, since they are more susceptible to losses from customer disputes.

Real-Time Transaction Monitoring. Using their personal computers, merchants can observe open batches of payment transactions at any of their locations, allowing early detection of problem transactions, such as abnormally large tickets or credits, and changes in business volume.

Cash Back on Debit. Merchants have the ability to offer a cash-back option to their customers for pin-based debit transactions.

Cardholder Name Capture. Cardholder Name Capture captures the cardholder's name in a settlement transaction database. The cardholder's name is then available for reporting back to the merchant when necessary for draft retrieval requests, chargeback notifications and to provide additional information regarding transactions that do not qualify for the lowest rates offered by Visa and MasterCard.

Logo on Receipt. The Logo on Receipt feature imports merchant logos onto a merchant's receipt.

On-line Download Maintenance. On-line Download Maintenance is an Internet interface to a merchant's point-of-sale terminal download system that allows a merchant to change the parameters that control how its point-of-sale terminal functions as opposed to having to call a service center to request such changes. This enables a merchant to more easily change its receipt message each day and assists a merchant in preventing employee fraud by setting parameters that restrict the actions that can be taken by various employees.

We currently have patent applications pending with the United States Patent and Trademark Office for our Real-Time Transaction Monitoring and On-line Download Maintenance value-added features.

While we will continue to utilize third-party front-end systems, we plan to continue incorporating additional functionality into HPS Exchange and to install an increasing percentage of new merchants onto HPS Exchange.

We believe that we are one of the first payment processors to develop all of our systems using a distributed application architecture, often referred to as "client-server" systems, which offers significant benefits to us in terms of cost, data manipulation and distribution, flexibility and scalability. We further believe that these systems help attract both new merchants and Relationship Managers and provide us with a competitive advantage over many of our competitors who rely on less flexible legacy systems.

Network Security

In the course of our operations, we solicit, compile and maintain a large database of information relating to our merchants and their transactions. We place significant emphasis on maintaining a high level of security in order to protect the information of our merchants and their customers. We maintain

current updates of network and operating system security releases and virus definitions, and have engaged a third party to regularly test our systems for vulnerability to unauthorized access.

Our internal network configuration provides multiple layers of security to isolate our databases from unauthorized access and implements detailed security rules to limit access to all critical systems. In response to potential security problems with payment processors' systems, Visa and MasterCard recently implemented new audit procedures to highlight and repair any security weaknesses in payment processors' systems. In November 2003, we were certified by Visa as having successfully completed their Cardholder Information Security Program (CISP) review of our payment processing and Internet-based reporting systems, and that certification was reconfirmed in January, 2005. We have engaged auditors to perform an annual SAS-70 review of the integrity of our systems. In addition, we have commissioned a TG-3 audit of PIN security procedures and undertaken an independent Cyber-Risk Assessment. Application components communicate using sophisticated security protocols and are directly accessible by a limited number of employees on a need-only basis. Our operations and customer support systems are located at our facilities in Jeffersonville, Indiana.

Disaster Recovery and Back-up Systems

We have implemented a disaster recovery plan for HPS Exchange to ensure business connectivity in the event of a system failure. As part of this plan, we have established an alternate processing site in Houston, Texas that has the same functionality as our AT&T co-location facility in Allen, Texas. In the event of a failure at our Allen site, we would switch our processing immediately to the Houston site.

We also rely on connections to the systems of our third-party front-end and back-end processing providers. In many cases, they have installed or developed communications circuits with backup connectivity to overcome telecommunications problems. In addition, our service center has installed redundant power sources and our administrative systems are backed up and archived daily.

Competition

The payment processing industry is highly competitive. We compete with other providers of payment processing services on the basis of the following factors:

quality of service;

reliability of service;

ability to evaluate, undertake and manage risk;

speed in approving merchant applications; and

price.

We compete with both small and large companies in providing payment processing and related services to a wide range of merchants. Our competitors sell their services either through a direct sales force, generally concentrating on larger accounts, through Independent Sales Organizations or banks, generally concentrating on smaller accounts, or through telemarketers.

There are a number of large payment processors, including First Data Merchant Services Corporation, National Processing, Inc., a subsidiary of Bank of America Corporation, Global Payments Inc. and NOVA Information Systems, Inc., a subsidiary of U.S. Bancorp, that serve a broad market spectrum from large to small merchants and provide banking, ATM and other payment-related services and systems in addition to bank card payment processing. There are also a large number of smaller payment processors that provide various services to small- and medium-sized merchants.

Some of our competitors have substantially greater capital resources than we have and operate as subsidiaries of financial institutions or bank holding companies, which may allow them on a consolidated basis to own and conduct depository and other banking activities that we do

not have the regulatory authority to own or conduct. Since they are affiliated with financial institutions or banks,

these competitors do not incur the costs associated with being sponsored by a bank for registration with card associations and they can settle transactions quickly for their own merchants. We do not, however, currently contemplate acquiring or merging with a financial institution in order to increase our competitiveness. We believe that our specific direct sales focus on small- and medium-size merchants, in addition to our understanding of the needs and risks associated with providing payment processing services to those merchants, gives us a competitive advantage over larger competitors, which do not have our focus, and over competitors of a similar or smaller size that may lack our experience and sales resources.

Employees

As of March 31, 2005, we employed 1,336 full- and part-time personnel, including 323 customer service, risk management, financial and operations support and underwriting employees, 58 systems and technology employees, 29 payroll services employees, 52 accounting and administration employees and 874 sales and marketing employees. None of our employees are represented by a labor union, and we have experienced no work stoppages. We consider our employee relations to be good.

Properties

Our principal executive offices are located in approximately 5,000 square feet of leased office space on Hulfish Street in Princeton, New Jersey. This lease expires on September 30, 2007. We also lease approximately 10,000 square feet of office space in Cleveland, Ohio under a lease that expires on June 30, 2009, 5,000 square feet in Scottsdale, Arizona under a lease that expires on October 31, 2006, 50,000 square feet in Jeffersonville, Indiana under a lease that expires on April 30, 2009, and 10,000 square feet in Frisco, Texas under a lease that expires on October 31, 2008. In September 2004, we leased approximately 9,300 square feet of office space on Nassau Street in Princeton under a lease that expires in 2013. We believe that these facilities are adequate for our current operations and, if necessary, can be replaced with little disruption to our company. Each of these leases, other than the original Princeton lease (Hulfish Street) and the Frisco lease, is renewable.

Legal Proceedings

In the ordinary course of our business, we are party to various legal actions, which we believe are incidental to the operation of our business. We believe that the outcome of the proceedings to which we are currently a party will not have a material adverse effect on our financial position, results of operations or cash flows.

Intellectual Property

We own trademarks for Heartland Payday, Heartland Payment Systems and HPS Exchange and have trademark applications pending for Hlearning, HPS, Instalert, Instaview, Netslect, Online Merchant, Passport and Secure Exchange. We have agreed with Heartland Bank and Heartland Card Company that we will not license or contractually permit any third party to use the name "Heartland" in connection with any financial services business in the State of Missouri. We currently have two patent applications pending with the United States Patent and Trademark Office. One of our patent applications is related to programming and downloading data to, and viewing activity at, card terminals from remote locations via the Internet. The other patent application relates to our Real-Time Transaction Monitoring and On-Line Download Maintenance value-added features and provides a system and method of aggregating multiple transactions over a networked-based electronic payment transaction processing system. The present applications seek a business process or business method patent and we are not aware of any challenges to either application. Most of our services and products are based on proprietary software that is updated to meet merchant needs and remain competitive. Protecting our rights to our proprietary software and the patents related to them is critical, as it allows us to offer distinctive services and products to merchants, which differentiates us from our competitors.

MANAGEMENT

Directors and Executive Officers

The following table sets forth information regarding our directors and executive officers as of July 15, 2005.

Name	Age	Position
Robert O. Carr	59	Chairman of the Board and Chief Executive Officer
Robert H.B. Baldwin, Jr.	50	Chief Financial Officer and Secretary
Michael C. Hammer	50	Chief Operations Officer
Thomas M. Sheridan	59	Executive Director
Brooks L. Terrell	42	Chief Technology Officer
Scott L. Bok	46	Director
Mitchell L. Hollin	42	Director
Robert H. Niehaus	49	Director
Marc J. Ostro	55	Director
Jonathan J. Palmer	62	Director
George F. Raymond	68	Director

Robert O. Carr has served as Chairman of our board of directors and as our Chief Executive Officer since our inception in October 2000. Mr. Carr had been Chairman of the Members' Committee and Chief Executive Officer of our predecessor, Heartland Payment Systems LLC, from March 1997 to October 2000 when the merger of Heartland Payment Systems LLC into our company became effective. Mr. Carr co-founded Heartland Payment Systems LLC with Heartland Bank in March 1997. Mr. Carr joined Heartland Payment Systems LLC after selling his interest in Credit Card Software Systems, Inc., an Independent Sales Organization he founded in 1987, specializing in the travel and entertainment industry. Mr. Carr received a B.S. and M.S. in mathematics and computer science from the University of Illinois.

Robert H.B. Baldwin, Jr. has served as our Chief Financial Officer and Secretary since our inception in October 2000. Mr. Baldwin had been Chief Financial Officer and Secretary of our predecessor, Heartland Payment Systems LLC, from May 2000 to October 2000. From July 1998 to May 2000, Mr. Baldwin served as the Chief Financial Officer of COMFORCE Corp., a publicly-traded staffing company. From 1985 through July 1998, Mr. Baldwin was a Managing Director in Smith Barney's Financial Institutions advisory business and from 1980 to 1985, he was a Vice President with Citicorp. Mr. Baldwin received a B.A. in history from Princeton University, and received an M.B.A. from Stanford University.

Michael C. Hammer was recently named our Chief Operations Officer, having previously served as our Chief Marketing Officer since our inception in October 2000. In October 1998, Mr. Hammer joined our predecessor, Heartland Payment Systems LLC, as Chief Marketing Officer and remained in that position until October 2000 when the merger of Heartland Payment Systems LLC into our company became effective. From 1995 to 1998, he served as Senior Vice President of Sales for Deluxe Corporation, a payment systems provider. Mr. Hammer was formerly a member of the Sales Executives Group of The Advisory Board, a Washington, D.C. based organization that brings together sales executives from across corporate America. Mr. Hammer received a B.A. in English from San Jose State University.

Thomas M. Sheridan has served as our Executive Director since December 2004. From 1998 to December, 2004, Mr. Sheridan was Senior Vice President at Nova Information Systems, the payments processing division of US Bancorp, and was responsible for Pricing and Portfolio Management. From 1997 to 1998, Mr. Sheridan was Vice President, Credit, Security and Settlement Operations, at PMT Services, which was acquired by Nova in 1998. From 1991 to 1997, Mr. Sheridan consulted for a

number of companies in the payments industry, specializing in acquisitions, integration and portfolio management. From 1989 to 1991, he was Chief Financial Officer for National Data Corporation's payments division, now called Global Payments. Prior to such time, he was a Vice President at First Interstate Bank, a Senior Vice President in Citibank's credit card operations, and in the finance department of Abbott Laboratories, a health care company. Mr. Sheridan received a B.S. degree in Chemical Engineering from the University of Illinois and an M.B.A. in Finance from Northwestern University.

Brooks L. Terrell has served as our Chief Technology Officer since our inception in October 2000. Mr. Terrell served as the Executive Vice President of Information Technology of our predecessor, Heartland Payment Systems LLC, from January 1997 to October 2000 when the merger of Heartland Payment Systems LLC into our company became effective. In 1992, he began an independent consulting business providing development and implementation services in the electronic payments industry. From 1986 to 1992, he was Software Development Manager with LeRoux, Pitts and Associates Inc., a software company specializing in electronic payments. Mr. Terrell received a B.A. in Religion and Greek from Baylor University in 1984.

Scott L. Bok has served as one of our directors since October 2001. Mr. Bok has served as the U.S. President of Greenhill & Co., Inc., an investment banking firm, since January 2004 and as a member of Greenhill & Co.'s Management Committee since its formation in January 2004. Greenhill & Co., Inc. is an affiliate of Greenhill Capital Partners, L.P. and its affiliated funds which collectively owned approximately 31.0% of our outstanding common stock as of March 31, 2005. Mr. Bok is also a member of the Investment Committee of Greenhill Capital Partners, LLC. In addition, Mr. Bok has been a director of Greenhill & Co., Inc. since March 2004. From 2001 until the formation of Greenhill & Co.'s Management Committee, Mr. Bok participated on the two-person administrative committee responsible for managing Greenhill's operations. Mr. Bok also serves as a Senior Member of GCP 2000, LLC and a Senior Member of Greenhill Capital Partners, LLC, which control the general partners of Greenhill Capital Partners, LLC. Mr. Bok joined Greenhill & Co. as a Managing Director in February 1997. Before joining Greenhill & Co., Mr. Bok was a managing director in the mergers, acquisitions and restructuring department of Morgan Stanley & Co., where he worked from 1986 to 1997, based in New York and London. From 1984 to 1986, Mr. Bok practiced mergers and acquisitions and securities law in New York with Wachtell, Lipton, Rosen & Katz. Mr. Bok is a member of the board of directors of various private companies. Mr. Bok received a B.S. in Economics from the University of Pennsylvania's Wharton School and a J.D. from the University of Pennsylvania Law School.

Mitchell L. Hollin has served as one of our directors since October 2001. Mr. Hollin is a Partner of LLR Capital, L.P., which is the general partner of LLR Equity Partners, L.P., an independent private equity firm, which he joined in August 2000. LLR Equity Partners, L.P. and its affiliated fund owned approximately 18.6% of our outstanding common stock as of March 31, 2005. Mr. Hollin also serves on the Investment Committee of LLR Equity Partners, L.P. From 1994 until joining LLR Capital, L.P., Mr. Hollin was a founder and Managing Director of Advanta Partners LP, a private equity firm affiliated with Advanta Corporation. Prior to his involvement with Advanta Partners LP, Mr. Hollin was a Vice President at Cedar Point Partners LP, a middle market buyout firm and before that an Associate at Patricof & Co. Ventures, Inc., an international venture capital firm. Mr. Hollin received a B.S. in Economics and an M.B.A. from the Wharton School of the University of Pennsylvania.

Robert H. Niehaus has served as one of our directors since October 2001. Mr. Niehaus is a Managing Director of Greenhill & Co., Inc. and serves as the Chairman and a Senior Member of GCP 2000, LLC and the Chairman and a Senior Member of Greenhill Capital Partners, LLC, which control the general partners of Greenhill Capital Partners. Greenhill Capital Partners and its affiliated funds owned approximately 31.0% of our outstanding common stock as of March 31, 2005. Mr. Niehaus has been a member of Greenhill & Co.'s Management Committee since its formation in January 2004. Mr. Niehaus joined Greenhill & Co. in January 2000 as a Managing Director to begin the formation of

Greenhill Capital Partners. Prior to joining Greenhill & Co., Mr. Niehaus spent 17 years at Morgan Stanley & Co., where he was a managing director in the merchant banking department from 1990 to 1999. Mr. Niehaus was vice chairman and a director of the Morgan Stanley Leveraged Equity Fund II, L.P., a \$2.2 billion private equity investment fund, from 1992 to 1999, and was vice chairman and a director of Morgan Stanley Capital Partners III, L.P., a \$1.8 billion private equity investment fund, from 1994 to 1999. Mr. Niehaus was also the chief operating officer of Morgan Stanley's merchant banking department from 1996 to 1998. Mr. Niehaus is a director of American Italian Pasta Company, a producer and marketer of dry pasta in North America, Global Signal Inc., a company that owns and manages wireless communications towers and other communications sites, and various private companies. Mr. Niehaus received a B.A. in International Affairs from the Woodrow Wilson School at Princeton University and an M.B.A. from the Harvard Business School.

Marc J. Ostro, Ph.D. has served as one of our directors since October 2002. Dr. Ostro has been a partner at TL Ventures, L.P., a Pennsylvania-based venture capital firm, since January 2002. Immediately prior to that, Dr. Ostro was a private consultant to the biotechnology industry since May 2000. From November 1997 to May 2000, he was Senior Managing Director and Group Leader for KPMG Life Science Corporate Finance (Mergers and Acquisitions). In 1981, Dr. Ostro co-founded The Liposome Company, a biotechnology company. Dr. Ostro received a B.S. in biology from Lehigh University, a Ph.D. in biochemistry from Syracuse University, and was a postdoctoral fellow and assistant professor at the University of Illinois Medical School. Dr. Ostro also currently serves as a director of Barrier Therapeutics, Inc.

Jonathan J. Palmer has served as one of our directors since November 2003. Since September 2004, Mr. Palmer has served as the Chief Executive Officer of Lucid Security, Inc., an innovator of intrusion prevention software. From 1999 to October 2003, Mr. Palmer served as President and Chief Executive Officer of Vital Processing Services. From 1996 to 1999, he served as President and CEO of Wellspring Resources, an outsourced benefits administrator. From 1990 to 1996, Mr. Palmer was the Chief Retail Banking and Technology Executive at Barnett Banks, where he created Barnett Technologies, an outsourced services firm offering a wide range of back office functions for banks. Prior to such time, he was an Executive Vice President with Shearson Lehman Brothers, and held a number of roles at Fidelity Bank in Philadelphia, succeeding to Vice Chairman in the late 1980s. Mr. Palmer received a B.A. in Applied Mathematics from LaSalle University, and an M.B.A. from the Wharton School of the University of Pennsylvania.

George F. Raymond has served as one of our directors since March 2004. Mr. Raymond has served as President of Buckland Corporation, a consulting company to the information technology industry, since 1989. Previously, Mr. Raymond was Chief Executive Officer of Automatic Business Centers, Inc., a payroll processing company he founded in 1972 and sold to Automatic Data Processing Corporation in 1989. Mr. Raymond is a director of BMC Software, Inc., a provider of business management software, DocuCorp International, Inc., an enterprise-wide software provider, Analytical Graphics, Inc., a software solutions provider, and Emtec Inc., a systems integrator. Mr Raymond received a B.B.A. in accounting from the University of Massachusetts and qualified as a C.P.A. in Pennsylvania.

Composition of The Board

Our amended and restated certificate of incorporation currently authorizes our board of directors to determine the number of directors on our board. We currently have 7 directors, each of whom shall be elected annually.

Committees of The Board of Directors

Our board of directors has an audit committee, a compensation committee and a nominating/corporate governance committee.

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Our audit committee is solely responsible for the appointment of and reviewing fee arrangements with our independent accountants, and approving any non-audit services by our independent accountants. Our audit committee reviews and monitors our internal accounting procedures and reviews the scope and results of the annual audit and other services provided by our independent accountants. Our audit committee currently consists of Messrs. Ostro, Palmer and Raymond, each of whom is an independent director under Rule 10A-3 under the Exchange Act, and is chaired by Mr. Raymond. We believe that each of the members of the audit committee is financially sophisticated and is able to read and understand our consolidated financial statements. Our board of directors has determined that Mr. Raymond is an audit committee "financial expert" as defined under the regulations of the Exchange Act.

Our compensation committee is primarily responsible for reviewing and approving the compensation and benefits of our executive officers and directors; evaluating the performance and compensation of our executive officers in light of our corporate goals and objectives; administering our employee benefit plans and making recommendations to our board of directors regarding these matters; and for administering our equity compensation plans. Our compensation committee currently consists of Messrs. Hollin, Niehaus and Palmer, each of whom is an independent director.

Our nominating/corporate governance committee makes recommendations to the board of directors concerning nominations to the board, including nominations to fill a vacancy (including a vacancy created by an increase in the board of directors). The nominating/corporate governance committee will consider nominees for directors nominated by stockholders upon submission in writing to our corporate secretary of the names of such nominees in accordance with our bylaws. This committee is also charged with shaping corporate governance policies and codes of ethical and legal conduct, and monitoring compliance with such policies. Our governance/nominating committee currently consists of Messrs. Bok, Ostro and Raymond, each of whom is an independent director.

Compensation Committee Interlocks and Insider Participation

No member of our compensation committee serves as a member of the board of directors or compensation committee of any entity that has one or more executive officers serving as a member of our board of directors or compensation committee. No member of our compensation committee has ever been an officer or employee of ours. There are no family relationships among any of our directors or executive officers.

Director Compensation

Members of our board of directors who are not our employees, receive annual retainers of \$10,000, or \$15,000 if they chair a committee, in addition to \$1,000 for each board meeting attended in person and \$500 for each committee meeting attended in person. They are also reimbursed for their out-of-pocket expenses related to their service on our board of directors.

Any new non-employee director who has not been in our prior employ will receive an initial option to purchase 10,000 shares of our common stock on the date such individual joins the board of directors. These options will vest over a period of two years. In addition, beginning on the date of the third annual stockholders meeting held after a non-employee board member joins the board of directors, such board member will automatically be granted a vested option to purchase 5,000 shares of our common stock. See "Management Employee Benefit Plans Heartland Payment Systems, Inc. 2004 Stock Incentive Plan."

Compensation of Executive Officers and Other Information

The following table shows the cash compensation paid or to be paid by us, and certain other compensation paid or accrued, during the fiscal year ended December 31, 2004 to our Chief Executive Officer and each of our five other most highly compensated executive officers, together the "Named Executive Officers."

Summary Compensation Table

Name and Principal Position	Year	Annual Compensation		Long-Term Compensation Awards
		Salary(\$)	Bonus(\$)	Securities Underlying Options(#)(1)
Robert O. Carr Chairman and Chief Executive Officer	2004	\$ 368,250	\$ 100,000	
Martin J. Uhle(2) President and Chief Operating Officer	2004	\$ 320,150	\$	
Robert H.B. Baldwin, Jr. Chief Financial Officer	2004	\$ 247,939	\$ 85,000	90,000
Michael C. Hammer Chief Marketing Officer	2004	\$ 202,895	\$ 75,000	70,000
Brooks L. Terrell Chief Technology Officer	2004	\$ 221,285	\$ 75,000	70,000
David L. Morris Chief Services Officer	2004	\$ 182,572	\$ 63,000	30,000

(1) The information indicated is for options granted in 2005 based on 2004 performance. The information in the immediately following table is for options granted in 2004 based on 2003 performance.

(2) Mr. Uhle resigned as of September 30, 2004. In addition to his salary, Mr. Uhle received \$123,932 in reimbursed relocation expenses as part of his severance agreement.

Option Grants In Last Fiscal Year

The following table sets forth information regarding stock options we granted during the fiscal year ended December 31, 2004 to the Named Executive Officers.

Name	Number Of Securities Underlying Options Granted(#)	Percentage Of Total Options Granted To Employees In Fiscal Year	Exercise Price (per share)	Expiration Date	Potential Realizable Value At Assumed Annual Rates Of Stock Appreciation For Option Term	
					5%	10%
Martin J. Uhle(1)	90,000	2.86%	\$ 6.25	1/15/2009	\$ 57,433	\$ 72,473
Robert H.B. Baldwin, Jr.	90,000	2.86%	\$ 6.25	1/15/2009	\$ 57,433	\$ 72,473
Michael C. Hammer	70,000	2.22%	\$ 6.25	1/15/2009	\$ 44,670	\$ 56,368
Brooks L. Terrell	70,000	2.22%	\$ 6.25	1/15/2009	\$ 44,670	\$ 56,368
David L. Morris	31,250	0.95%	\$ 6.25	1/15/2009	\$ 19,942	\$ 25,164

(1) Mr. Uhle resigned as of September 30, 2004.

Aggregated Option Exercises in Last Fiscal Year and Fiscal Year End Option Values

The following table summarizes the value of the options exercised in fiscal 2004 and the value of unexercised options held by the Named Executive Officers as of December 31, 2004. The value of unexercised, in-the-money options at fiscal year end is calculated using the difference between the option exercise price and the estimated fair value at December 31, 2004, which has been deemed to be

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\$9.28 per share, multiplied by the number of shares underlying the option. An option is in-the-money if the fair value of the common stock subject to the option is greater than the exercise price. The assumed initial public offering price of \$15.00 per share (the midpoint of the range on the cover of this prospectus) is higher than the estimated fair value at fiscal year end and the value of unexercised options would be higher than the numbers shown in the table if the value were calculated by subtracting the exercise price from the initial public offering price.

Name	Shares Acquired On Exercise (#)	Value Realized (\$)	Number Of Securities Underlying Unexercised Options At Fiscal Year-End (#) Exercisable/ Unexercisable	Value of Unexercised In-The- Money Options At Fiscal Year-End (\$) Exercisable/ Unexercisable
Robert O. Carr			350,000/250,000	\$1,183,750/756,250
Martin J. Uhle(1)	114,000	\$ 449,850	0/0	\$0/0
Robert H.B. Baldwin, Jr.	272,000	\$ 1,034,000	422,500/67,500	\$1,778,063/204,188
Michael C. Hammer			89,500/52,500	\$360,738/158,813
Brooks L. Terrell			89,500/52,500	\$360,738/158,813
David L. Morris			11,820/22,500	\$39,593/68,063

(1) Mr. Uhle resigned as of September 30, 2004 and exercised options to purchase 114,000 shares of common stock on October 25, 2004.

Change in Control Arrangements

Each of Robert O. Carr, Robert H.B. Baldwin, Jr., Michael C. Hammer and Brooks L. Terrell entered into an employee confidential information and noncompetition agreement with us in November 2001, which provides that in the event they are terminated by us for other than cause or disability, they will be entitled to receive severance pay in an amount equal to the base salary for a twelve month period that would have been paid to them plus medical benefits for 12 months. In addition, if any of them are terminated other than for cause or their employment with us is terminated due to their death, they shall also be entitled to receive a pro rata portion of any bonus that they would have been entitled to receive for the fiscal quarter in which they are terminated as if they had been employed by us for all of such quarter or, if their bonus was payable on an annual rather than a quarterly basis, then their pro rata portion of such bonus shall be computed based on the number of days they were employed by us during such year.

In addition, in December 2002, Mr. Baldwin entered into a supplement to his employee confidential information and noncompetition agreements. The supplement provides that (i) in the event a material change occurs within 24 months of a change in control of our company or (ii) Robert O. Carr is no longer our chief executive officer and there is a change in his place of business that is more than 50 miles from our present principal offices, which is deemed to be a relocation, and (iii) Mr. Baldwin elects within three months following such material change or relocation to terminate his employment with us, his employment shall be deemed to have been terminated by us other than for cause and he shall be entitled to be paid severance and a bonus payment in accordance with the terms described above. A change of control is defined as any event where a person or persons, other than the then-current holders of our capital stock, has the right to elect, appoint or designate a majority of our board of directors, regardless of whether such event occurs as a result of the sale, conversion or redemption of any of our securities or any contractual obligation of ours and our stockholders. A material change is defined as a material adverse change in Mr. Baldwin's duties, responsibilities or authority or the assignment to him of any duties, responsibilities or authority which are inconsistent with his status or position or a material decrease in his base salary, other than any decrease that is effective for all of our officers and does not disproportionately affect Mr. Baldwin.

Thomas Sheridan entered into an employee confidential information and noncompetition agreement with us in December 2004, which provides that (i) in the event a material change occurs within 24 months of a change in control of our company or (ii) Robert O. Carr is no longer our chief executive officer and (iii) Mr. Sheridan elects within three months following such material change to terminate his employment with us, his employment shall be deemed to have been terminated by us other than for cause and he shall be entitled to receive severance pay in an amount equal to the base salary for a twelve month period that would have been paid to him plus medical benefits for twelve months and a pro rata portion of any bonus that he would have been entitled to receive for the fiscal quarter in which he is terminated as if he had been employed by us for all of such quarter or, if his bonus is payable on an annual rather than a quarterly basis, then his pro rata portion of such bonus shall be computed based on the number of days he was employed by us during such year. In addition, all stock options granted to him shall vest and become exercisable for a period of six months following the date of such termination. A change of control is defined as any event where a person or persons, other than the then-current holders of our capital stock, has the right to elect, appoint or designate a majority of our board of directors, regardless of whether such event occurs as a result of the sale, conversion or redemption of any of our securities or any contractual obligation of ours and our stockholders. A material change is defined as a material adverse change in Mr. Sheridan's duties, responsibilities or authority or the assignment to him of any duties, responsibilities or authority which are inconsistent with his status or position or a material decrease in his base salary, other than any decrease that is effective for all of our officers and does not disproportionately affect Mr. Sheridan.

Employee Benefit Plans

Heartland Payment Systems, Inc. Amended and Restated 2000 Equity Incentive Plan

Introduction. Our Board of Directors adopted the Amended and Restated 2000 Equity Incentive Plan on July 29, 2003, and our stockholders approved the 2000 Plan on that same date. The 2000 Plan was amended on _____, 2005.

Share Reserve. We have authorized 10,000,000 shares of our common stock for issuance under the 2000 Plan.

Eligibility. Employees, officers, directors, and consultants of our company or our subsidiaries are eligible to participate in the 2000 Plan. However, only employees may be granted "incentive stock options."

Administration. The 2000 Plan is currently administered by our compensation committee. Our compensation committee determines, among other things, which eligible persons are to receive awards, the number of shares of our common stock subject to each award, the exercise schedule for each option and each stock appreciation right, the vesting schedule for each share of common stock, and the other terms and conditions of each award, consistent with the provisions of the 2000 Plan. The terms and conditions of each award shall be set forth in a written award agreement with the recipient.

Options. Options granted under the 2000 Plan may be either "incentive stock options," which are intended to qualify for certain U.S. federal income tax benefits under Section 422 of the Code, or "non-qualified stock options." The holder of an option granted under the 2000 Plan will be entitled to purchase a number of shares of our common stock at a specified exercise price during a specified time period, as determined by our compensation committee. Options granted under the 2000 Plan may become exercisable based on the recipient's continued employment or service or the achievement of performance or other goals and objectives. The exercise price for an option may be paid in cash, in shares of our common stock valued at fair market value on the exercise date, by delivery of a full-recourse, interest-bearing promissory note, or by such other method as the compensation committee may establish. Options granted under the 2000 Plan generally may be transferred only by will or by the laws of descent and distribution.

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Stock Appreciation Rights. A recipient of a stock appreciation right under the 2000 Plan will be entitled to receive cash, or shares of our common stock having a fair market value, equal to the excess of (a) the fair market value of a share of our common stock on the date of exercise (or, in our compensation committee's discretion, as of any time during a specified period before or after the date of exercise) over (b) the grant price of the stock appreciation right. The grant price for a stock appreciation right granted under the 2000 Plan will be determined by our compensation committee, but may not be less than the fair market value of a share of our common stock on the date of grant. Stock appreciation rights will become exercisable at such times or upon the occurrence of such events as determined by our compensation committee.

Shares of Common Stock. Shares of common stock granted under the 2000 Plan generally will "vest" based on the continued employment or service of the recipient or the achievement of performance or other goals and objectives. Shares of common stock that have not vested generally will be subject to forfeiture by the recipient, without payment of any consideration by our company, if the recipient's employment or service terminates. Unless otherwise permitted by our compensation committee, shares of common stock granted under the 2000 Plan may not be transferred by the recipient prior to vesting.

Certain Corporate Transactions; Change in Control. In the event of certain corporate transactions, such as a merger or consolidation in which we are not the surviving entity or a sale of all or substantially all of the assets of our company, the 2000 Plan provides that (a) each outstanding option will be assumed or substituted with a comparable option by our successor company or its parent or (b) in the discretion of our compensation committee, the 2000 Plan and each outstanding option shall terminate on the effective date of such transaction and the recipient will receive a cash payment with a fair market value equal to the amount that would have been received upon the exercise of the option had the option been exercised immediately prior to such transaction.

No award agreement entered into pursuant to the 2000 Plan may provide for the acceleration of any exercise schedule or vesting schedule with respect to an award solely because of a "change in control" of our company. However, notwithstanding anything to the contrary in the 2000 Plan or any award agreement, awards may provide for the acceleration of the exercise schedule or vesting schedule in the event of the involuntary dismissal of a recipient within a specified period of time following a change in control.

Amendment and Termination. The board of directors may amend or modify the 2000 Plan at any time, subject to any approval by our stockholders as required by law or the recipients of outstanding awards, as applicable. The 2000 Plan will terminate no later than July 30, 2013.

Heartland Payment Systems, Inc. 2002 PEPSHares Plan

Introduction. Our 2002 PEPSHares Plan was adopted by our board of directors in April 2002 and approved by our stockholders in May 2002.

Share Reserve. The maximum aggregate number of shares of common stock that may be granted subject to option awards under the PEPSHares Plan in any calendar year is 2,400,000 shares, less other grants of options or restricted stock pursuant to any of our other stock incentive plans during the plan year. However, the maximum aggregate number of shares available for awards under the plan in 2002 was limited to 1,000,000 shares, and the maximum aggregate number of shares may be similarly limited in subsequent years at the discretion of the plan administrator. The options may be granted as either "incentive stock options," which have potential tax benefits under Section 422 of the Code, or "non-qualified options."

Eligibility. The individuals eligible to participate in our PEPSHares plan include our employees and employees of our subsidiaries. Officers are not entitled to participate in the PEPSHares plan.

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Administration. The plan administrator for the PEPShares plan is currently the compensation committee. The plan administrator determines, among other things, which eligible employees are to receive option grants, the number of shares subject to each such grant, the vesting schedule to be in effect for the grant, the terms and conditions of each award and whether and under what circumstances the exercise price for shares of common stock subject to option grants may be paid in consideration other than cash. Such terms shall be set forth in a written option agreement.

Compensation Deferral Option. Except to the extent such power is reserved by the board of directors, the plan administrator has the exclusive authority to select the employees who may defer their compensation on a monthly basis. The plan administrator will determine the maximum amount and minimum amount that eligible employees may elect to defer. The amounts deferred by a participating employee will be credited to a bookkeeping account ("Account") to record the employee's interest under the PEPShares Plan. At the discretion of the plan administrator, the deferred compensation shall be invested in an interest-bearing account for the benefit of the participating employee. However, any amounts credited to such interest bearing accounts remain our assets and will be subject to the claims of our creditors in the event of our insolvency. Each selected employee who files a timely election will automatically be granted, on the date amounts are withheld pursuant to his or her salary reduction election (the "grant date"), an option to purchase that number of shares of common stock determined by dividing the salary reduction amount by the fair market value per share of our common stock on the grant date. The options will be exercisable at a price per share equal to the fair market value of the option shares on the grant date. As a result, the exercise price payable for the shares will be equal to the amount by which the employee's salary is reduced under the PEPShares Plan. The option will become exercisable in a series of five equal annual installments of 20%, contingent on continued service with us, provided that all unvested options will vest as of the final vesting date. The final vesting date for participants who enrolled in the PEPShares Plan during 2002 with respect to participation in the PEPShares Plan in 2002 and 2003 is December 31, 2005. The final vesting date for participants who enrolled after 2002 is as determined by the plan administrator at the time of enrollment in the PEPShares Plan. Options granted to participants who enrolled in the PEPShares Plan during 2002 with respect to participation in the PEPShares Plan in 2002 and 2003 expire on December 31, 2006. Options granted to participants who enrolled after 2002 expire on the date the plan administrator determines at the time of enrollment. The vesting of options may be accelerated as described below. The PEPShares Plan will terminate on April 29, 2007 (five years after it became effective), unless it is terminated sooner by the board of directors, as permitted under the PEPShares Plan. When the PEPShares Plan terminates, the balance of the participant's Account (deferred compensation not previously used to exercise options) is paid to the participant. Outstanding options at the time the PEPShares Plan terminates will expire in accordance with their terms. If a participant ceases service with us for any reason, any unvested option, as well as any vested, but unexercised option, will terminate and the plan administrator shall make a single lump sum payment to the optionee equal to the amount of deferred compensation in his or her Account. Notwithstanding the foregoing, if a participant ceases services due to disability or death, vested options may be exercised during the 12 month period following such death or disability.

Buyout of Future Commissions Option. Each participant in the PEPShares plan whose salary is commission-based will be granted an option to purchase that number of shares of common stock determined by dividing 30 times the amount of such participant's initial monthly deferral by the fair market value per share of our common stock at the grant date. The option will be exercisable at a price per share equal to the fair market value of the option shares on the grant date. Unless otherwise permitted at the sole discretion of the plan administrator, the PEPShares plan requires that the exercise price for these options be paid through the sale to us of a portion of such participant's merchant portfolio equity. The amount of such portfolio equity that will be purchased by us in satisfaction of the exercise price will be determined by the plan administrator.

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Accelerated Vesting. The plan administrator may accelerate, at its sole discretion, any outstanding options under this plan. Options held by Relationship Managers and sales managers entitled to receive residual commissions will vest on the date this offering is consummated if the holder has achieved 100% or more of his or her minimum margin requirement (as calculated on or before the vesting date in accordance with the Award Agreement entered into by such employee) for the period from the first day of the calendar month following the month in which the employee became a participant to the date this offering is consummated. All options held by salaried employees under this plan will vest on the date this offering is consummated. The vesting of options under this plan may also be accelerated in connection with a change of control of our company as described below.

Consideration. At the discretion of the plan administrator, the exercise price for the shares of the common stock subject to option grants made under our PEPShares plan may be paid in cash, by surrender of shares of our common stock that have been owned by the optionee for more than six (6) months (or such other period required by the plan administrator) and that have a fair market value equal to the aggregate exercise price on the exercise date, by sale to us of a portion of such participant's merchant portfolio equity or such other method as the compensation committee may establish. In addition, the plan administrator may provide financial assistance to one or more optionees in the exercise of their outstanding options or the purchase of their unvested options by allowing such individuals to deliver a full-recourse, interest-bearing promissory note in payment of the exercise price. Participants may not use their deferred compensation to pay the exercise price for shares of common stock subject to options held by them until the earlier of the final vesting date of such options or the date this offering is consummated.

Change of Control. In the event that we are acquired by a merger, a sale by our shareholders of more than 50% of our outstanding voting stock or a sale of all or substantially all of our assets, each outstanding option that was granted to a commission-based employee under this plan, which (i) will not be assumed by the successor corporation or otherwise continued in effect, or (ii) will not be replaced with a comparable award of a successor corporation, will immediately vest; provided that such option would have vested had December 31, 2005 been immediately prior to such change of control. Options that are not continued or assumed by the successor corporation and are unexercised shall terminate and cease to remain outstanding immediately following the consummation of the change in control.

Amendment and Termination. The board of directors may amend or modify the PEPShares plan at any time, subject to any required stockholder approval, or participant consent. The PEPShares plan will terminate no later than April 30, 2007.

No Compensation Deferrals Permitted with Respect to Compensation Earned After December 31, 2004. Pursuant to its authority under the PEPShares plan, the Administrator has determined that no elections to defer compensation earned after December 31, 2004 will be permitted and no amounts will be deferred and contributed to the PEPShares plan from compensation earned after December 31, 2004.

Indemnification and Limitation of Liability

Our charter documents provide that our directors and officers shall be indemnified by us to the fullest extent permitted by Delaware law, as it now exists or may in the future be amended, against all expenses and liabilities reasonably incurred in connection with their service for or on our behalf. In addition, our certificate of incorporation provides that our directors will not be personally liable for monetary damages to us for breaches of their fiduciary duty as directors unless they violated their duty of loyalty to either us or our stockholders, acted in bad faith, knowingly or intentionally violated the law, authorized illegal dividends or redemptions or derived an improper personal benefit from their action as directors. We have insurance which insures our directors and officers against certain losses and which insures us against our obligations to indemnify our directors and officers. We have entered into indemnification agreements with each of our directors and executive officers that provide them with rights to indemnification and expense advancement to the fullest extent permitted by Delaware law.

RELATED PARTY TRANSACTIONS

Since January 1, 2002, we have been a party to several transactions in which the amount involved exceeded \$60,000 and in which any of our directors or executive officers, any holder of more than 5% of our capital stock or any member of their immediate families had a direct or indirect material interest.

Scott L. Bok, the U.S. President of Greenhill & Co., Inc. and a Senior Member of GCP 2000, LLC and a Managing Director of Greenhill Capital Partners, LLC, which control the general partners of Greenhill Capital Partners, Robert H. Niehaus, the Chairman and a Senior Member of GCP 2000, LLC and Chairman and a Managing Director of Greenhill Capital Partners, LLC and Mitchell L. Hollin, a partner of LLR Partners Inc., are members of our board of directors. In March 2003, Carr Holdings, L.L.C., a New Jersey limited liability company, which is owned and managed by Robert O. Carr and Jill Carr, Robert O. Carr's wife, sold an aggregate of 370,000 shares of our common stock to Greenhill Capital Partners, L.P. and its affiliated investment funds and LLR Equity Partners, L.P. and its affiliated investment fund at a price of \$5.00 per share. In this prospectus, we refer to Greenhill Capital Partners, L.P. and its affiliated investment funds collectively as Greenhill Capital Partners and LLR Equity Partners, L.P. and its affiliated investment fund collectively as LLR Equity Partners. We were responsible for paying all reasonable out-of-pocket expenses incurred by the purchasers in connection with the sale, which expenses totaled approximately \$7,500.

On March 21, 2003 and in connection with such sale, we entered into an agreement with Carr Holdings, L.L.C., Greenhill Capital Partners and LLR Equity Partners. Under the agreement, Greenhill Capital Partners and LLR Equity Partners agreed to either (i) not vote any of the shares purchased from Carr Holdings, LLC for the election of directors, or (ii) vote such shares in favor of the directors designated by the holders of a majority of our issued and outstanding common stock, in each case for so long as Carr Holdings, LLC, The Robert O. Carr 2001 Charitable Remainder Unitrust and each of their respective permitted transferees own in the aggregate, more than 50% of our issued and outstanding common stock.

In July 2003, Greenhill Capital Partners and LLR Equity Partners granted Robert O. Carr an irrevocable option to purchase up to an aggregate of 2,000,000 shares of our Series A Senior Convertible Participating Preferred Stock at any time on or before July 31, 2006 at a purchase price of \$6.25 per share.

In October 2004, our former President and Chief Operating Officer sold 129,000 shares of common stock back to us at a price of \$9.28 per share in connection with his severance agreement.

On November 17, 2004, Carr Holdings, L.L.C., sold an aggregate of 108,000 shares of our common stock to Greenhill Capital Partners and LLR Equity Partners at a price of \$9.28 per share. We paid all the expenses incurred by Carr Holdings, L.L.C. in connection with the sale, which expenses totaled approximately \$2,232.

On March 28, 2005, Carr Holdings, L.L.C. sold 40,000 shares of our common stock to Thomas Sheridan, our Executive Director, at a price of \$9.28 per share. In addition, Carr Holdings, L.L.C. granted Mr. Sheridan an option to purchase an additional 40,000 shares of our common stock at any time prior to the earlier of (i) March 31, 2006, if we have not consummated our initial public offering or (ii) six months and 15 days after the consummation of our initial public offering.

On May 3, 2005, Carr Holdings, L.L.C. sold 27,236 shares of our common stock to LLR Equity Partners, L.P. and 2,764 shares of our common stock to LLR Equity Partners Parallel, L.P. at a price of \$9.80 per share. We paid the expenses incurred by Carr Holdings, L.L.C. in connection with the sale, which expenses totaled approximately \$1,000.

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Jeffrey T. Nichols, Robert O. Carr's son-in-law, is our Director of Merchant Acquisition and was paid a salary of \$96,611, \$125,601 and \$136,421 in the years ended December 31, 2002, 2003 and 2004, respectively.

We have entered into change in control arrangements with some of our executive officers and granted options under our stock option plans to some of our executive officers. We have also entered into indemnification agreements with each of our executive officers and directors. See "Management Change in Control Arrangements" and "Description of Capital Stock Indemnification Arrangements."

All future transactions, if any, between us and our officers, directors and principal stockholders and their affiliates and any transactions between us and any entity with which our officers, directors or five percent stockholders are affiliated, will be approved by a majority of the board of directors, including a majority of the independent and disinterested outside directors, and will be on terms no less favorable to us than could be obtained from unaffiliated third parties.

PRINCIPAL STOCKHOLDERS

Set forth below is information relating to the beneficial ownership of our common stock as of July 15, 2005, by each person known by us to beneficially own more than 5% of our outstanding shares of common stock of each class, each of our directors and our Named Executive Officers, and all of our directors and executive officers as a group.

Each stockholder's percentage ownership in the following table is based on 29,794,934 shares of common stock outstanding as of July 15, 2005, as adjusted to reflect the conversion of all outstanding shares of our convertible participating preferred stock upon the closing of this offering and treating as outstanding all options held by that stockholder and exercisable within 60 days of July 15, 2005. As of July 15, 2005, there were 135 holders of our common stock.

Except as otherwise indicated, and subject to applicable community property laws, the persons named in the table have sole voting and investment power with respect to all shares of common stock held by them. Unless otherwise indicated, the address of each officer, director and 5% stockholder listed below is c/o Heartland Payment Systems, Inc., 47 Hulfish Street, Suite 400, Princeton, New Jersey 08542.

Name of Beneficial Owner	Number of Shares Beneficially Owned Prior to this Offering	Percentage of Shares Beneficially Owned	
		Prior to this Offering	After this Offering
5% Holders:			
Greenhill Capital Partners, L.P. and affiliated investment funds(1)	8,632,084	29.0%	20.5%
LLR Equity Partners, L.P. and affiliated investment fund(2)	5,209,252	17.5%	16.1%
Directors and Executive Officers			
Robert O. Carr(3)	10,942,000	36.3%	33.0%
Robert H.B. Baldwin, Jr.(4)	939,500	3.1%	2.9%
Michael C. Hammer(5)	524,500	1.8%	1.6%
Brooks L. Terrell(6)	674,500	2.3%	2.1%
Scott L. Bok(1)	8,632,084	29.0%	20.5%
Mitchell L. Hollin(2)	5,209,252	17.5%	16.1%
Robert H. Niehaus(1)	8,632,084	29.0%	20.5%
David L. Morris(7)	76,820	*	*
Thomas Sheridan(8)	160,000	*	*
Marc J. Ostro(9)	30,000	*	*
Jonathan J. Palmer(10)	20,000	*	*
George F. Raymond(11)	20,000	*	*
All directors and executive officers as a group (12 persons)(12)	26,188,656	84.4%	71.5%

*

Less than 1% of the outstanding stock

(1)

Beneficial ownership consists of 5,285,438 shares of common stock held by Greenhill Capital Partners, L.P.; 1,612,082 shares of common stock held by Greenhill Capital, L.P.; 853,228 shares of common stock held by Greenhill Capital Partners (Executives), L.P.; and 881,336 shares of common stock held by Greenhill Capital Partners (Cayman), L.P. By virtue of their ownership and positions as the Senior Members of GCP 2000, LLC and as Managing Directors of Greenhill Capital Partners, LLC, which control the general partners of Greenhill Capital Partners, L.P. and its affiliated investment funds, Scott L. Bok, Robert F. Greenhill and Robert H. Niehaus may be deemed to beneficially own these shares. In addition, GCP Managing Partner, L.P. and GCP, L.P.,

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the general partners of Greenhill Capital Partners, L.P. and its affiliated investment funds, as well as Greenhill Capital Partners, LLC and GCP 2000, LLC, which control the general partners, and Greenhill & Co., Inc., the sole member of Greenhill Capital Partners, LLC, may be deemed to beneficially own these shares. Beneficial ownership includes 1,250,000 shares of common stock that are subject to an option granted to Robert O. Carr. Each of Scott L. Bok and Robert H. Niehaus disclaims beneficial ownership of these shares except to extent of each of their pecuniary interest therein.

- (2) Beneficial ownership consists of 4,729,296 shares of common stock held by LLR Equity Partners, L.P. and 479,956 shares of common stock held by LLR Equity Partners Parallel, L.P. By virtue of his position as a Partner of LLR Capital, L.P., which is the General Partner of LLR Equity Partners and its affiliated investment funds, Mr. Hollin may be deemed to beneficially own these shares. Beneficial ownership includes 750,000 shares of common stock that are subject to an option granted to Robert O. Carr.
- (3) Beneficial ownership consists of 8,143,488 shares of common stock held by Carr Holdings, L.L.C., a New Jersey limited liability company owned and managed by Robert O. Carr and Jill Carr, Mr. Carr's wife; 400,000 shares of common stock held by The Robert O. Carr 2001 Charitable Remainder Unitrust; 10,780 shares of common stock held by The Robert O. Carr 2000 Irrevocable Trust for Emily Carr; 10,780 shares of common stock held by The Robert O. Carr 2000 Irrevocable Trust for Ryan Carr; 10,780 shares of common stock held by The Robert O. Carr 2000 Irrevocable Trust for Kelly Carr; 8,086 shares of common stock held by The Robert O. Carr 2003 Grantor Retained Annuity Trust; 8,086 shares of common stock held by The Jill A Carr 2003 Grantor Retained Annuity Trust; options to purchase 350,000 shares of common stock under our 2000 Equity Incentive Plan; and an option from Greenhill Capital Partners, L.P. and its affiliated funds and LLR Equity Partners, L.P. and its affiliated investment fund, to purchase up to 2,000,000 shares of common stock.
- (4) Beneficial ownership consists of 333,476 shares of common stock held by Mr. Baldwin, 138,524 shares of common stock held by Margaret J. Sieck and Whitney H. Baldwin as Trustees for an Indenture created June 30, 2004 and options to purchase 467,500 shares of common stock under our 2000 Equity Incentive Plan.
- (5) Beneficial ownership consists of 400,000 shares of common stock held by the MCMJH Limited Partnership, an Arizona Limited Partnership of which Michael C. Hammer is the Managing Partner and options to purchase 124,500 shares of common stock under our 2000 Equity Incentive Plan.
- (6) Beneficial ownership consists of 550,000 shares of common stock held by the B. Terrell Limited Partnership, a Texas limited partnership of which Brooks L. Terrell is the general partner; and options to purchase 124,500 shares of common stock under our 2000 Equity Incentive Plan.
- (7) Beneficial ownership consists of 50,000 shares of common stock held by Mr. Morris and his wife, Lisa T. Morris, jointly; options to purchase 26,820 shares of common stock under our 2000 Equity Incentive Plan.
- (8) Beneficial ownership consists of 40,000 shares of common stock held by Mr. Sheridan; options to purchase 80,000 shares of common stock under our 2000 Equity Incentive Plan; and an option from Carr Holdings, L.L.C. to purchase 40,000 shares of common stock.
- (9) Beneficial ownership consists of options to purchase 30,000 shares of common stock under our 2000 Equity Incentive Plan.
- (10) Beneficial ownership consists of options to purchase 20,000 shares of common stock under our 2000 Equity Incentive Plan.
- (11) Beneficial ownership consists of options to purchase 20,000 shares of common stock under our 2000 Equity Incentive Plan.
- (12) Includes options to purchase an aggregate of 1,243,320 shares of common stock exercisable within 60 days of July 31, 2005 under our 2000 Equity Incentive Plan.

SELLING STOCKHOLDERS

The following table presents certain information regarding the beneficial ownership of our common stock outstanding as of July 15, 2005 to be sold in this offering by the selling stockholders. Please see "Related Party Transactions" for a description of the material transactions between us and the selling stockholders.

Name of Beneficial Owner	Shares Beneficially Owned Prior to this Offering(1)		Shares Being Sold in the Offering	Shares Beneficially Owned After the Offering		Maximum Number of Shares Being Sold in the Over-Allotment Option, if Any	Shares Beneficially Owned After the Offering if the Underwriters' Over-Allotment Option is Exercised in Full	
	Number	Percentage		Number	Percentage		Number	Percentage
Greenhill Capital Partners, L.P.(2)(3)(4)(15)	5,285,438	17.7%	1,224,602	4,060,836	12.5%	183,690	3,877,146	11.9%
Greenhill Capital Partners (Executives), L.P.(2)(3)(4)(15)	853,228	2.9%	197,688	655,540	2.0%	29,653	625,887	1.9%
Greenhill Capital Partners (Cayman), L.P.(2)(3)(4)(15)	881,336	3.0%	204,200	677,136	2.1%	30,630	646,506	2.0%
Greenhill Capital, L.P.(2)(3)(4)(15)	1,612,082	5.4%	373,510	1,238,572	3.8%	56,027	1,182,545	3.6%
Carr Holdings, L.L.C.(5)(6)	8,143,488	27.3%	126,000	8,017,488	24.7%	200,000	7,817,488	24.0%
Alan M. Atkins(5)	940,000	3.2%	660,000	280,000	*	186,000	94,000	*
Donnie E. Lassiter(5)	620,000	2.1%	240,000	380,000	1.2%	66,500	313,500	1.0%
Linda Vann Lassiter(5)	650,000	2.2%	250,000	400,000	1.2%	70,300	329,700	1.0%
Thomas White, Trustee of the Lassiter Trust, f/b/o Sara Lynn Lassiter u/a/o July 20, 2000(5)	250,000	*	100,000	150,000	*	26,600	123,400	*
Thomas White, Trustee of the Lassiter Trust, f/b/o Trenton Vann Lassiter u/a/o July 20, 2000(5)	250,000	*	100,000	150,000	*	26,600	123,400	*
Wes Williams(5)(10)	75,000	*	67,500	7,500	*		7,500	*
Donald L. Nighswonger and Susan K. Nighswonger, Joint Tenants with Rights of Survivorship(5)(10)(11)	89,200	*	22,000	67,200	*		67,200	*
Jeff Nichols and Corrie Nichols, Jointly(5)(10)	64,420	*	35,134	29,286	*		29,286	*
Joan M. Herman(5)(10)	28,970	*	20,000	8,970	*		8,970	*
Denise A. Miller(5)(10)	29,416	*	20,000	9,416	*		9,416	*
Rayanne E. Welsch(5)(7)	148,862	*	20,000	128,862	*		128,862	*
Elizabeth A. Swartout(7)(8)	177,562	*	60,000	117,562	*		117,562	*
Amy L. Welsch(7)(8)	177,562	*	60,000	117,562	*		117,562	*
Gregory M. Welsch(7)(8)	264,334	*	60,000	204,334	*		204,334	*
Martin J. Uhle(9)(10)(11)	406,400	1.4%	200,000	206,400	*		206,400	*
California Restaurant Association(12)(13)	90,000	*	45,000	45,000	*		45,000	*
Kenneth or Jill Moss(10)	89,334	*	20,000	69,334	*		69,334	*
Judy Altenburg(10)(11)(14)	486,468	1.6%	10,320	476,148	1.5%		476,148	1.5%
Richard Ross(10)(14)	164,514	*	6,000	158,514	*		158,514	*
Brett Sturm(10)(14)	159,682	*	6,000	153,682	*		153,682	*

* Less than 1% of the outstanding stock.

(1) Beneficial ownership is adjusted to treat as outstanding all options held by that stockholder and exercisable within 60 days of July 15, 2005.

(2)

Each of the selling stockholders acquired such selling stockholder's beneficial ownership of the shares of common stock offered by this prospectus and some or all of the other shares of common stock beneficially owned by such selling stockholder by conversion of the Series A Senior Convertible Participating Preferred Stock, par value \$0.01, which each selling stockholder received in our October 11, 2001 sale of 13,333,334 shares of Series A Senior Convertible Participating Preferred Stock. Such issuance of the Series A Senior Convertible Participating Preferred Stock was exempt from registration pursuant to Section 4(2) of the Securities Act.

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- (3) Each of the selling stockholders acquired such selling stockholder's beneficial ownership of the shares of common stock offered by this prospectus and some or all of the other shares of common stock beneficially owned by such selling stockholder pursuant to the sales of our common stock by Carr Holdings, L.L.C. on March 21, 2003 and November 17, 2004.
- (4) Scott L. Bok, Robert F. Greenhill and Robert H. Niehaus may be deemed to have investment or voting power over the shares held by each entity.
- (5) Each of the selling stockholders acquired such selling stockholder's beneficial ownership of the shares of common stock offered by this prospectus and some or all of the other shares of common stock beneficially owned by such selling stockholder pursuant to an exchange of such selling stockholder's limited liability company membership interests of Triad, L.L.C., a New Jersey limited liability company, for our common stock pursuant to an agreement and plan of merger between us and Triad dated September 30, 2000, pursuant to which Triad was merged into us upon the filing of the certificates of merger with the states of Delaware and New Jersey on October 3, 2000 and October 2, 2000, respectively. Each outstanding limited liability company membership interest of Triad was converted into 2,000 shares of our common stock.
- (6) Robert O. Carr and Jill Carr may be deemed to have investment or voting power over the shares held by Carr Holdings, L.L.C.
- (7) Rayanne E. Welsch, Elizabeth A. Swartout, Amy L. Welsch and Gregory M. Welsch acquired beneficial ownership of the shares of common stock offered by this prospectus and some or all of the other shares of common stock beneficially owned by such selling stockholder pursuant to transfers from Welsch Holdings, LLC. Welsch Holdings, LLC acquired beneficial ownership of our common stock pursuant to the merger of Triad into us as described in Note (5) above.
- (8) Elizabeth A. Swartout, Amy L. Welsch and Gregory M. Welsch acquired beneficial ownership of the shares of common stock offered by this prospectus and some or all of the other shares of common stock beneficially owned by such selling stockholder pursuant to an asset purchase sale effective on March 31, 2002. In exchange for the assets we purchased from Welsch Financial Merchant Services, Inc., a Pennsylvania corporation, we issued shares of our common stock to Elizabeth A. Swartout, Amy L. Welsch and Gregory M. Welsch, each a shareholder of Welsch Financial Merchant Services at the time. Such selling stockholders also received additional shares of our common stock in April 2003 pursuant to an earnout provision associated with the asset sale.
- (9) Martin J. Uhle acquired his beneficial ownership of the shares of common stock offered by this prospectus and some or all of the other shares of common stock beneficially owned by him pursuant to an exchange of his limited liability company membership interest of Uhle and Associates, L.L.C., an Ohio limited liability company, for our common stock pursuant to an agreement and plan of merger between us and Uhle and Associates dated September 29, 2000, pursuant to which Uhle and Associates was merged into us upon the filing of the certificates of merger with the states of Delaware and Ohio on October 3, 2000 and September 29, 2000, respectively. Each outstanding limited liability company membership interest of Uhle and Associates was converted into 73.4 shares of our common stock.
- (10) Each of the selling stockholders acquired such selling stockholder's beneficial ownership of the shares of common stock offered by this prospectus and some or all of the other shares of common stock beneficially owned by such selling stockholder in October 2000 pursuant to a grant of our common stock under our 2000 Equity Incentive Plan.
- (11) Each of the selling stockholders acquired such selling stockholder's beneficial ownership of the shares of common stock offered by this prospectus and some or all of the other shares of common stock beneficially owned by such selling stockholder pursuant to an exercise of stock option grants under our 2000 Equity Incentive Plan.
- (12) The California Restaurant Association, a California non-profit corporation, acquired beneficial ownership of the shares of common stock offered by this prospectus and some or all of the other shares of common stock beneficially owned by such selling stockholder pursuant to an issuance by us on December 19, 2003, pursuant to which the California Restaurant Association purchased 90,000 shares of our common stock at \$6.25 per share. The shares issued by us to the California Restaurant Association were redeemed by us from other stockholders. Such issuance was exempt from registration pursuant to Section 4(2) of the Securities Act.
- (13) The members of the California Restaurant Association Board of Directors may be deemed to have investment or voting power over the shares held by the California Restaurant Association.
- (14) Each of the selling stockholders acquired such selling stockholder's beneficial ownership of the shares of common stock offered by this prospectus and some or all of the other shares of common stock beneficially owned by such selling stockholder from us in exchange for such selling stockholders giving up rights to a portion of their commissions.
- (15) Each of Greenhill Capital Partners, L.P. and its affiliated investment funds is an affiliate of a registered broker-dealer and has informed us that:

it purchased the securities in the ordinary course of business, and

at the time the securities were purchased, it had no agreements or understandings, directly or indirectly, with us or any of our affiliates or any person acting on our behalf or on behalf of any of our affiliates to distribute the securities.

DESCRIPTION OF CAPITAL STOCK

The following description of our capital stock does not purport to be complete and is subject to, and qualified in its entirety by, our amended and restated certificate of incorporation and amended and restated bylaws, which we have included as exhibits to the registration statement of which this prospectus forms a part.

Authorized Capitalization

At the closing of this offering, our capital structure will consist of 100,000,000 authorized shares of common stock and 10,000,000 shares of undesignated preferred stock. Immediately following the completion of this offering, an aggregate of 32,406,460 shares of common stock will be issued and outstanding and no shares of preferred stock will be issued and outstanding.

Common Stock

The holders of our common stock are entitled to one vote per share on any matter to be voted upon by stockholders. The holders of our common stock are entitled to dividends as our board of directors may declare from time to time from legally available funds subject to the preferential rights of the holders of any shares of our preferred stock that we may issue in the future.

Our amended and restated certificate of incorporation does not provide for cumulative voting in connection with the election of directors. Accordingly, directors will be elected by a plurality of the shares voting once a quorum is present. No holder of our common stock will have any preemptive right to subscribe for any shares of capital stock issued in the future.

Upon any voluntary or involuntary liquidation, dissolution or winding up of our affairs, the holders of our common stock are entitled to share, on a pro rata basis, all assets remaining after payment to creditors and subject to prior distribution rights of any shares of preferred stock that we may issue in the future. All of the outstanding shares of common stock are, and the shares offered by us in this offering will be, fully paid and non-assessable.

Preferred Stock

7,619,048 shares of our convertible participating preferred stock will be automatically converted into 13,333,334 shares of our common stock upon completion of this offering, assuming an initial public offering price of \$15.00 per share, the midpoint of the range on the cover of this prospectus. Consequently, as of the closing of this offering, no shares of our preferred stock will be outstanding. Under our amended and restated certificate of incorporation, our board of directors, without any further action by our stockholders, is authorized to issue shares of preferred stock in one or more classes or series. The board may fix the rights, preferences and privileges of the preferred stock, along with any limitations or restrictions, including voting rights, dividend rights, conversion rights, redemption privileges and liquidation preferences of each class or series of preferred stock. The preferred stock could have voting or conversion rights that could adversely affect the voting power or other rights of holders of our common stock. The issuance of preferred stock could also have the effect, under certain circumstances, of delaying, deferring or preventing a change of control of our company. We currently have no plans to issue any shares of preferred stock.

Registration Rights

We have entered into a shareholders' agreement with the holders of our convertible redeemable preferred stock and some of the holders of our common stock. Immediately following this offering, the holders of approximately 30,485,160 shares of common stock, including shares to be issued upon the automatic conversion of the convertible participating preferred stock upon completion of this offering,

will be entitled to registration rights with respect to their shares. Any group of holders of at least 10% of the securities with registration rights can require us to register all or part of their shares at any time following six months after this offering, so long as the thresholds in the shareholders' agreement are met with respect to the amount of securities to be sold. After we have completed four such registrations we are no longer subject to these demand registration rights. In addition, the holders of securities with registration rights may also require us to include their shares in future registration statements that we file, subject to reduction at the option of the underwriters of such an offering. Upon any of these registrations, these shares will be freely tradable in the public market without restriction. We are obligated under the shareholders' agreement to pay the registration expenses incurred in connection with any registration, qualification or compliance relating to the exercise of a holder's registration rights. Additionally, we have agreed to indemnify and hold harmless holders (and their affiliates) of registrable securities covered by a registration statement against certain liabilities, including liabilities under the Securities Act of 1933, or to contribute to payments the holders (or their affiliates) may be required to make because of any of those liabilities.

Voting Agreement

On March 21, 2003, we entered into letter agreement with Carr Holdings, LLC, LLR Equity Partners, L.P., LLR Equity Partners Parallel, L.P., Greenhill Capital Partners, L.P., Greenhill Capital Partners (Cayman), L.P., Greenhill Capital Partners, (Executives), L.P. and Greenhill Capital, L.P. Pursuant to such agreement, Carr Holdings, LLC agreed to sell an aggregate of 370,000 common shares to LLR Equity Partners, L.P., LLR Equity Partners Parallel, L.P., Greenhill Capital Partners, L.P., Greenhill Capital Partners (Cayman), L.P., Greenhill Capital Partners, (Executives), L.P. and Greenhill Capital, L.P. In connection with such sale, each buyer agreed either (i) not to vote any of the shares purchased by it in connection with any designation of directors under the Amended and Restated Shareholders' Agreement dated October 11, 2001, or (ii) to vote the shares purchased by it in favor of the directors designated by holders of a majority of our issued and outstanding shares of common stock, in each case for so long as Carr Holdings, LLC, The Robert O. Carr 2001 Charitable Remainder Unitrust and each of their respective permitted transferees own, in the aggregate, more than 50% of our issued and outstanding common stock.

Warrants

As of March 31, 2005, we had outstanding warrants to purchase 168,904 shares of our common stock at a price of \$0.005 per share, which expire on July 25, 2006.

Anti-Takeover Effects Of Certain Provisions Of Delaware Law And Our Amended And Restated Certificate Of Incorporation And Bylaws

Effect of Delaware Anti-Takeover Statute

We are subject to Section 203 of the Delaware General Corporation Law, an anti-takeover law. In general, Section 203 prohibits a Delaware corporation from engaging in any business combination with any interested stockholder for a period of three years following the date that the stockholder became an interested stockholder, unless:

prior to that date, the board of directors of the corporation approved either the business combination or the transaction that resulted in the stockholder becoming an interested stockholder;

upon consummation of the transaction that resulted in the stockholder becoming an interested stockholder, the interested stockholder owned at least 85% of the voting stock of the corporation outstanding at the time the transaction commenced, excluding for purposes of determining the number of shares outstanding those shares owned by persons who are directors

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and also officers and by excluding employee stock plans in which employee participants do not have the right to determine confidentially whether shares held subject to the plan will be tendered in a tender or exchange offer; or

on or subsequent to that date, the business combination is approved by the board of directors of the corporation and authorized at an annual or special meeting of stockholders, and not by written consent, by the affirmative vote of at least $66\frac{2}{3}\%$ of the outstanding voting stock that is not owned by the interested stockholder.

Section 203 defines "business combination" to include the following:

any merger or consolidation involving the corporation and the interested stockholder;

any sale, transfer, pledge or other disposition of 10% or more of the assets of the corporation involving the interested stockholder;

subject to certain exceptions, any transaction that results in the issuance or transfer by the corporation of any stock of the corporation to the interested stockholder;

any transaction involving the corporation that has the effect of increasing the proportionate share of the stock of any class or series of the corporation beneficially owned by the interested stockholder; or

the receipt by the interested stockholder of the benefit of any loans, advances, guarantees, pledges or other financial benefits provided by or through the corporation.

In general, Section 203 defines an interested stockholder as an entity or person beneficially owning 15% or more of the outstanding voting stock of the corporation and any entity or person affiliated with or controlling or controlled by any of these entities or persons.

Amended and Restated Certificate of Incorporation and Bylaw Provisions

Our amended and restated certificate of incorporation and bylaws include provisions that may have the effect of discouraging, delaying or preventing a change in control or an unsolicited acquisition proposal that a stockholder might consider favorable, including a proposal that might result in the payment of a premium over the market price for the shares held by stockholders.

Supermajority Voting

Our amended and restated certification of incorporation requires the approval of the holders of at least $66\frac{2}{3}\%$ of our combined voting power to effect certain amendments to our amended and restated certificate of incorporation. Our bylaws may be amended by either a majority of the board of directors, or the holders of $66\frac{2}{3}\%$ of our voting stock. Holders of $66\frac{2}{3}\%$ of our voting stock may remove, for cause, any director or the entire board of directors.

Authorized but Unissued or Undesignated Capital Stock

At the closing of this offering, our authorized capital stock will consist of 100,000,000 shares of common stock and 10,000,000 shares of preferred stock. No preferred stock will be designated upon the closing of this offering. After this offering, we will have outstanding 32,406,460 shares of common stock. The authorized but unissued (and in the case of preferred stock, undesignated) stock may be issued by the board of directors in one or more transactions. In this regard, our amended and restated certificate of incorporation grants the board of directors broad power to establish the rights and preferences of authorized, unissued and undesignated preferred stock. The issuance and designation of shares of preferred stock pursuant to the board of directors' authority described above could decrease the amount of earnings and assets available for distribution to holders of common stock and adversely

affect the rights and powers, including voting rights, of such holders and may have the effect of delaying, deferring or preventing a change in control. The board of directors does not currently intend to seek stockholder approval prior to any issuance of preferred stock, unless otherwise required by law.

Special Meetings of Stockholders

Our bylaws provide that special meetings of our stockholders may be called only by our Chairman of the board of directors or by our Chief Executive Officer.

No Stockholder Action by Written Consent

Our amended and restated certificate of incorporation and bylaws provide that an action required or permitted to be taken at any annual or special meeting of our stockholders may only be taken at a duly called annual or special meeting of stockholders. This provision prevents stockholders from initiating or effecting any action by written consent, and thereby taking actions opposed by the board.

Notice Procedures

Our bylaws establish advance notice procedures with regard to all stockholder proposals to be brought before meetings of our stockholders, including proposals relating to the nomination of candidates for election as directors, the removal of directors and amendments to our amended and restated certificate of incorporation or bylaws. These procedures provide that notice of such stockholder proposals must be received in writing by our Secretary not less than 150 days prior to the meeting. The notice must include a brief description of the business desired to be brought before the meeting, the name and address of the stockholder proposing such business and the class and number of shares owned by such stockholder.

Limitation of Director Liability

Our amended and restated certificate of incorporation limits the liability of our directors (in their capacity as directors but not in their capacity as officers) to us or our stockholders to the fullest extent permitted by Delaware law. Specifically, our directors will not be personally liable for monetary damages for breach of a director's fiduciary duty as a director, except for liability:

for any breach of the director's duty of loyalty to us or our stockholders;

for acts or omissions not in good faith or which involve intentional misconduct or a knowing violation of law;

under Section 174 of the Delaware General Corporation Law, which relates to unlawful payments of dividends or unlawful stock repurchases or redemptions; or

for any transaction from which the director derived an improper personal benefit.

Indemnification Arrangements

Our bylaws provide that our directors and officers shall be indemnified and provide for the advancement to them of expenses in connection with actual or threatened proceedings and claims arising out of their status as such to the fullest extent permitted by the Delaware General Corporation Law. We have entered into indemnification agreements with each of our directors and executive officers that provide them with rights to indemnification and expense advancement to the fullest extent permitted under the Delaware General Corporation Law.

Listing

We have applied to have our common stock included for quotation on the New York Stock Exchange under the symbol "HPY."

Transfer Agent And Registrar

The transfer agent and registrar for our common stock is Registrar and Transfer Company.

SHARES ELIGIBLE FOR FUTURE SALE

Prior to this offering, there has been no public market for our common stock, and we cannot predict the effect, if any, that market sales of shares of our common stock or the availability of shares of our common stock for sale will have on the market price of our common stock prevailing from time to time. Nevertheless, sales of substantial amounts of our common stock in the public market could adversely affect the market price of our common stock and could impair our future ability to raise capital through the sale of our equity securities.

Upon completion of this offering, we will have 32,406,460 shares of common stock outstanding, assuming no exercise of the underwriters' over-allotment option. The number of shares of common stock to be outstanding after this offering is based on the number of shares outstanding as of March 31, 2005, and excludes 12,400,000 shares of our common stock authorized for issuance under our stock option plans, of which 9,261,002 shares were subject to outstanding options as of March 31, 2005, at a weighted average exercise price of \$6.43 per share.

Of the outstanding shares, the 7,762,500 shares sold in this offering, any shares issued upon exercise of the underwriters' over-allotment option, shares eligible for sale under Rule 144(k) and shares eligible for sale pursuant to our registration statement on Form S-8 will be freely tradable without restriction under the Securities Act, except that any shares held by our "affiliates," as that term is defined in Rule 144 promulgated under the Securities Act, may only be sold in compliance with the limitations described below. The remaining shares are "restricted securities" as defined under Rule 144. Restricted shares may be sold in the public market only if registered or if they qualify for a resale under Rules 144, 144(k) or 701 promulgated under the Securities Act, which rules are summarized below. Subject to the lock-up agreements described below and the provisions of Rules 144, 144(k) and 701 and our registration statement on Form S-8, additional shares will be available for sale in the public market as follows:

Number of Shares

Date

On September 25, 2005, 90 days after our registration statement on Form 10 became effective, these shares will be freely tradeable under Rules 144 and 701. After 180 days from the date of this prospectus (or earlier with Citigroup's consent), the lock-up will be released and these shares will be freely tradable under Rule 144 (subject, in some cases to volume limitations), Rule 144(k) or Rule 701. After 180 days from the date of this prospectus, these restricted securities will have been held for less than one year and will not yet be available for resale under Rule 144.

Rule 144

In general, under Rule 144, as currently in effect, beginning on September 25, 2005, a person who has beneficially owned shares of our common stock for at least one year would be entitled to sell those shares. Persons who have owned shares of our common stock for at least one year prior to the proposed sale would be entitled to sell, within any three-month period, a number of shares that does not exceed the greater of:

1% of the number of shares of common stock then outstanding, which will equal approximately 324,065 shares immediately after this offering; or

the average weekly trading volume of the common stock on the New York Stock Exchange during the four calendar weeks preceding the filing of a notice on Form 144 with respect to that sale.

Rule 144(k)

Under Rule 144(k), a person who is not deemed to have been one of our "affiliates" at any time during the 90 days preceding a sale, and who has beneficially owned the shares proposed to be sold for at least two years, generally including the holding period of any prior owner other than an "affiliate," is entitled to sell such shares without complying with the manner of sale, notice filing, volume limitation or notice provisions of Rule 144.

Rule 701

In general, under Rule 701, any of our employees, directors, officers, consultants or advisors who purchased shares from us in connection with a compensatory stock or option plan or other written agreement in a transaction that was completed in reliance on Rule 701 and complied with the requirements of Rule 701 is eligible to resell those shares beginning on September 25, 2005 in reliance on Rule 144, without having to comply with certain restrictions, including the holding period, contained in Rule 144.

Stock Options

As of March 31, 2005, options to purchase a total of 9,261,002 shares of common stock were outstanding, of which 7,524,904 are currently exercisable. We intend to file a Form S-8 registration statement under the Securities Act to register all shares of common stock issued or issuable under our stock option plans. Accordingly, shares of common stock underlying these options will be eligible for sale in the public markets, subject to vesting restrictions or the lock-up agreements described below. See "Management Employee Benefit Plans."

Lock-up Agreements

We, each of our officers and directors and holders of substantially all of our common stock, including any securities convertible into or exchangeable or exercisable for or repayable with common stock, and preferred stock have agreed, with certain limited exceptions, not to sell or otherwise dispose of any shares of our common stock or options to acquire shares of our common stock or take any action to do any of the foregoing during the 180-day period following the date of this prospectus except for shares of common stock sold in this offering by us and the selling stockholders. Citigroup may, in its sole discretion and at any time without notice, release all or any portion of the securities subject to lock-up agreements. See "Underwriting."

Registration Rights

Following this offering, under specified circumstances and subject to customary conditions, holders of approximately 30,485,160 shares of our outstanding common stock, including shares to be issued upon the automatic conversion of the convertible participating preferred stock immediately upon completion of this offering, will have demand and piggyback registration rights with respect to their shares of common stock, subject to the 180-day lock-up arrangement described above, to require us to register their shares of common stock under the Securities Act, and rights to participate in any future registrations of securities. If the holders of these registrable securities request that we register their shares, and if the registration is effected, these shares will become freely tradable without restriction under the Securities Act. Any sales of securities by these stockholders could have a material adverse effect on the trading price of our common stock. See "Description of Capital Stock Registration Rights."

UNDERWRITING

Citigroup Global Markets Inc. together with Credit Suisse First Boston LLC, Robert W. Baird & Co. Incorporated, William Blair & Company, L.L.C., KeyBanc Capital Markets, a division of McDonald Investments Inc. and SunTrust Capital Markets, Inc. are acting as representatives of the underwriters named below. Subject to the terms and conditions stated in the underwriting agreement dated the date of this prospectus, each underwriter named below has agreed to purchase, and we and the selling stockholders have agreed to sell to that underwriter, the number of shares set forth opposite the underwriter's name.

Underwriter	Number of Shares
Citigroup Global Markets Inc.	
Credit Suisse First Boston LLC	
Robert W. Baird & Co. Incorporated	
William Blair & Company, L.L.C.	
KeyBanc Capital Markets, a division of McDonald Investments Inc.	
SunTrust Capital Markets, Inc.	
Total	6,750,000

The underwriting agreement provides that the obligations of the underwriters to purchase the shares included in this offering are subject to approval of legal matters by counsel and to other conditions. The underwriters are obligated to purchase all the shares (other than those covered by the over-allotment option described below) if they purchase any of the shares.

The underwriters propose to offer some of the shares directly to the public at the public offering price set forth on the cover page of this prospectus and some of the shares to dealers at the public offering price less a concession not to exceed \$ per share. The underwriters may allow, and dealers may reallow, a concession not to exceed \$ per share on sales to other dealers. If all of the shares are not sold at the initial offering price, the representatives may change the public offering price and the other selling terms. The representatives have advised us and the selling stockholders that the underwriters do not intend sales to discretionary accounts to exceed five percent of the total number of shares of our common stock offered by them.

We and the selling stockholders have granted to the underwriters an option, exercisable for 30 days from the date of this prospectus, to purchase up to 1,012,500 additional shares of common stock at the public offering price less the underwriting discount. The underwriters may exercise the option solely for the purpose of covering over-allotments, if any, in connection with this offering. To the extent the option is exercised, each underwriter must purchase a number of additional shares approximately proportionate to that underwriter's initial purchase commitment.

We, our officers and directors, the selling stockholders and our other stockholders, have agreed that, for a period of 180 days from the date of this prospectus, we and they will not, with certain limited exceptions, without the prior written consent of Citigroup, dispose of or hedge any shares of our common stock or any securities convertible into or exchangeable for our common stock except for shares of common stock sold in this offering by us and the selling stockholders. Citigroup in its sole discretion may release any of the securities subject to these lock-up agreements at any time without notice.

At our request, the underwriters have reserved up to 5% of the shares of common stock for sale at the initial public offering price to persons who are directors, officers or employees, or who are otherwise associated with us through a directed share program. The number of shares of common stock available for sale to the general public will be reduced by the number of directed shares purchased by participants in the program. Any directed shares not purchased will be offered by the underwriters to the general public on

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the same basis as all other shares of common stock offered. The directed share program materials will include a lock-up agreement requiring each purchaser in the directed share program to agree that for the period of 25 days from the date of this prospectus, such purchasers will not, without prior written consent of Citigroup, dispose of or hedge any shares of our common stock purchased in the directed share program, except for our officers and directors who have agreed that, for a period of 180 days from the date of this prospectus, they will not dispose of or hedge any shares of our common stock purchased in the directed share program. The purchasers in the directed share program will be subject to substantially the same form of lock-up agreement as our officers, directors, the selling stockholders and our other stockholders. We have agreed to indemnify the underwriters against certain liabilities and expenses, including liabilities under the Securities Act, in connection with the sales of the directed shares.

Each underwriter has represented, warranted and agreed that:

it has not offered or sold and, prior to the expiry of a period of six months from the closing date, will not offer or sell any shares included in this offering to persons in the United Kingdom except to persons whose ordinary activities involve them in acquiring, holding, managing or disposing of investments (as principal or agent) for the purposes of their businesses or otherwise in circumstances which have not resulted and will not result in an offer to the public in the United Kingdom within the meaning of the Public Offers of Securities Regulations 1995;

it has only communicated and caused to be communicated and will only communicate or cause to be communicated any invitation or inducement to engage in investment activity (within the meaning of section 21 of the Financial Services and Markets Act 2000, or FSMA), received by it in connection with the issue or sale of any shares included in this offering in circumstances in which section 21(1) of the FSMA does not apply to us;

it has complied and will comply with all applicable provisions of the FSMA with respect to anything done by it in relation to the shares included in this offering in, from or otherwise involving the United Kingdom; and

the offer in The Netherlands of the shares included in this offering is exclusively limited to persons who trade or invest in securities in the conduct of a profession or business (which include banks, stockbrokers, insurance companies, pension funds, other institutional investors and finance companies and treasury departments of large enterprises).

Prior to this offering, there has been no public market for our common stock. Consequently, the initial public offering price for the shares will be determined by negotiations among us, the selling stockholders and the representatives. Among the factors to be considered in determining the initial public offering price will be our record of operations, our current financial condition, our future prospects, our markets, the economic conditions in and future prospects for the industry in which we compete, our management, and currently prevailing general conditions in the equity securities markets, including current market valuations of publicly traded companies considered comparable to our company. We cannot assure you, however, that the prices at which the shares will sell in the public market after this offering will not be lower than the initial public offering price or that an active trading market in our common stock will develop and continue after this offering.

We have applied to have our common stock listed on the New York Stock Exchange under the symbol "HPY".

The following table shows the underwriting discounts and commissions that we and the selling stockholders are to pay to the underwriters in connection with this offering. These amounts are shown assuming both no exercise and full exercise of the underwriters' option to purchase additional shares of common stock.

	Paid By Heartland		Paid by Selling Stockholders	
	No Exercise	Full Exercise	No Exercise	Full Exercise
Per share	\$ 1.05	\$ 1.05	\$ 1.05	\$ 1.05
Total	\$ 2,753,148	\$ 2,896,473	\$ 4,334,352	\$ 5,254,152

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In connection with the offering, Citigroup on behalf of the underwriters, may purchase and sell shares of common stock in the open market. These transactions may include short sales, syndicate covering transactions and stabilizing transactions. Short sales involve syndicate sales of common stock in excess of the number of shares to be purchased by the underwriters in the offering, which creates a syndicate short position. "Covered" short sales are sales of shares made in an amount up to the number of shares represented by the underwriters' over-allotment option. In determining the source of shares to close out the covered syndicate short position, the underwriters will consider, among other things, the price of shares available for purchase in the open market as compared to the price at which they may purchase shares through the overallotment option. Transactions to close out the covered syndicate short involve either purchases of the common stock in the open market after the distribution has been completed or the exercise of the over-allotment option. The underwriters may also make "naked" short sales of shares in excess of the over-allotment option. The underwriters must close out any naked short position by purchasing shares of common stock in the open market. A naked short position is more likely to be created if the underwriters are concerned that there may be downward pressure on the price of the shares in the open market after pricing that could adversely affect investors who purchase in the offering. Stabilizing transactions consist of bids for or purchases of shares in the open market while the offering is in progress.

The underwriters also may impose a penalty bid. Penalty bids permit the underwriters to reclaim a selling concession from a syndicate member when Citigroup repurchases shares originally sold by that syndicate member in order to cover syndicate short positions or make stabilizing purchases.

Any of these activities may have the effect of preventing or retarding a decline in the market price of the common stock. They may also cause the price of the common stock to be higher than the price that would otherwise exist in the open market in the absence of these transactions. The underwriters may conduct these transactions on the New York Stock Exchange or in the over-the-counter market, or otherwise. If the underwriters commence any of these transactions, they may discontinue them at any time.

We are responsible for paying all expenses incurred by the selling stockholders in connection with this offering. We estimate that our portion of the total expenses of this offering will be \$4.5 million.

In June 2005, Citigroup Global Markets Inc. made a \$1,000,000 personal loan to Robert O. Carr. The loan bears interest at a market rate and is secured by shares of our common stock owned by Mr. Carr. If Mr. Carr defaults on this loan, Citigroup Global Markets Inc. will have the right to sell into the market pledged shares with a value equal to the unpaid amounts due under the loan.

Citigroup performed advisory services for us in conjunction with the 1999 sale of a merchant portfolio, for which it received customary fees and expenses. In addition, KeyBank, an affiliate of KeyBanc Capital Markets, provides sponsorship into the MasterCard and Visa associations for us for a fee, and also makes credit lines available to us and makes interchange advances to our merchants, for which we pay the prime rate. None of the other underwriters have performed banking, investment banking or advisory services for us. The underwriters may, from time to time, engage in transactions with and perform services for us in the ordinary course of their business.

A prospectus in electronic format may be made available by one or more of the underwriters on a website maintained by i-Deal. The representatives may agree to allocate a number of shares to underwriters for sale to their online brokerage account holders. The representatives will allocate shares to underwriters that may make Internet distributions on the same basis as other allocations. In addition, shares may be sold by the underwriters to securities dealers who resell shares to online brokerage account holders.

We and the selling stockholders have agreed to indemnify the underwriters against certain liabilities, including liabilities under the Securities Act of 1933, or to contribute to payments the underwriters may be required to make because of any of those liabilities.

LEGAL MATTERS

The validity of the common stock offered hereby will be passed upon for us by Dorsey & Whitney LLP, New York, New York. Various legal matters relating to the offering will be passed upon for the underwriters by Cleary Gottlieb Steen & Hamilton LLP.

EXPERTS

The consolidated financial statements as of December 31, 2003 and 2004, and for each of the three years in the period ended December 31, 2004 included in this prospectus and included in this registration statement have been audited by Deloitte & Touche LLP, an independent registered public accounting firm, as stated in their report appearing herein and elsewhere in the registration statement (which report expresses an unqualified opinion and includes an explanatory paragraph referring to the restatement of the consolidated financial statements), and have been so included in reliance upon the report of such firm given upon their authority as experts in accounting and auditing.

WHERE YOU CAN FIND MORE INFORMATION

We have filed with the Securities and Exchange Commission, Washington, D.C., under the Securities Act, a registration statement on Form S-1 relating to the common stock we are offering. This prospectus does not contain all of the information included in the registration statement and its exhibits and schedules thereto. For further information with respect to us and the shares we are offering pursuant to this prospectus, you should refer to the registration statement and its exhibits and schedules. Statements contained in this prospectus as to the contents of any contract, agreement or other document referred to are not necessarily complete, and you should refer to the copy of that contract or other document filed as an exhibit to the registration statement. You may read or obtain a copy of the registration statement at the commission's public reference room at 450 Fifth Street, N.W., Washington, D.C. 20549. You may obtain information on the operation of the public reference room by calling the commission at 1-800-SEC-0330. The commission maintains a website that contains reports, proxy information statements and other information regarding registrants that file electronically with the commission. The address of this website is <http://www.sec.gov>.

Additionally, on April 28, 2005 we filed with the SEC a registration statement on Form 10 pursuant to Section 12(g) of the Securities Exchange Act of 1934. On June 27, 2005, this registration statement became effective and consequently we are subject to the information and periodic reporting requirements of the Securities Exchange Act of 1934, and, in accordance therewith, will file periodic reports, proxy statements and other information with the SEC. Such periodic reports, proxy statements and other information will be available for inspection and copying at the public reference room and web site of the SEC referred to above.

HEARTLAND PAYMENT SYSTEMS, INC. AND SUBSIDIARY

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REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

The accompanying consolidated financial statements of Heartland Payment Systems, Inc. and subsidiary (the "Company") have been adjusted to give effect to the two-for-one stock split of the common stock of Heartland Payment Systems, Inc., which is to be effected in connection with the Company's planned initial public offering. The following report is in the form which will be furnished by Deloitte & Touche LLP, an independent registered public accounting firm, upon consummation of such stock split, which is described in the second paragraph in Note 20 to the accompanying consolidated financial statements and assuming that no other events shall have occurred that would affect the accompanying consolidated financial statements or notes thereto.

REPORT OF INDEPENDENT REGISTERED PUBLIC ACCOUNTING FIRM

"To the Board of Directors and Stockholders of
Heartland Payment Systems, Inc.

We have audited the accompanying consolidated balance sheets of Heartland Payment Systems, Inc. and subsidiary (the "Company") as of December 31, 2003 and 2004, and the related consolidated statements of operations, changes in stockholders' (deficit) equity, and cash flows for each of the three years in the period ended December 31, 2004. These financial statements are the responsibility of the Company's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with the standards of the Public Company Accounting Oversight Board (United States of America). Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. The Company is not required to have, nor were we engaged to perform, an audit of its internal control over financial reporting. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Company's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for our opinion.

In our opinion, such consolidated financial statements present fairly, in all material respects, the financial position of the Company at December 31, 2003 and 2004, and the results of their operations and their cash flows for each of the three years in the period ended December 31, 2004 in conformity with accounting principles generally accepted in the United States of America.

As discussed in Note 21, the accompanying consolidated financial statements have been restated.

Princeton, New Jersey
March 28, 2005 (as
to the effects of the matters
described in Note 20; July 18, 2005
as to the restatement described in Note 21.)"

/s/ Deloitte & Touche LLP
Princeton, New Jersey

July 18, 2005

HEARTLAND PAYMENT SYSTEMS, INC. AND SUBSIDIARY

CONSOLIDATED BALANCE SHEETS

(In thousands, except share data)

	December 31,		March 31,
	2003	2004	2005
	(As Restated See Note 21)	(As Restated See Note 21)	(As Restated See Note 21) (unaudited)
Assets			
Current assets			
Cash and cash equivalents	\$ 13,004	\$ 13,237	\$ 12,706
Receivables	44,934	64,325	64,664
Investments	1,354	1,100	1,340
Inventory	966	818	362
Prepaid expenses	611	2,151	2,989
Current deferred tax assets, net	3,684	2,129	2,179
Total current assets	64,553	83,760	84,240
Capitalized customer acquisition costs, net	22,321	34,247	35,586
Deferred tax assets, net	7,783	4,651	4,488
Property and equipment, net	5,499	10,944	11,827
Deposits and other assets	586	324	251
Total assets	\$ 100,742	\$ 133,926	\$ 136,392
Liabilities and stockholders' (deficit) equity			
Current liabilities			
Due to sponsor bank	\$ 34,225	\$ 45,153	\$ 45,465
Accounts payable	17,923	27,103	26,891
Current portion of accrued buyout liability	17,985	9,327	10,258
Merchant deposits and loss reserves	4,761	7,175	8,145
Accrued expenses and other	5,685	6,701	5,932
Current portion of borrowings and financing arrangement	3,654	5,286	5,227
Total current liabilities	84,233	100,745	101,918
Long-term portion of borrowings and financing arrangements	12,312	7,808	7,324
Warrants with mandatory redemption provisions	2,111	1,566	1,655
Long-term portion of accrued buyout liability		17,708	16,665
Total liabilities	98,656	127,827	127,562
Commitments and contingencies (Note 15)			
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	43,401		
Stockholders' (deficit) 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

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	<u>December 31,</u>	<u>March 31,</u>	
Common Stock, \$.001 par value, 100,000,000 shares authorized, 16,019,196, 16,437,760 and 16,451,080 issued and outstanding in 2003, 2004 and at the period ending March 31, 2005, respectively	8	8	8
Warrants outstanding	1,500		
Additional paid-in capital	1,001	41,065	41,110
Accumulated other comprehensive income (loss)	3	(10)	(18)
Accumulated deficit	(43,827)	(34,972)	(32,278)
	<u>(41,315)</u>	<u>6,099</u>	<u>8,830</u>
Total liabilities and stockholders' (deficit) equity	<u>\$ 100,742</u>	<u>\$ 133,926</u>	<u>\$ 136,392</u>

See notes to consolidated financial statements.

HEARTLAND PAYMENT SYSTEMS, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF OPERATIONS

(In thousands, except per share data)

	Year Ended December 31,			Three Months Ended March 31,	
	2002	2003	2004	2004	2005
	(unaudited)				
	(As Restated See Note 21)	(As Restated See Note 21)	(As Restated See Note 21)	(As Restated See Note 21)	
Revenue:					
Gross processing revenue	\$ 330,975	\$ 414,715	\$ 595,524	\$ 119,202	\$ 166,172
Other revenue, net	9,607	7,522	7,225	2,002	3,693
Total net revenue	340,582	422,237	602,749	121,204	169,865
Costs of services:					
Interchange	242,407	302,057	438,738	86,372	122,416
Dues and assessments	12,616	15,945	23,348	4,785	6,415
Processing and servicing	44,224	50,805	70,232	14,748	19,820
Customer acquisition costs	12,422	13,380	18,908	4,135	5,841
Depreciation and amortization	1,587	2,571	3,912	876	1,283
Total costs of services	313,256	384,758	555,138	110,916	155,775
Selling and administrative	20,786	25,751	31,501	7,233	8,989
Total expenses	334,042	410,509	586,639	118,149	164,764
Income from operations	6,540	11,728	16,110	3,055	5,101
Other income (expense):					
Interest income	171	124	182	38	110
Interest expense	(1,182)	(1,188)	(1,385)	(298)	(435)
Fair value adjustment for warrants with mandatory redemption provisions	(509)	(893)	(509)		(90)
Other, net	(62)	(740)	833	833	(3)
Total other income (expense)	(1,582)	(2,697)	(879)	573	(418)
Income before income taxes	4,958	9,031	15,231	3,628	4,683
Provision for (benefit from) income taxes	51	(11,102)	6,376	1,482	1,989
Net income	\$ 4,907	\$ 20,133	\$ 8,855	\$ 2,146	\$ 2,694
Accretion of Series A Senior Convertible Participating Preferred Stock	(6,509)				

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	Year Ended December 31,		Three Months Ended March 31,	
Income allocated to Series A Senior Convertible Participating Preferred Stock	(9,843)	(4,263)	(1,037)	(1,295)
Net (loss) income attributable to Common Stock	\$ (1,602)	\$ 10,290	\$ 4,592	\$ 1,109
Net income	\$ 4,907	\$ 20,133	\$ 8,855	\$ 2,146
Other comprehensive income, net of tax:				
Unrealized gains (losses) on investments	17	(14)	(13)	7
Comprehensive income	\$ 4,924	\$ 20,119	\$ 8,842	\$ 2,153
Earnings (loss) per share:				
Basic	\$ (0.10)	\$ 0.65	\$ 0.28	\$ 0.07
Diluted	\$ (0.10)	\$ 0.62	\$ 0.26	\$ 0.07
Weighted average number of shares outstanding:				
Basic	15,642	15,932	16,408	16,296
Diluted	15,642	32,231	33,786	32,871

See notes to consolidated financial statements.

HEARTLAND PAYMENT SYSTEMS, INC. AND SUBSIDIARY
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS' (DEFICIT) EQUITY
(In thousands)

	Preferred Stock		Common Stock			Additional Paid-In Capital	Accumulated Other Comprehensive Income	Accumulated Deficit	Total
	Shares	Amount	Shares	Amount	Warrants				
Balance, January 1, 2002 as previously reported		\$	15,440	\$	8	\$	\$	(47,916)	\$ (46,408)
Adjustments to as previously reported								(15,193)	(15,193)
Balance, January 1, 2002 (as restated see note 21)		\$	15,440	\$	8	\$	\$	(63,109)	\$ (61,601)
Issuance of Common Stock for commission buyout			124			282			282
Issuance of Common Stock in connection with Welsch Financial Merchant Services, Inc. purchase			284			670			670
Repurchase of Common Stock			(96)			(201)			(201)
Accretion of Series A Senior Convertible Participating Preferred Stock						(751)		(5,758)	(6,509)
Accumulated other comprehensive income							17		17
Net income for the period (as restated see note 21)								4,907	4,907
Balance, December 31, 2002 (as restated see note 21)		\$	15,752	\$	8	\$	\$	17	\$ (63,960) \$ (62,435)
Issuance of Common Stock for earnout provisions		\$	267	\$		\$	\$		\$ 998
Issuance of Common Stock options exercised			2			11			11
Repurchase of Common Stock			(2)			(8)			(8)
Accumulated other comprehensive loss							(14)		(14)
Net income for the period (as restated see note 21)								20,133	20,133
Balance, December 31, 2003 (as restated see note 21)		\$	16,019	\$	8	\$	\$	3	\$ (43,827) \$ (41,315)
Reclassification of Series A Senior Convertible Participating Preferred Stock to stockholders' (deficit) equity	7,619	\$	8	\$		\$	\$		\$ 43,401
Issuance of Common Stock options exercised			554			1,584			1,584
Redemption of warrants issued in connection with Series A Senior Convertible Participating Preferred					(1,500)	(3,750)			(5,250)

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	Preferred Stock		Common Stock		Accumulated Other Comprehensive Income			
Stock								
Repurchase of Common Stock								
					(1,231)			(1,231)
Deferred compensation on accelerated vesting of options			(135)			68		68
Accumulated other comprehensive income							(13)	(13)
Net income for the period (as restated see note 21)							8,855	8,855
Balance, December 31, 2004 (as restated see note 21)	7,619	\$ 8	16,438	\$ 8	\$ 41,065	\$ (10)	(34,972)	\$ 6,099
Issuance of Common Stock options exercised (unaudited)			13		45			45
Accumulated other comprehensive income (unaudited)							(8)	(8)
Net income for the period (unaudited)							2,694	2,694
Balance, March 31, 2005 (unaudited)	7,619	\$ 8	16,451	\$ 8	\$ 41,110	\$ (18)	(32,278)	\$ 8,830

See notes to consolidated financial statements.

HEARTLAND PAYMENT SYSTEMS, INC. AND SUBSIDIARY

CONSOLIDATED STATEMENTS OF CASH FLOWS

(In thousands)

	Year Ended December 31,			Three Months Ended March 31,	
	2002	2003	2004	2004	2005
	(unaudited)				
	(As Restated See Note 21)	(As Restated See Note 21)	(As Restated See Note 21)	(As Restated See Note 21)	
Cash flows from operating activities:					
Net income	\$ 4,907	\$ 20,133	\$ 8,855	\$ 2,146	\$ 2,694
Adjustments to reconcile net income to net cash (used in) provided by operating activities:					
Depreciation and amortization	10,359	15,394	22,740	4,686	6,844
Fair value adjustment for warrants with mandatory redemption provisions	509	893	509		90
Deferred compensation charge on accelerated vesting of options			68		
(Gain) loss on disposal of property and equipment	(44)	64			
Deferred taxes		(11,467)	4,687	1,003	113
Changes in operating assets and liabilities:					
Increase in receivables	(6,029)	(11,499)	(19,391)	(4,144)	(338)
(Increase) decrease in inventory	(351)	349	147	106	456
Increase in capitalized customer acquisition costs	(13,068)	(19,911)	(30,739)	(6,142)	(6,924)
(Increase) decrease in prepaid expenses	(1,113)	254	(1,796)	(386)	(830)
Decrease in deposits and other assets	497	95	262	347	24
Increase in due to sponsor bank and accounts payable	6,190	11,115	20,108	5,101	100
Increase (decrease) in accrued expenses and other	1,621	1,591	1,013	612	(768)
(Decrease) increase in merchant deposits and loss reserves	(1,684)	(407)	2,414	177	970
Increase (decrease) in accrued buyout liability	1,182	5,433	9,050	1,710	(112)
Net cash provided by operating activities	2,976	12,037	17,927	5,216	2,319
Cash flows from investing activities:					
Purchase of investments	(1,631)	(310)	(120)	(250)	(250)
Maturities of investments	146	469	362	252	1
Purchases of property and equipment	(3,621)	(3,666)	(9,115)	(1,119)	(2,102)
Proceeds from disposal of property and equipment	45				
Net cash used in investing activities	(5,061)	(3,507)	(8,873)	(1,117)	(2,351)
Cash flows from financing activities:					
Redemption of warrants issued in connection with Series A Senior Convertible Participating Preferred Stock			(5,250)		
Redemption of warrants issued in connection with debt financing			(1,055)	(1,055)	
Proceeds from debt issuance	3,609	500			
Principal payments on borrowings and financing arrangements	(6,297)	(4,102)	(2,869)	(934)	(544)
Issuance of Common Stock		11	1,584	(37)	45
Repurchase of Common Stock	(201)	(8)	(1,231)		

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	Year Ended December 31,			Three Months Ended March 31,	
Net cash used in financing activities	(2,889)	(3,599)	(8,821)	(2,026)	(499)
Net increase (decrease) in cash	(4,974)	4,931	233	2,073	(531)
Cash and cash equivalents, beginning of period	13,047	8,073	13,004	13,004	13,237
Cash and cash equivalents, end of period	\$ 8,073	\$ 13,004	\$ 13,237	\$ 15,077	\$ 12,706
Supplemental cash flow information:					
Cash paid for interest	\$ 1,178	\$ 1,164	\$ 1,387	\$ 225	\$ 409
Cash paid for income taxes	43	116	851	273	801
Supplemental schedule of non cash activities:					
Accretion of Series A Senior Convertible Participating Preferred Stock	6,509				
Value of merchant contract conversions assigned to satisfy financing arrangement	2,196				
Stock issued to satisfy buyout and earnout liabilities	952	999			
Amortization of other assets	216	255	255	64	64

See notes to consolidated financial statements.

HEARTLAND PAYMENT SYSTEMS, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

1. ORGANIZATION AND OPERATIONS

The accompanying consolidated financial statements include those of Heartland Payment Systems, Inc. (the "Company") and its wholly-owned subsidiary, Heartland Payroll Company ("HPC"). All intercompany balances and transactions with the Company's wholly-owned subsidiary have been eliminated upon consolidation. 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.

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

As discussed in Note 20, 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 contemplated in connection with a proposed public offering of the Company's common stock during 2005.

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 financial statements, and the reported amounts of revenues and expenses during the reporting period. Estimates include 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 December 31, 2004, 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 15.3% of the Company's total processing volume in December 2004.

HEARTLAND PAYMENT SYSTEMS, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS --(Continued)

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 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

HEARTLAND PAYMENT SYSTEMS, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS --(Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES --(Continued)

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 December 31, 2004.

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. 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.

HEARTLAND PAYMENT SYSTEMS, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS --(Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES --(Continued)

For December 31, 2004 and March 31, 2005, 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. At December 31, 2003, the total accrued buyout liability is classified as current in accordance with ARB No. 43, which requires a liability to be classified as current if by its terms it is due on demand. At December 31, 2003, the Company's vested Relationship Managers and sales managers had the contractual right to sell their residual equity to the Company. This right was eliminated in May 2004.

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. The estimated fair value of options granted during 2002 and 2003 was \$0 and \$0, respectively, due to the Company's use of a 0% volatility factor as a private company. The fair value of options for the periods ended December 31, 2002, 2003 and 2004, and the three months ended March 31, 2004 and 2005 was estimated at the date of grant using a Black-Scholes option-pricing model with the following assumptions: weighted-average risk-free interest rate of 2.93%, 1.82%, 2.31%, 2.20% and 3.43%

HEARTLAND PAYMENT SYSTEMS, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS --(Continued)

2. SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES --(Continued)

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.

3. RECEIVABLES

A summary of receivables by major class are as follows at December 31, 2003 and 2004 and March 31, 2005:

	December 31,		March 31, 2005
	2003	2004	
	(In thousands)		(unaudited) (In thousands)
Accounts receivable from merchants	\$ 43,468	\$ 60,739	\$ 62,432
Accounts receivable from others	1,466	3,753	2,399
	44,934	64,492	64,831
Less allowance for doubtful accounts		(167)	(167)
	\$ 44,934	\$ 64,325	\$ 64,664

Receipts from settlement of the accounts receivable from merchants are primarily used to satisfy accounts payable to bank card processing banks.

HEARTLAND PAYMENT SYSTEMS, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS --(Continued)

4. INVESTMENTS

The cost, gross unrealized gains (losses) and estimated fair value for available-for-sale investments by major security type and class of security are as follows at December 31, 2003 and 2004 and March 31, 2005:

	Cost	Gross Unrealized Gains	Gross Unrealized Losses	Estimated Fair Value
(In thousands)				
December 31, 2003				
Debt securities of the U.S. Government	\$ 440	\$ 6	\$	\$ 446
Corporate debt securities	360	5	(1)	364
Certificates of deposit	544			544
	<u>\$ 1,344</u>	<u>\$ 11</u>	<u>\$ (1)</u>	<u>\$ 1,354</u>
December 31, 2004				
Debt securities of the U.S. Government	\$ 195	\$	(1)	\$ 194
Corporate debt securities	360	1	(4)	357
Certificates of deposit	549			549
	<u>\$ 1,104</u>	<u>\$ 1</u>	<u>\$ (5)</u>	<u>\$ 1,100</u>
March 31, 2005 (unaudited)				
Debt securities of the U.S. Government	\$ 443	\$	(3)	\$ 440
Corporate debt securities	360		(11)	349
Certificates of deposit	551			551
	<u>\$ 1,354</u>	<u>\$</u>	<u>\$ (14)</u>	<u>\$ 1,340</u>

As of December 31, 2004, all unrealized losses in investments were the result of increases in interest rates. The unrealized losses in any individual security did not exceed 1.5% of the Company's cost basis. These investments are not considered other-than-temporarily impaired because the Company has the ability and intent to hold these investments for a period of time sufficient for a forecasted recovery in value, which may be upon maturity.

The maturity schedule of all investments owned along with amortized cost and estimated fair value as of March 31, 2005 (unaudited) is as follows:

	Amortized Cost	Estimated Fair Value
(In thousands)		
Due in one year or less	\$ 802	\$ 801
Due after one year through five years	552	539
	<u>\$ 1,354</u>	<u>\$ 1,340</u>

HEARTLAND PAYMENT SYSTEMS, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS --(Continued)

5. CAPITALIZED CUSTOMER ACQUISITION COSTS, NET

A summary of the capitalized customer acquisition costs, net is as follows as of December 31, 2003 and 2004 and March 31, 2005:

	December 31,		March 31,
	2003	2004	2005
	(In thousands)		(unaudited) (In thousands)
Capitalized signing bonuses	\$ 27,428	\$ 40,407	\$ 42,754
Less accumulated amortization	(11,926)	(15,862)	(17,454)
	\$ 15,502	\$ 24,545	\$ 25,300
Capitalized customer deferred acquisition costs	13,055	21,349	26,576
Less accumulated amortization	(6,236)	(11,647)	(16,290)
	6,819	9,702	10,286
	\$ 22,321	\$ 34,247	\$ 35,586

Amortization expense was \$8.8 million, \$13.1 million and \$18.3 million for the years ended December 31, 2002, 2003 and 2004, respectively, and \$4.0 million (unaudited) and \$5.6 million (unaudited) for the three months ended March 31, 2004 and 2005, respectively.

The Company believes that no impairment has occurred as of December 31, 2003 and 2004. Net signing bonus adjustments from estimated amounts to actual were \$0.8 million and \$1.4 million for the years ended December 31, 2003, and 2004, respectively, and \$0.5 million (unaudited) for the three months ended March 31, 2005. Fully amortized signing bonuses of \$5.7 million and \$7.2 million were written off during the years ended December 31, 2003 and 2004 respectively and \$1.9 million (unaudited) for the three months ended March 31, 2005.

6. PROPERTY AND EQUIPMENT, NET

A summary of property and equipment, net is as follows as of December 31, 2003 and 2004 and March 31, 2005:

	December 31,		March 31,
	2003	2004	2005
	(In thousands)		(unaudited) (In thousands)
Computer hardware and software	\$ 7,252	\$ 13,611	\$ 15,173
Furniture, fixtures and equipment	1,401	1,709	1,713
Leasehold improvements	877	1,601	2,138
	9,530	16,921	19,024
Less accumulated depreciation	(4,031)	(5,977)	(7,197)
	\$ 5,499	\$ 10,944	\$ 11,827

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Depreciation expense of property and equipment was \$1.4 million, \$2.3 million and \$3.7 million for the years ended December 31, 2002, 2003 and 2004, respectively, and \$0.7 million (unaudited) and \$1.2 million (unaudited) for the three months ended March 31, 2004 and 2005, respectively. Fully depreciated assets of \$1.2 million, \$1.1 million and \$1.7 million were written off during 2002, 2003, and 2004, respectively.

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HEARTLAND PAYMENT SYSTEMS, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS --(Continued)

7. BORROWINGS AND FINANCING ARRANGEMENTS

A summary of borrowings are as follows as of December 31, 2003 and 2004 and March 31, 2005:

	December 31,		March 31,
	2003	2004	2005
	(In thousands)		(unaudited) (In thousands)
Financing Arrangements	\$ 12,863	\$ 10,241	\$ 9,698
Revolver Advance Facility	2,069	2,069	2,069
Purpose and Ability Line of Credit	784	784	784
Welsch Asset Purchase Agreement Note	250		
	<u>15,966</u>	<u>13,094</u>	<u>12,551</u>
Less Current Portion	<u>3,654</u>	<u>5,286</u>	<u>5,227</u>
Long-term portion of borrowings and financing arrangements	<u>\$ 12,312</u>	<u>\$ 7,808</u>	<u>\$ 7,324</u>

Principal payments due on borrowings and financing arrangements for the next five years are as follows:

Year Ended December 31,	(in thousands)
2005	\$ 5,286
2006	2,160
2007	1,851
2008	1,503
2009	1,315
Thereafter	979
	<u>\$ 13,094</u>

Financing Arrangements

On December 31, 1999 the Company signed a Merchant Services Purchase and Sale Agreement with National Processing Company, which was amended by a First Modification Agreement in December, 2000, and Amendment No. 1 to the First Modification Agreement in December, 2001. Under these agreements, the Company agreed to the transfer of merchant contracts generating a specified amount of net revenue to the transferee, and to pay all cash flows, net of servicing fees and chargeback losses, associated with specific lists of merchant contracts that were committed to the arrangement. This transaction has been treated as a financing arrangement, as discussed in Note 2. As a result, the Company had recorded a liability of \$23.0 million on December 31, 1999, which was reduced by servicing payments and the value of converted contracts. The respective amendments of the agreements had the effect of triggering sale treatment for those contracts that were converted to the transferee's systems in 2000, 2001 and 2002. Effective August 1, 2002, the Company signed a five-year servicing agreement with the transferee, in which the Company agreed to provide servicing to those merchants in a defined final pool that had not been converted to the transferee's processing systems, and that no further conversions would be made. The servicing agreement is terminable by the transferee upon the occurrence of certain change in control events, upon material breach by the Company, if merchant losses exceed a specified threshold, or if the Company enters into bankruptcy, receivership or other like status, in which event the transferee will be responsible for the conversion of

HEARTLAND PAYMENT SYSTEMS, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS --(Continued)

7. BORROWINGS AND FINANCING ARRANGEMENTS --(Continued)

the remaining serviced merchants to their processing systems. The interest rate at December 31, 2004 was 4.26%

On November 1, 2000, the Company signed a Merchant Portfolio Purchase Agreement and an associated Servicing Agreement with Certegy Inc., each of which was amended on January 16, 2002. Under these agreements, the Company pays all cash flows, net of servicing fees and chargeback losses, related to the transferred merchant contracts to the transferee. This transaction has been treated as a financing arrangement, as discussed in Note 2. As a result, the Company recorded a liability of \$22.0 million on November 1, 2000, and the payments made represent interest plus principal repayments. The interest rate at December 31, 2004 is 2.53%. The servicing agreement is terminable only upon material breach by either party, or if the Company enters into bankruptcy, receivership or other like status.

Loan and Security Agreement

On August 28, 2002, the Company signed a Loan and Security Agreement for two loan instruments; this Agreement was amended on November 6, 2003 and June 23, 2004. The first instrument is a Revolver Advance Facility ("Revolver"), which is to be used solely to fund the buyout of future commissions from current or former Relationship Managers or from Independent Sales Organizations ("ISOs"). The Company may draw down on the Revolver up to but not exceeding an aggregate unpaid principal amount outstanding of \$3,500,000. The entire principal balance plus all accrued interest and fees is due on May 31, 2005 (subsequently extended to August 31, 2005), or on demand if there were to be a default. The Revolver accrues interest at a rate equal to the prime rate, which was 5.25% at December 31, 2004. The Company's assets, including accounts receivable, inventory, furniture and equipment and general intangibles, serve as collateral to secure the Revolver.

On May 26, 2005, the Company entered into an amendment to its Loan and Security Agreement, which extended the scheduled maturity date from May 31, 2005 to August 31, 2005.

The second instrument is a \$3,000,000 Purpose and Ability Line of Credit Facility ("Line of Credit"). The Line of Credit accrues interest at the prime rate, which was 5.25% at December 31, 2004, and is secured by the assets of the Company, including accounts receivable, inventory, furniture and equipment and general intangibles. The entire principal balance plus all accrued interest and fees is due upon demand.

The Company is subject to standard loan covenants and financial statement reporting requirements on both of the debt instruments and was in compliance at December 31, 2003 and 2004.

Welsch Asset Purchase Agreement

Effective March 31, 2002, the Company entered into an Asset Purchase Agreement with Welsch Financial Merchant Services, Inc. The purchase price included a note for \$2,000,000. The outstanding amount of this note was \$250,000 and \$0 at December 31, 2003 and 2004, respectively.

8. MERCHANT DEPOSITS AND LOSS RESERVES

The Company's merchants have the liability for any charges properly reversed by the cardholder through a mechanism known as a chargeback. If the merchant is unable to pay this amount, the Company will be liable to the Visa and MasterCard associations for the reversed charges.

HEARTLAND PAYMENT SYSTEMS, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS --(Continued)

8. MERCHANT DEPOSITS AND LOSS RESERVES --(Continued)

During 2003, the Company adopted FIN 45. Under FIN 45, the Company's obligation to stand ready to perform is minimal. The Company requires personal guarantees, merchant deposits and letters of credit from certain merchants to minimize its obligation. As of December 31, 2003, December 31, 2004 and March 31, 2005, the Company held merchant deposits totaling \$4.2 million, \$6.7 million and \$7.7 million (unaudited), and letters of credit totalling \$80,000, \$30,000 and \$480,000 (unaudited), respectively.

The Visa and MasterCard associations generally allow chargebacks up to four months after the later of the date the transaction is processed or the delivery of the product or service to the cardholder. As the majority of the Company's transactions involve the delivery of the product or service at the time of the transaction, a reasonable basis for determining an estimate of the Company's exposure to chargebacks is the last four months' processing volume on its portfolio, which was \$5.0 billion, \$6.6 billion, \$9.0 billion and \$9.4 billion (unaudited) for the four months ended December 31, 2002, 2003 and 2004, and March 31, 2005, respectively. However, for the four months ended December 31, 2002, 2003, 2004 and March 31, 2005, the Company was presented with \$4.5 million, \$5.4 million, \$5.6 million and \$5.5 million (unaudited), respectively, in chargebacks by issuing banks. In the years ended December 31, 2002, 2003, and 2004 and the three months ended March 31, 2005, the Company incurred merchant credit losses of \$561,928, \$605,256, \$939,500 and \$299,714 (unaudited), respectively, on total dollar volume processed of \$14.4 billion, \$17.9 billion, \$25.0 billion and \$6.9 billion (unaudited), respectively. These credit losses are included in "cost of services" in the Company's consolidated statements of operations.

The loss recorded by the Company for chargebacks associated with any individual merchant is typically small, due both to the relatively small size and the processing profile of the Company's clients. However, from time to time the Company will encounter instances of merchant fraud, and the resulting chargeback losses may be considerably more significant to the Company. The Company has established a reserve for estimated credit and fraud losses on its consolidated balance sheets, amounting to \$773,000, \$558,225, \$468,000 and \$471,000 (unaudited) on December 31, 2002, 2003 and 2004 and March 31, 2005, respectively. This reserve is determined by performing an analysis of the Company's historical loss experience applied to current processing volume and exposures.

A summary of the loss reserve for the years ended December 31, 2002, 2003 and 2004 and March 31, 2005 is as follows:

	December 31			March 31,
	2002	2003	2004	2005
	(In thousands)			(unaudited) (In thousands)
Beginning balance	\$ 736	\$ 773	\$ 558	\$ 468
Additions to reserve	598	390	849	303
Charges against reserve	(561)	(605)	(939)	(300)
Ending Balance	\$ 773	\$ 558	\$ 468	\$ 471

HEARTLAND PAYMENT SYSTEMS, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS --(Continued)

9. ACCRUED BUYOUT LIABILITY

A summary of the accrued buyout liability is as follows as of December 31, 2003 and 2004 and March 31, 2005:

	December 31,		March 31,
	2003	2004	2005
	(In thousands)		(unaudited) (In thousands)
Vested Relationship Managers and sales managers	\$ 17,632	\$ 25,788	\$ 25,709
Unvested Relationship Managers and sales managers	353	1,247	1,214
	17,985	27,035	26,923
Less current portion	17,985	9,327	10,258
Long-term portion of accrued buyout liability	\$	\$ 17,708	\$ 16,665

	December 31,			March 31,
	2002	2003	2004	2005
	(In thousands)			(unaudited) (In thousands)
Beginning balance	\$ 13,321	\$ 13,551	\$ 17,985	\$ 27,035
Increase in settlement obligation, net	8,774	9,174	11,263	3,175
Buyouts	(8,544)	(4,740)	(2,213)	(3,287)
Ending balance	\$ 13,551	\$ 17,985	\$ 27,035	\$ 26,923

The increase in settlement obligation is due to new merchant account signings, as well as same store sales growth and changes in gross margin, primarily attributable to account attrition.

In calculating the accrued buyout liability for unvested Relationship Managers and sales managers, the Company has assumed that 31% of the unvested Relationship Managers and sales managers will vest in the future, which represents the Company's historical vesting rate. A 5% increase to 36% in the expected vesting rate would have increased the accrued buyout liability for unvested Relationship Managers and sales managers by \$56,974 at December 31, 2003, \$201,139 at December 31, 2004 and \$195,713 (unaudited) at March 31, 2005.

10. CONVERTIBLE PREFERRED STOCK AND WARRANTS

The Series A Senior Convertible Participating Preferred Stock (the "Convertible Preferred") is convertible by the holders at any time and automatically converts upon the closing of a qualified public offering up to 15,238,096 shares of the Company's Common Stock, participates equally in dividends and distributions with the Common Stock, pays no other dividends and has a liquidation preference of \$80 million. The Convertible Preferred was redeemable at the option of two-thirds of the holders after October 1, 2006 at the higher of the liquidation preference or value per common share. The carrying value of the Convertible Preferred was accreted to its mandatory redeemable value by \$6,509,019 in the year ended December 31, 2002, using the effective interest rate method. During 2002, the Company stopped accreting the Convertible Preferred because the terms of the Certificate of Designations for the Convertible Preferred and the Shareholders' Agreement by and among the holders of the Company's Common Stock and the Convertible Preferred were amended to eliminate certain rights of the holders of the Convertible Preferred that might, in certain circumstances, have allowed those holders to cause redemption of the Convertible Preferred. The holders of the Convertible Preferred have the right to elect three directors to the Company's Board and have certain other rights with respect to the governance of the Company.

HEARTLAND PAYMENT SYSTEMS, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS --(Continued)

10. CONVERTIBLE PREFERRED STOCK AND WARRANTS --(Continued)

In addition, the holders of the Convertible Preferred received five-year warrants to purchase an additional 2,000,000 shares of the Company's Common Stock at a price of \$2.63 per share, which were valued at \$1.5 million. The Company redeemed these warrants on September 28, 2004 by paying the holders the net consideration of \$5.25 million.

In August 2004, the Certificate of Designations of the Convertible Preferred was amended to eliminate after October 1, 2006 certain rights of the holders to treat a merger of the Company as a liquidation event. This amendment was in addition to amendments made in 2002 to the terms of the Certificate of Designations for the Convertible Preferred and the Shareholders' Agreement by and among the holders of the Company's Common Stock. As a result of the amendment, the Company has classified the Convertible Preferred as a part of stockholders' (deficit) equity in its December 31, 2004 and March 31, 2005 financial statements.

The Board of Directors is authorized to issue shares of preferred stock in one or more classes or series without any further action by the Company's stockholders.

On July 26, 2001, the Company signed a Loan and Security Agreement with BHC Interim Funding, L.P., and received a Term Loan (the "BHC Bridge Loan") in the amount of \$4.76 million, which accrued interest at a rate of 13.75%, and was secured by a first priority lien on the Company's merchant contracts and certain other assets. The BHC Bridge Loan was repaid on October 11, 2001. In connection with this agreement, the Company issued 337,810 five-year mandatory redeemable warrants to purchase its Common Stock for \$0.005, which were valued at \$605,049. Commencing July 26, 2003, the holder can require the Company to redeem these warrants at their per share fair value. The Company records these warrants at their estimated fair value and adjusted these warrants by \$0.5 million and \$0.9 million in December 2002 and 2003 because transactions indicated that \$3.61 and \$6.25 per share, respectively, was an appropriate fair value. On January 8, 2004, the warrant holder elected to cause the Company to redeem 168,906 shares at the fair value of \$6.25 per share. The Company has adjusted the warrants by an additional \$0.5 million in the period ending December 31, 2004 and by \$0.1 million (unaudited) on March 31, 2005 to reflect the estimated fair value of \$9.28 and \$9.80 per share, respectively.

11. INCOME TAXES

Income tax provision (benefit) for the years ended December 31, 2002, 2003 and 2004 and the three months ended March 31, 2005 and 2004 is as follows:

	December 31,			March 31,	
	2002	2003	2004	2004	2005
					(unaudited)
					(In thousands)
Current tax:					
Federal	\$	\$	\$	\$	\$
State	51	235	371	122	345
Deferred taxes:					
Federal		(9,364)	3,859	847	92
State		(2,103)	828	157	21
Provision for (benefit from) income taxes	\$	\$	\$	\$	\$
	51	(11,102)	6,376	1,482	1,989

HEARTLAND PAYMENT SYSTEMS, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS --(Continued)

11. INCOME TAXES --(Continued)

The net deferred tax asset was comprised of the following:

	December 31,		March 31,
	2003	2004	2005
	(In thousands)		(unaudited) (In thousands)
Merchant contract costs	\$ 12,348	\$ 15,317	\$ 15,671
Borrowings and financing arrangement	5,466	4,353	4,123
Federal net operating loss carryforwards	1,188		
State net operating loss carryforwards	221		
Loss reserve and accounts receivable allowance	251	270	271
Other	138	1	2
Deferred tax asset	19,612	19,941	20,067
Capitalized signing bonus	6,588	10,432	10,753
Deferred state tax liability	736	447	439
Software development	645	1,065	1,193
Property and equipment	176	1,217	1,015
Deferred tax liability	8,145	13,161	13,400
Net deferred tax asset	11,467	6,780	6,667
Less current portion	3,684	2,129	2,179
	\$ 7,783	\$ 4,651	\$ 4,488

Based on the Company's performance in 2003 and the Company's forecast of future taxable income, management determined that the deferred tax assets that were previously provided were more likely than not to be realized, and the valuation allowance was released as of December 31, 2003. As a result, the Company realized a tax benefit within the consolidated statement of operations for the year ended December 31, 2003.

At December 31, 2004 the Company has fully utilized all federal and state net operating loss carryforwards.

The differences in federal income taxes provided and the amounts determined by applying the federal statutory tax rate (34% and 35%, respectively) to income before income taxes for the years ended December 31, 2002, 2003 and 2004 and for the three months ended March 31, 2005 and 2004 are:

December 31,			March 31,	
2002	2003	2004	2004	2005
			(unaudited)	
			(In thousands)	

(In thousands)

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	December 31,				March 31,					
U.S. federal income tax at statutory rate	34.00%	\$ 1,686	35.00%	\$ 3,161	35.00%	\$ 5,331	35.00%	\$ 1,237	35.00%	\$ 1,639
U.S. state and local income taxes, net	0.68%	34	(13.44)%	(1,214)	5.12%	779	5.12%	181	5.08%	238
Warrants	3.49%	173	3.46%	313	1.17%	178	1.17%	42	1.24%	58
Change in valuation allowance	(37.75)%	(1,872)	(143.98)%	(13,004)						
Change in tax rate	0.00%		(4.23)%	(383)						
Nondeductible expenses	0.35%	17	0.28%	26	0.58%	88	0.59%	23	0.25%	12
Other, net	0.26%	13	(0.01)%	(1)			(0.01)%	(1)	0.91%	42
		<u> </u>		<u> </u>		<u> </u>		<u> </u>		<u> </u>
Provision for (benefit from) income taxes	1.03%	\$ 51	(122.92)%	\$ (11,102)	41.87%	\$ 6,376	41.87%	\$ 1,482	42.48%	\$ 1,989
		<u> </u>		<u> </u>		<u> </u>		<u> </u>		<u> </u>

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HEARTLAND PAYMENT SYSTEMS, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS --(Continued)

11. INCOME TAXES --(Continued)

Tax contingencies are recorded for probable exposures involving tax positions taken that could be challenged by taxing authorities. These probable exposures result from the varying application of statutes, rules, regulations and interpretations. The Company does not have income tax contingencies.

12. STOCK INCENTIVE PLAN

On July 29, 2003, the Company amended its employee and director stock option plan, the Heartland Payment Systems, Inc. Amended and Restated 2000 Equity Incentive Plan (the "Plan"). The maximum number of shares with respect to which Plan awards may be granted during the term of the Plan is 10,000,000 (as adjusted for a two-for-one stock split contemplated in connection with the proposed public offering of the Company's common stock during 2005), of which 843,406, 2,583,458, 3,167,594 and 682,782 (unaudited) options were granted during 2002, 2003, 2004 and the three months ended March 31, 2005, respectively. The options were granted with a term of 10 years, or in certain cases five years, and an exercise price equal to or in excess of the estimated fair value at the date of the grant. Lacking any transactions in our common stock, the fair value was determined using a "sum of the parts" of the value of the Company's merchant portfolio, payroll business line and financial condition. This model used the portfolio valuation multiple achieved in the Company's transfer of merchant portfolios to National Processing Company, "market" multiples of revenue for the payroll business, and added the Company's net cash, receivables and payables. This approach resulted in values that were higher than a third-party evaluation of the fair value of the Company's common stock that was performed as of March 2003. This approach was employed for all option grants through December 2003 and resulted in option issuances at prices (\$5 through July 2003 and \$6.25 through year-end 2003) that were above the third-party and internally determined fair value. At year-end 2003, two transactions, a sale of common stock by certain executives, senior managers, and former consultants to an institutional investor, and a redemption at their fair value of warrants held by BHC Interim Fund, L.P., occurred, each at a price of \$6.25 per share. This value was used as the fair value for issuances in the first quarter of 2004. For the second quarter of 2004, given the Company's decision to file a registration statement, newly issued options' exercise prices were raised to \$7.50 per share. On the date of the initial filing of a registration statement for the public offering of the Company's stock, this was raised to \$9.28 per share, reflecting a private company discount to the price that the underwriters estimated that the initial public offering could have been priced at, if the offering had occurred on that date. The majority of the options granted vested immediately; however, 22,500, 375,000, 755,474 and 884,350 (unaudited) options as of December 31, 2002, 2003, 2004 and March 31, 2005, respectively, vest over a period of one to five years. During 2004, the Company accelerated the vesting of 22,500 options as a part of a separation agreement.

In April 2002, the Company approved its 2002 PEPShares Plan, as amended (the "PEPShares Plan"). The maximum number of shares with respect to which the PEPShares Plan option awards may be granted during the term of the PEPShares Plan is 2,400,000 (as adjusted for a two-for-one stock split contemplated in connection with the proposed public offering of the Company's common stock during 2005), of which 742,772, 618,968 and 282,152 options were granted in 2002, 2003 and 2004, respectively. The options will be exercisable at a price per share equal to the estimated fair value at the date of the grant. The options will become exercisable in a series of five equal annual installments of 20%, contingent on continued service with the Company, provided that all unvested options will vest as of their final vesting date. The vesting of options may be accelerated upon the completion of an initial public offering. The Administrator of the PEPShares Plan determined that no elections to defer

HEARTLAND PAYMENT SYSTEMS, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS --(Continued)

12. STOCK INCENTIVE PLAN --(Continued)

compensation earned after December 31, 2004 will be permitted and no amounts will be deferred and contributed to the PEPShares Plan from compensation earned after December 31, 2004.

Equity Incentive and PEPShares plan activity in 2002, 2003, 2004 and the three months ended March 31, 2005 was as follows:

	2000 Equity Incentive Plan		2002 PEPShares Plan	
	Shares	Weighted-Average Exercise Price	Shares	Weighted-Average Exercise Price
Options outstanding at January 1, 2002	1,362,344	\$ 2.91		\$
Issued	843,406	\$ 5.00	742,772	\$ 5.00
Forfeited/cancelled	(122,398)	\$ 3.47	(91,728)	\$ 5.00
Outstanding at December 31, 2002	2,083,352	\$ 3.72	651,044	\$ 5.00
Options exercisable at December 31, 2002	2,060,852	\$ 3.71	130,208	\$ 5.00
Issued	2,583,458	\$ 5.50	618,968	\$ 5.97
Exercised	(2,156)	\$ 5.00		\$
Forfeited/cancelled	(14,556)	\$ 5.14	(7,030)	\$ 5.00
Outstanding at December 31, 2003	4,650,098	\$ 4.70	1,262,982	\$ 5.48
Options exercisable at December 31, 2003	4,275,098	\$ 4.57	384,212	\$ 5.31
Issued	3,167,594	\$ 7.87	282,152	\$ 7.72
Exercised	(552,520)	\$ 2.85	(2,044)	\$ 5.14
Forfeited/cancelled	(133,078)	\$ 5.83	(4,960)	\$ 5.14
Outstanding at December 31, 2004	7,132,094	\$ 6.23	1,538,130	\$ 5.89
Options exercisable at December 31, 2004	6,376,620	\$ 6.11	686,380	\$ 5.57
Issued (unaudited)	682,782	\$ 9.76		\$
Exercised (unaudited)	(13,320)	\$ 3.42		\$
Forfeited/cancelled (unaudited)	(70,532)	\$ 6.89	(8,152)	\$ 6.11
Outstanding at March 31, 2005 (unaudited)	7,731,024	\$ 6.54	1,529,978	\$ 5.89
Options exercisable at March 31, 2005 (unaudited)	6,846,674	\$ 6.35	678,228	\$ 5.64

HEARTLAND PAYMENT SYSTEMS, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS --(Continued)

12. STOCK INCENTIVE PLAN --(Continued)

Options outstanding and exercisable at December 31, 2004 summarized by exercise are:

Exercise price per share	Outstanding		
	2000 Equity Incentive Plan	2002 PEPShares Plan	Total
\$3.00	700,944		700,944
\$5.00	2,376,610	777,598	3,154,208
\$6.25	2,189,854	593,294	2,783,148
\$7.50	311,232	51,186	362,418
\$9.28	1,553,454	116,052	1,669,506
	7,132,094	1,538,130	8,670,224
Exercise price per share	Exercisable		
	2000 Equity Incentive Plan	2002 PEPShares Plan	Total
\$3.00	700,944		700,944
\$5.00	2,376,610	438,598	2,815,208
\$6.25	1,676,480	214,334	1,890,814
\$7.50	311,232	10,238	321,470
\$9.28	1,311,354	23,210	1,334,564
	6,376,620	686,380	7,063,000

HEARTLAND PAYMENT SYSTEMS, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS --(Continued)

12. STOCK INCENTIVE PLAN --(Continued)

Options outstanding and exercisable at March 31, 2005 (unaudited) summarized by exercise price are:

Exercise price per share	Outstanding		
	2000 Equity Incentive Plan	2002 PEPShares Plan	Total
\$3.00	681,540		681,540
\$5.00	2,361,340	773,398	3,134,738
\$6.25	2,176,848	590,974	2,767,822
\$7.50	299,656	50,686	350,342
\$9.28	1,588,308	114,920	1,703,228
\$9.80	623,332		623,332
	7,731,024	1,529,978	9,261,002
Exercise price per share	Exercisable		
	2000 Equity Incentive Plan	2002 PEPShares Plan	Total
\$3.00	681,540		681,540
\$5.00	2,361,340	434,398	2,795,738
\$6.25	1,764,598	212,014	1,976,612
\$7.50	299,656	9,738	309,394
\$9.28	1,311,208	22,078	1,333,286
\$9.80	428,332		428,332
	6,846,674	678,228	7,524,902

13. FAIR VALUE OF FINANCIAL INSTRUMENTS

Management uses methods and assumptions to estimate the fair value of each class of financial instruments for which it is practicable to estimate fair value. Fair value equals quoted market price for securities held as available-for-sale investments. Other financial instruments include cash and cash equivalents, certificates of deposit, receivables, various accounts payable and accrued expenses. The fair value of such financial instruments approximates their carrying value due to their short maturity and pricing terms.

14. EMPLOYEE BENEFIT PLAN

The Company offers a defined contribution plan to all employees. Company contributions are generally based upon fixed amounts of eligible compensation and the Company contributed approximately \$142,586, \$189,188 and \$256,539 to the Plan for the years ended December 31, 2002, 2003 and 2004, respectively.

15. COMMITMENTS AND CONTINGENCIES

Litigation The Company is involved in certain legal proceedings and claims, which arise in the ordinary course of business. In the opinion of the Company, the results of any of these matters, individually and in the aggregate, are not expected to have a material effect on its results of operations, financial condition or cash flows.

HEARTLAND PAYMENT SYSTEMS, INC. AND SUBSIDIARY

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS --(Continued)

15. COMMITMENTS AND CONTINGENCIES --(Continued)

Leases The Company leases various office spaces and certain equipment under operating leases with remaining terms ranging up to eight years. The majority of the office space lease agreements contain renewals; **Three months ended Three months ended June 30,**

2012 June 30, 2011 (in thousands) (in thousands) Revenues Segment

Results

(non-GAAP) GAAP

Adjustments GAAP

Results Segment

Results

(non-GAAP) GAAP

Adjustments GAAP

Results Change in

GAAP results

(\$ Change in

GAAP results

(%)

Pre-need cemetery revenues

\$33,773 \$(8,631) \$25,142 \$32,836 \$(6,804) \$26,032 \$(890) -3.4%

At-need cemetery revenues

20,428 (850) 19,578 20,562 (1,132) 19,430 148 0.8%

Investment income from trusts

10,542 (4,526) 6,016 6,977 (1,921) 5,056 960 19.0%

Interest income

1,799 1,799 1,596 1,596 203 12.7%

Funeral home revenues

8,189 (334) 7,855 7,563 (200) 7,363 492 6.7%

Other cemetery revenues

873 245 1,118 443 187 630 488 77.5%

Total revenues

75,604	(14,096)	61,508	69,977	(9,870)	60,107	1,401	2.3%
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Costs and expenses

Cost of goods sold

8,788	(1,552)	7,236	8,131	(915)	7,216	20	0.3%
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Cemetery expense

14,775	14,775	15,462	15,462	(687)	-4.4%
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Selling expense

14,778	(1,655)	13,123	14,022	(1,835)	12,187	936	7.7%
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General and administrative expense

7,195	7,195	7,031	7,031	164	2.3%
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Corporate overhead

7,756	7,756	5,986	5,986	1,770	29.6%
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Depreciation and amortization

2,230	2,230	2,042	2,042	188	9.2%
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Funeral home expense

6,688	(73)	6,615	5,698	5,698	917	16.1%
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Acquisition related costs

782	782	1,025	1,025	(243)	-23.7%
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Total costs and expenses

62,992	(3,280)	59,712	59,397	(2,750)	56,647	3,065	5.4%
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Operating profit

\$12,612	\$(10,816)	\$1,796	\$10,580	\$(7,120)	\$3,460	\$(1,664)	-48.1%
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Revenues

Pre-need cemetery revenues were \$25.1 million for the three months ended June 30, 2012, a decrease of \$0.9 million, or 3.4%, as compared to \$26.0 million during the same period last year. The decrease was primarily caused by an increase of \$0.9 million in the value of cemetery contracts written which was offset by an increase of \$1.8 million in deferred revenue.

At-need cemetery revenues were \$19.6 million for the three months ended June 30, 2012, an increase of \$0.2 million, or 0.8%, as compared to \$19.4 million during the same period last year. The increase was primarily caused by a decrease of \$0.1 million in the value of cemetery contracts written which was offset by a decrease of \$0.3 million in deferred revenue.

The value of pre-need and at-need contracts was negatively impacted by the termination of our operating agreement with the Archdiocese of Detroit that occurred March 31, 2012. Further, the value of pre-need and at-need contracts was positively impacted by the acquisitions consummated during 2011 and 2012 as the results of operations for these cemeteries are included in the three months ended June 30, 2012, but have little to no impact on the three months ended June 30, 2011.

Investment income from trusts was \$6.0 million for the three months ended June 30, 2012, an increase of \$1.0 million, or 19.0%, as compared to \$5.0 million during the same period last year. On a segment basis, we had an increase of \$3.6 million, which was offset by an adjustment of \$2.6 million related to funds for which we have not met the requirements that allow us to recognize them as revenue.

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Interest income on accounts receivable was \$1.8 million for the three months ended June 30, 2012, an increase of \$0.2 million, or 12.7%, as compared to \$1.6 million during the same period last year.

Revenues for the Funeral Home segment were \$7.9 million for the three months ended June 30, 2012, an increase of \$0.5 million, or 6.7%, compared to \$7.4 million during the same period last year. The majority of the increase was driven by the 10 funeral homes we acquired subsequent to the second quarter of 2011, and was primarily attributable to a \$0.1 million increase in pre-need revenues and a \$0.4 million increase in other revenues.

Other cemetery revenues were \$1.1 million for the three months ended June 30, 2012, an increase of \$0.5 million, or 77.5%, as compared to \$0.6 million during the same period last year.

Costs and Expenses

Cost of goods sold were \$7.2 million during the three months ended June 30, 2012 and 2011. The ratio of cost of goods sold to cemetery revenues increased to 16.2% during the three months ended June 30, 2012 as compared to 15.9% during the same period last year. The change in the ratio primarily relates to changes in product mix.

Cemetery expenses were \$14.8 million during the three months ended June 30, 2012, a decrease of \$0.7 million, or 4.4%, compared to \$15.5 million during the same period last year. The major components of the overall expense decrease were \$0.6 million in labor costs, \$0.4 million in real estate taxes and \$0.1 million in utilities offset by an increase in repairs and

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maintenance of \$0.4 million. Cemetery expenses relate to the current costs of managing and maintaining our cemetery properties. These costs are expensed as incurred and are not deferred. Accordingly, from a margin standpoint, the most effective gauge of measuring cemetery expenses is as a ratio of segment level pre-need and at-need cemetery revenues. Changes in this ratio give an indication of our ability to manage and control our operating costs relative to our overall cemetery operations. An increase in the ratio indicates that expense increases related to the operation and maintenance of our cemetery properties exceeded increases in the value of contracts written, while a decrease in the ratio indicates that expense growth did not exceed increases in the value of contracts written. In the short-term, this ratio can be positively or negatively impacted by our acquisitions, including such factors as how long it takes us to fully implement our pre-need sales programs and whether there are any unanticipated costs. Over the long-term, we would expect this ratio to slightly decline as many of the expenses in this category are fixed in nature. The ratio of cemetery expenses to segment level pre-need and at-need cemetery revenues was 27.3% during the three months ended June 30, 2012 as compared to 29.0% during the same period last year.

Selling expenses were \$13.1 million during the three months ended June 30, 2012, an increase of \$0.9 million, or 7.7%, as compared to \$12.2 million during the same period last year. The major components of the overall expense increase were \$0.4 million in commissions, \$0.3 million in telephone and telemarketing costs and a reduction in deferred selling expenses of \$0.2 million. The ratio of selling expenses to cemetery revenues was 29.3% during the three months ended June 30, 2012 as compared to 26.8% during the same period last year. This ratio gives some indication of how effectively the money we invest in selling efforts is translating into sales. However, the majority of our selling expenses are sales commissions and bonuses which are based on a percentage of the value of actual contracts written. As a result, we would expect this ratio to remain fairly consistent.

General and administrative expenses were \$7.2 million during the three months ended June 30, 2012, an increase of \$0.2 million, or 2.3%, compared to \$7.0 million during the same period last year. The majority of the increase was primarily due to increases in professional fees and insurance costs. General and administrative expenses are expensed as incurred and are not deferred. Accordingly, from a margin standpoint, the most effective gauge of measuring general and administrative expenses is as a ratio of segment level pre-need and at-need cemetery revenues. Changes in this ratio give an indication of our ability to manage and control our general and administrative costs relative to our overall cemetery operations. An increase in the ratio indicates that general and administrative percentage expense increases related to our cemetery properties exceeded percent increases in the value of contracts written, while a decrease in the ratio indicates that expense growth on a percentage basis did not exceed percentage increases in the value of contracts written. In the short-term, this ratio can be positively or negatively impacted by our acquisitions, including such factors as how long it takes us to fully implement our pre-need sales programs and whether there are any unanticipated costs. Over the long-term, we would expect this ratio to slightly decrease as many of the expenses in this category are fixed in nature. The ratio of general and administrative expenses to segment level pre-need and at-need cemetery revenues remained fairly consistent at 13.3% and 13.2% during the three months ended June 30, 2012 and 2011, respectively.

Total corporate overhead was \$7.8 million for the three months ended June 30, 2012, an increase of \$1.8 million, or 29.6% compared to \$6.0 million during the same period last year. The increase was primarily attributable to an increase of \$0.2 million in labor costs, \$1.1 million in professional fees and \$0.5 million in other corporate expenses.

Depreciation and amortization was \$2.2 million during the three months ended June 30, 2012, an increase of \$0.2 million, or 9.2%, as compared to \$2.0 million during the period last year. The increase was primarily due to additional depreciation and amortization from recent acquisitions.

Funeral home expenses were \$6.6 million for the three months ended June 30, 2012, an increase of \$0.9 million, or 16.1%, compared to \$5.7 million during the same period last year. The increase was primarily attributable to an increase of \$0.5 million in personnel expenses, \$0.1 million in merchandise costs, and \$0.1 million in advertising costs, with the remainder attributable to various increases in general and administrative and other expense categories.

Acquisition related costs were \$0.8 million for the three months ended June 30, 2012, a decrease of \$0.2 million, or 23.7%, as compared to \$1.0 million during the same period last year. These costs will vary from period to period depending on the amount of acquisition activity that takes place.

Non-segment Allocated Results

As previously mentioned, certain income statement amounts are not allocated to segment operations. These amounts are those line items that can be found on our income statement below operating profit and above income before income taxes.

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The table below summarizes these items and the changes between the three months ended June 30, 2012 and 2011:

	2012	Three months ended June 30, 2011		Change (%)
		(in thousands)		
		2011	Change (\$)	
Gain (loss) on termination of operating agreement	\$ (83)	\$	\$ (83)	n/a
Gain on acquisition	122		122	n/a
Interest expense	4,870	4,352	518	11.9%
Income tax benefit	\$ (866)	\$ (1,707)	\$ 841	-49.3%

Interest expense has increased during the three months ended June 30, 2012 as compared to the same period last year. This increase is caused by increased borrowings on our credit facility, which are offset in part by reduced interest rates. Average amounts outstanding under our credit facility were \$61.5 million and \$3.0 million during the three months ended June 30, 2012 and 2011, respectively. However, amendments that we made to our credit facility have reduced our interest rate and the rate was approximately 2.8% lower during the three months ended June 30, 2012 as opposed to the same period last year.

The gain on acquisition relates to one of our second quarter 2012 acquisitions. Refer to Note 13 of our unaudited condensed consolidated financial statements in Item 1 of the Form 10-Q for a more detailed discussion. The amount recognized under gain on termination of operating agreement relates to an adjustment that reduces a previously recognized gain on an operating agreement terminated in the first quarter of 2012.

We had an income tax benefit of \$0.9 million for the three months ended June 30, 2012, as compared to a benefit of \$1.7 million during the same period last year. Our effective tax rate differs from our statutory tax rate primarily because our legal entity structure includes different tax filing entities, including a significant number of partnerships that are not subject to paying tax.

Six Months Ended June 30, 2012 Compared to Six Months Ended June 30, 2011**Cemetery Operations Southeast**

In 2011 we made several acquisitions in our Cemetery Operations Southeast segment. Of these acquisitions, 6 occurred during the third quarter of 2011 and 5 occurred during the fourth quarter of 2011. Therefore, the results of operations for these properties have no impact on the six months ended June 30, 2011, but are included in the six months ended June 30, 2012. These additions are contributing the majority of the increase in revenues and costs and expenses for this segment.

The table below compares the results of operations for our Cemetery Operations Southeast for the six months ended June 30, 2012 to the same period last year:

	2012	Six months ended June 30, 2011		Change (%)
		(in thousands)		
		2011	Change (\$)	
		(non-GAAP)		
Total revenues	\$ 63,475	\$ 56,146	\$ 7,329	13.1%
Total costs and expenses	44,912	39,730	5,182	13.0%
Operating profit	\$ 18,563	\$ 16,416	\$ 2,147	13.1%

Revenues

The increase in revenues was related to an overall increase in the value of contracts written, with an increase of \$1.3 million in the value of at-need contracts and \$4.0 million in the value of pre-need contracts. We also had an increase of \$1.1 million in income from our trusts and \$0.5 million in interest on accounts receivable.

Table of Contents**Total costs and expenses**

The increase in costs and expenses was primarily related to:

A \$1.2 million increase in cost of goods sold. This was attributable to the corresponding increase in the value of contracts written.

A \$1.1 million increase in selling expenses. This was primarily attributable to an increase of \$0.4 million in salary and benefit expenses, \$0.6 million in commission related expenses, and \$0.1 million in telephone and telemarketing costs.

A \$1.4 million increase in cemetery expenses. The increase was primarily due to increases of \$0.8 million in labor costs, \$0.5 million in repair and maintenance costs, and \$0.1 million in utility and fuel costs.

A \$1.2 million increase in general and administrative expense primarily due to an increase of \$0.7 million in labor costs, \$0.2 million in insurance costs, \$0.1 million in professional fees and \$0.2 million in general office costs.

A \$0.3 million increase in depreciation.

Cemetery Operations Northeast

The table below compares the results of operations for our Cemetery Operations Northeast for the six months ended June 30, 2012 to the same period last year:

	2012	Six months ended June 30, 2011	Change (\$) (in thousands) (non-GAAP)	Change (%)
Total revenues	\$ 31,716	\$ 28,112	\$ 3,604	12.8%
Total costs and expenses	20,491	19,519	972	5.0%
Operating profit	\$ 11,225	\$ 8,593	\$ 2,632	30.6%

Revenues

The increase in revenues was related to an overall increase in the value of contracts written, with an increase of \$0.6 million in the value of at-need contracts and \$1.0 million in the value of pre-need contracts. In addition, we had an increase of \$2.0 million in income from our trusts.

Total costs and expenses

The increase in costs and expenses was primarily related to:

A \$0.4 million increase in cost of goods sold. This was attributable to the corresponding increase in the value of contracts written.

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A \$0.7 million increase in selling expense. This was primarily attributable to an increase of \$0.3 million in labor costs, \$0.2 million in commissions and \$0.1 million in telephone and telemarketing costs.

A \$0.1 million decrease in cemetery expenses primarily attributable to a decrease in labor costs.

Cemetery Operations West

Effective March 31, 2012, we terminated our operating agreement with the Archdiocese of Detroit. Therefore, the results of operations for these properties are only included in the six months ended June 30, 2012 up to that point, but are included in the entire period for the six months ended June 30, 2011. The removal of these properties from our results of operations is responsible for a \$2.2 million decrease in revenues and \$1.4 million decrease in costs and expenses period over period, and therefore is responsible for the majority of the decrease in revenues and costs and expenses.

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Further, in the second quarter of 2011 we made 3 acquisitions and in the second quarter of 2012 we made 1 acquisition in our Cemetery Operations West segment. The results of operations for these properties have less impact, and in some cases no impact, on the six months ended June 30, 2011, but are included in the six months ended June 30, 2012. These acquisitions are increasing revenues and expenses period over period.

The table below compares the results of operations for our Cemetery Operations West for the six months ended June 30, 2012 to the same period last year:

	2012	Six months ended June 30, 2011	Change (\$)	Change (%)
		(in thousands)	(non-GAAP)	
Total revenues	\$ 35,218	\$ 38,093	\$ (2,875)	-7.5%
Total costs and expenses	23,284	25,297	(2,013)	-8.0%
Operating profit	\$ 11,934	\$ 12,796	\$ (862)	-6.7%

Revenues

The decrease in revenues was driven by a decrease in the value of contracts written as a result of the aforementioned contract termination. There was a decrease of \$2.1 million in the value of pre-need contracts written and a decrease of \$1.1 million in the value of at-need contracts written, offset by an increase of \$0.1 million in income from our trusts.

Total costs and expenses

The decrease in costs and expenses was driven by reduced expenses as a result of the aforementioned contract termination and primarily related to:

A \$0.2 million decrease in cost of goods sold. This was attributable to the corresponding decrease in the value of contracts written.

A \$0.1 million decrease in selling expense. The decrease was primarily due to decreases of \$0.2 million in commissions and \$0.1 million in labor costs, offset by an increase of \$0.2 million in telephone and telemarketing costs.

A \$1.3 million decrease in cemetery expenses. The decrease was primarily due to decreases of \$0.6 million in labor costs, \$0.2 million in utility costs, \$0.1 million in repair and maintenance costs and \$0.3 million in real estate taxes.

A \$0.2 million decrease in general and administrative expenses. The decrease was primarily due to a decrease of \$0.1 million in labor costs and several other small decreases.

A \$0.1 million decrease in depreciation.

Funeral Home Segment

In 2011 and 2012, we acquired 14 funeral homes. Of these acquisitions, 4 occurred during the second quarter of 2011, 4 occurred during the third quarter of 2011, 4 occurred during the fourth quarter of 2011 and 2 occurred during the second quarter of 2012. Therefore, the results of operations for these properties have no impact on the six months ended June 30, 2011, but are included in the six months ended June 30, 2012.

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These additions are primarily responsible for the entire increase to revenues and the majority of the increase to costs and expenses for this segment.

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The table below compares the results of operations for our Funeral Home segment for the six months ended June 30, 2012 to the same period last year:

	2012	Six months ended June 30, 2011	Change (\$) (in thousands) (non-GAAP)	Change (%)
Total revenues	\$ 17,462	\$ 15,044	\$ 2,418	16.1%
Total costs and expenses	14,625	11,574	3,051	26.4%
Operating profit	\$ 2,837	\$ 3,470	\$ (633)	-18.2%

Revenues

The increase in revenues was primarily attributable to a \$1.0 million increase in at-need revenues, a \$0.9 million increase in pre-need revenues and a \$0.5 million increase in other revenues.

Total costs and expenses

The increase in costs and expenses was primarily attributable to an increase of \$1.4 million in personnel expenses, \$0.2 million in facility costs, \$0.4 million in merchandise costs and \$0.6 million in depreciation, with the remainder attributable to increases in other general expense categories.

Corporate Segment

The table below compares expenses incurred by the Corporate segment for the six months ended June 30, 2012 to the same period last year:

	2012	Six months ended June 30, 2011	Change (\$) (in thousands) (non-GAAP)	Change (%)
Selling, cemetery and general and administrative expenses	\$ 899	\$ 675	\$ 224	33.2%
Depreciation and amortization	822	1,478	(656)	-44.4%
Acquisition related costs	1,113	1,958	(845)	-43.2%
Corporate expenses				
Corporate personnel expenses	6,197	5,658	539	9.5%
Other corporate expenses	8,162	6,286	1,876	29.8%
Total corporate overhead	14,359	11,944	2,415	20.2%
Total corporate expenses	\$ 17,193	\$ 16,055	\$ 1,138	7.1%

The increase in selling, cemetery and general and administrative expenses allocated to the Corporate segment was primarily attributable to commissions and training. The increase in total corporate overhead was primarily attributable to an increase of \$0.5 million in labor costs, \$1.1 million in professional fees, and \$0.1 million in advertising costs, with the remainder attributable to various corporate expenses. Acquisition related costs will vary from period to period depending on the amount of acquisition activity that takes place.

Reconciliation of Segment Results of Operations to Consolidated Results of Operations

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As discussed in the segment sections of this Management's Discussion and Analysis of Financial Condition and Results of Operations, cemetery revenues and their associated costs as reported at the segment level are not deferred until such time that we meet the delivery component for revenue recognition.

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The table below analyzes results of operations and the changes therein for the six months ended June 30, 2012 as compared to the same period last year. The table is structured so that our readers can determine whether changes were based upon changes in the level of merchandise and services and other revenues generated during each period and/ or changes in the timing of when merchandise and services were delivered:

	Six months ended June 30, 2012 (in thousands)			Six months ended June 30, 2011 (in thousands)			Change in	
	Segment Results (non-GAAP)	GAAP Adjustments	GAAP Results	Segment Results (non-GAAP)	GAAP Adjustments	GAAP Results	Change in GAAP results (\$)	Change in GAAP results (%)
Revenues								
Pre-need cemetery revenues	\$ 63,615	\$ (15,726)	\$ 47,889	\$ 60,657	\$ (17,212)	\$ 43,445	\$ 4,444	10.2%
At-need cemetery revenues	40,860	(1,978)	38,882	40,207	(3,460)	36,747	2,135	5.8%
Investment income from trusts	20,405	(8,909)	11,496	17,267	(7,442)	9,825	1,671	17.0%
Interest income	3,737		3,737	3,138		3,138	599	19.1%
Funeral home revenues	17,462	(670)	16,792	15,044	(349)	14,695	2,097	14.3%
Other cemetery revenues	1,792	507	2,299	1,087	401	1,488	811	54.5%
Total revenues	147,871	(26,776)	121,095	137,400	(28,062)	109,338	11,757	10.8%
Costs and expenses								
Cost of goods sold	16,419	(2,763)	13,656	15,003	(2,794)	12,209	1,447	11.9%
Cemetery expense	27,567		27,567	27,548		27,548	19	0.1%
Selling expense	28,612	(3,702)	24,910	26,769	(5,038)	21,731	3,179	14.6%
General and administrative expense	14,388		14,388	13,458		13,458	930	6.9%
Corporate overhead	14,359		14,359	11,944		11,944	2,415	20.2%
Depreciation and amortization	4,560		4,560	4,488		4,488	72	1.6%
Funeral home expense	13,487	(116)	13,371	11,007		11,007	2,364	21.5%
Acquisition related costs	1,113		1,113	1,958		1,958	(845)	-43.2%
Total costs and expenses	120,505	(6,581)	113,924	112,175	(7,832)	104,343	9,581	9.2%
Operating profit	\$ 27,366	\$ (20,195)	\$ 7,171	\$ 25,225	\$ (20,230)	\$ 4,995	\$ 2,176	43.6%

Revenues

Pre-need cemetery revenues were \$47.9 million for the six months ended June 30, 2012, an increase of \$4.4 million, or 10.2%, as compared to \$43.5 million during the same period last year. The increase was primarily caused by an increase of \$3.0 million in the value of cemetery contracts written and a decrease of \$1.5 million in deferred revenue.

At-need cemetery revenues were \$38.9 million for the six months ended June 30, 2012, an increase of \$2.1 million, or 5.8%, as compared to \$36.8 million during the same period last year. The increase was primarily caused by an increase of \$0.7 million in the value of cemetery contracts written and a decrease in deferred revenue of \$1.4 million.

The majority of the increase in the value of pre-need and at-need contracts was primarily driven by our Cemetery Operations - Southeast segment where we acquired 6 cemeteries during the third quarter of 2011 and 5 cemeteries during the fourth quarter of 2011. Therefore, the results of operations for these cemeteries are included in the six months ended June 30, 2012, but have no impact on the six months ended June 30, 2011. In addition, the value of pre-need and at-need contracts was negatively impacted by the termination of our operating agreement

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with the Archdiocese of Detroit that occurred March 31, 2012.

Investment income from trusts was \$11.5 million for the six months ended June 30, 2012, an increase of \$1.7 million, or 17.0%, as compared to \$9.8 million during the same period last year. On a segment basis, we had an increase of \$3.1 million, which was offset by an adjustment of \$1.4 million related to funds for which we have not met the requirements that would allow us to recognize them as revenue.

Interest income on accounts receivable was \$3.7 million for the six months ended June 30, 2012, an increase of \$0.6 million, or 19.1%, as compared to \$3.1 million during the same period last year.

Revenues for the Funeral Home segment were \$16.8 million for the six months ended June 30, 2012, an increase of \$2.1 million, or 14.3%, compared to \$14.7 million during the same period last year. The increase was driven by the 10 funeral homes we acquired in 2011 and 2012, and was primarily attributable to a \$0.6 million increase in at-need revenues, a \$0.6 million increase in pre-need revenues and a \$0.9 million increase in other revenues.

Other cemetery revenues were \$2.3 million for the six months ended June 30, 2012, as compared to \$1.5 million during the same period last year.

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Costs and Expenses

Cost of goods sold were \$13.7 million during the six months ended June 30, 2012, an increase of \$1.5 million, or 11.9%, as compared to \$12.2 million during the same period last year. The ratio of cost of goods sold to cemetery revenues increased slightly to 15.7% during the six months ended June 30, 2012 as compared to 15.2% during the same period last year.

Cemetery expenses were \$27.6 million during the six months ended June 30, 2012 and 2011. Overall expense increases of \$0.1 million in labor costs and \$0.4 million in repairs and maintenance were offset by decreases of \$0.4 million in real estate taxes and \$0.1 million in utilities. Cemetery expenses relate to the current costs of managing and maintaining our cemetery properties. These costs are expensed as incurred and are not deferred. Accordingly, from a margin standpoint, the most effective gauge of measuring cemetery expenses is as a ratio of segment level pre-need and at-need cemetery revenues. The ratio of cemetery expenses to segment level pre-need and at-need cemetery revenues was 26.4% during the six months ended June 30, 2012 as compared to 27.3% during the same period last year.

Selling expenses were \$24.9 million during the six months ended June 30, 2012, an increase of \$3.2 million, or 14.6%, as compared to \$21.7 million during the same period last year. The majority of our selling expenses are directly related to sales commissions and bonuses, which would be directly related to changes in the value of pre-need and at-need contracts written. The ratio of selling expenses to cemetery revenues increased to 28.7% during the six months ended June 30, 2012 as compared to 27.1% during the same period last year. The major components of the overall expense increase include \$0.8 million in commissions, \$0.6 million in salaries and benefits and \$0.4 million in telephone and telemarketing expense, as well as a reduction in deferred selling expenses of \$1.3 million.

General and administrative expenses were \$14.4 million during the six months ended June 30, 2012, an increase of \$0.9 million, or 6.9%, compared to \$13.5 million during the same period last year. The majority of the increase was due to increases of \$0.6 million in labor costs, \$0.3 million in insurance costs and \$0.2 million in professional fees offset by decreases to other general expenses. General and administrative expenses are expensed as incurred and are not deferred. Accordingly, from a margin standpoint, the most effective gauge of measuring general and administrative expenses is as a ratio of segment level pre-need and at-need cemetery revenues. The ratio of general and administrative expenses to segment level pre-need and at-need cemetery revenues increased slightly to 13.8% during the six months ended June 30, 2012 compared to 13.3% during the same period last year.

Total corporate overhead was \$14.4 million during the six months ended June 30, 2012, an increase of \$2.4 million, or 20.2%, compared to \$12.0 million during the same period last year. The increase was primarily attributable to an increase of \$0.5 million in labor costs, \$1.1 million in professional fees, and \$0.1 million in advertising costs, with the remainder attributable to general office costs.

Depreciation and amortization was \$4.6 million during the six months ended June 30, 2012, an increase of \$0.1 million, or 1.6%, as compared to \$4.5 million during the period last year. The increase was primarily due to additional depreciation and amortization from recent acquisitions.

Funeral home expenses were \$13.4 million for the six months ended June 30, 2012, an increase of \$2.4 million, or 21.5%, as compared to \$11.0 million during the same period last year. The increase was primarily attributable to an increase of \$1.4 million in labor costs, \$0.4 million in merchandise costs, \$0.2 million in facility costs and \$0.1 million in advertising costs, with the remainder attributable to various increases in general and administrative and other expense.

Acquisition related costs were \$1.1 million for the six months ended June 30, 2012, a decrease of \$0.8 million, or 43.2%, as compared to \$1.9 million during the same period last year. These costs will vary from period to period depending on the amount of acquisition activity that takes place.

Non-segment Allocated Results

As previously mentioned, certain income statement amounts are not allocated to segment operations. These amounts are those line items that can be found on our income statement below operating profit and above income before income taxes.

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The table below summarizes these items and the changes between the six months ended June 30, 2012 and 2011:

	2012	Six months ended June 30, 2011	Change (\$) (in thousands)	Change (%)
Expenses related to refinancing	\$	\$ 453	\$ (453)	-100.0%
Early extinguishment of debt		4,010	(4,010)	-100.0%
Gain (loss) on termination of operating agreement	1,737		1,737	n/a
Gain on acquisition	122		122	n/a
Interest expense	9,836	9,442	394	4.2%
Income tax benefit	\$ (667)	\$ (2,511)	\$ 1,844	-73.4%

During the six months ended June 30, 2011, we incurred \$0.5 million of expenses when we amended our credit facilities in January of 2011 and incurred an early extinguishment of debt charge of \$4.0 million related to a one-time make-whole premium we paid in connection with the early repayment of our \$35.0 million in Class B and Class C Senior Secured Notes.

During the six months ended June 30, 2012, we recognized a gain of \$1.7 million related to the termination of an operating agreement.

The gain on acquisition relates to one of our second quarter 2012 acquisitions. Refer to Note 13 of our unaudited condensed consolidated financial statements in Item 1 of the Form 10-Q for a more detailed discussion.

Interest expense has increased during the six months ended June 30, 2012 as compared to the same period last year. This increase is caused by increased borrowings on our credit facility, which are offset in part by a change in our debt mix and reduced interest rates. Average amounts outstanding under our credit facility were \$54.7 million and \$8.9 million during the six months ended June 30, 2012 and 2011, respectively. However, amendments that we made to our credit facility have reduced our interest rate and the rate was approximately 2.8% lower at June 30, 2012 as opposed to the same period last year. In addition, we had \$35.0 million of Senior Secured Notes which bore interest at 12.5% outstanding at the beginning of 2011. The Senior Secured Notes were repaid in February of 2011.

We had an income tax benefit of \$0.7 million for the six months ended June 30, 2012, as compared to a benefit of \$2.5 million during the same period last year. Our effective tax rate differs from our statutory tax rate primarily because our legal entity structure includes different tax filing entities, including a significant number of partnerships that are not subject to paying tax.

Table of Contents**Supplemental data**

The following table presents supplemental operating data for the periods presented:

	Three months ended June 30, 2012	Three months ended June 30, 2011	Six months ended June 30, 2012	Six months ended June 30, 2011
Operating Data:				
Interments performed	11,127	11,096	22,928	22,780
Interment rights sold:				
Lots	7,627	8,373	13,857	14,278
Mausoleum crypts (including pre-construction)	624	940	1,201	1,548
Niches	245	320	519	582
Total interment rights sold	8,496	9,633	15,577	16,408
Number of contracts written	25,834	27,152	50,240	51,139
Aggregate contract amount, in thousands (excluding interest)	\$ 66,070	\$ 64,232	\$ 127,094	\$ 121,135
Average amount per contract (excluding interest)	\$ 2,557	\$ 2,366	\$ 2,530	\$ 2,369
Number of pre-need contracts written	12,930	13,653	24,516	25,215
Aggregate pre-need contract amount, in thousands (excluding interest)	\$ 43,292	\$ 41,790	\$ 81,978	\$ 77,200
Average amount per pre-need contract (excluding interest)	\$ 3,348	\$ 3,061	\$ 3,344	\$ 3,062
Number of at-need contracts written	12,904	13,499	25,724	25,924
Aggregate at-need contract amount, in thousands	\$ 22,778	\$ 22,442	\$ 45,116	\$ 43,935
Average amount per at-need contract	\$ 1,765	\$ 1,663	\$ 1,754	\$ 1,696

Liquidity and Capital Resources**Overview**

Our primary short-term liquidity needs are to fund general working capital requirements, repay our debt obligations, service our debt, make routine maintenance capital improvements and pay distributions. We will need additional liquidity to construct mausoleum and lawn crypts on the grounds of our cemetery properties.

Our primary sources of liquidity are cash flow from operations and amounts available under our credit facilities as described below. In the past, we have been able to increase our liquidity through long-term bank borrowings and the issuance of additional common units and other partnership securities, including debt, subject to the restrictions in our credit facility and under our senior secured notes.

We believe that cash generated from operations and our borrowing capacity under our credit facility, which is discussed below, will be sufficient to meet our working capital requirements as well as our anticipated capital expenditures for the foreseeable future.

In addition to macroeconomic conditions, our ability to satisfy our debt service obligations, fund planned capital expenditures, make acquisitions and pay distributions to partners will depend upon our future operating performance. Our operating performance is primarily dependent on the sales volume of customer contracts, the cost of purchasing cemetery merchandise that we have sold, the amount of funds withdrawn from merchandise trusts and perpetual care trusts and the timing and amount of collections on our pre-need installment contracts.

Long-term Debt

10.25% Senior Notes due 2017

We have outstanding \$150.0 million aggregate principal amount of 10.25% Senior Notes due 2017 (the Senior Notes), with an original issue discount of approximately \$4.0 million. We pay 10.25% interest per annum on the principal amount of the Senior Notes, payable in cash semi-annually in arrears on June 1 and December 1 of each year. The Senior Notes mature on December 1, 2017. As of June 30, 2012, we were in compliance with all applicable covenants included in the Indenture governing the Senior Notes.

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Credit Facility

On January 19, 2012, we entered into the Third Amended and Restated Credit Agreement (the "Credit Agreement"). The terms of the Credit Agreement are substantially the same as the terms of the prior agreement which was amended numerous times prior to entering into the Credit Agreement. Capitalized terms which are not defined in the following description shall have the meaning assigned to such terms in the Credit Agreement.

The Credit Agreement provides for a total Revolving Credit Facility of \$130.0 million (the "Credit Facility"). Previously, the agreement had an Acquisition Credit Facility and a Revolving Credit Facility with different borrowing limits. The proceeds of the Credit Facility may be used to finance working capital requirements, Permitted Acquisitions and the purchase and construction of mausoleums. The maturity date of the Credit Facility is January 19, 2017.

At June 30, 2012, amounts outstanding under the Credit Facility bear interest at a rate of 3.7%. Amounts borrowed may be either Base Rate Loans or Eurodollar Rate Loans and amounts repaid or prepaid during the term may be reborrowed. Depending on the type of loan, borrowings bear interest at the Base Rate or Eurodollar Rate, plus applicable margins ranging from 1.25% to 2.75% and 2.25% to 3.75%, respectively, depending on our Consolidated Leverage Ratio. The Base Rate is the highest of the Prime Rate, the Federal Funds Rate plus 0.50%, or the Eurodollar Rate plus 1.0%. The Eurodollar rate is the British Bankers Association LIBOR Rate.

The Credit Agreement requires us to pay an unused Commitment Fee, which is calculated based on the amount by which the commitments under the Credit Agreement exceed the outstanding amounts under the Credit Facility. The Commitment Fee Rate under the Credit Agreement ranges from 0.375% to 0.75% depending on our Consolidated Leverage Ratio.

The Credit Agreement contains restrictive covenants that, among other things, prohibit distributions upon defined events of default, restrict investments and sales of assets and require us to maintain certain financial covenants, including specified financial ratios. A material decrease in revenues could cause us to breach certain financial covenants. Any such breach could allow the Lenders to accelerate our debt which would have a material adverse effect on our business, financial condition or results of operations. As of June 30, 2012 we were in compliance with all applicable covenants under the Credit Agreement.

Amounts outstanding under our credit facility fluctuated during the six months ended June 30, 2012 and 2011. At the beginning of 2012, we had \$43.8 million outstanding on our credit facilities. These amounts were combined into one facility in January of 2012. We borrowed an additional \$7.3 million and \$10.9 million during the first and second quarters of 2012, respectively, and have outstanding borrowings of \$62.0 million on our Credit Facility at June 30, 2012. At the beginning of 2011, we had \$33.5 million outstanding on our credit facilities which we repaid in February of 2011. We did not have any additional borrowings on our credit facilities from this point through the end of May 2011, when we borrowed \$8.0 million. The average amounts borrowed under our credit facilities were \$54.7 million and \$8.9 million for the six months ended June 30, 2012 and 2011, respectively.

For a more detailed description of our long-term debt agreements, see our 2011 Form 10-K.

Cash Flow from Operating Activities

Cash flows provided by operating activities were \$14.2 million during the six months ended June 30, 2012, an increase of \$17.3 million compared to cash flows used in operating activities of \$3.1 million during the same period last year. The increase is primarily due to a decrease in cash used for payables of \$7.9 million, a decrease of cash inflows into the merchandise trusts of \$9.3 million, a decrease in interest paid of \$0.5 million and a decrease in acquisition related costs of \$0.8 million, combined with increased cash flows of \$2.1 million from our accounts receivable and the use of \$3.5 million more in cash to satisfy merchandise liabilities.

Cash Flow from Investing Activities

Net cash used in investing activities was \$8.9 million during the six months ended June 30, 2012 as compared to \$9.3 million during the same period last year. Cash flows used for investing activities during the six months ended June 30, 2012 were \$3.4 million paid for the acquisition of 1 cemetery and 2 funeral homes and the execution of a revised operating agreement and \$5.4 million for other capital expenditures. Cash flows used for investing activities during the six months ended June 30, 2011 were \$3.8 million for the acquisition of six cemetery properties and four funeral homes and \$5.5 million for other capital expenditures.

Cash Flow from Financing Activities

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Cash flows used in financing activities were \$9.6 million during the six months ended June 30, 2012 as compared to cash provided by financing activities of \$17.6 million during the same period last year. Cash flows used in financing activities for the six months ended June 30, 2012 were cash distributions to unit holders of \$23.6 million and financing costs related to our amended credit facility of \$1.8 million, offset by net borrowings of \$15.8 million. Cash flows provided by financing activities

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for the six months ended June 30, 2011 were \$103.2 million of proceeds from our public offering and contribution from our general partner of \$2.2 million offset by net repayments of long-term debt of \$61.6 million, cash distributions to unit holders of \$21.1 million, the payment of a \$4.0 million make-whole premium related to the pay-off of \$35.0 million in Senior Secured Notes and cost of financing activities of \$1.1 million.

Capital Expenditures

The following table summarizes total maintenance capital expenditures and expansion capital expenditures, including expenditures for the construction of mausoleums and for acquisitions, for the periods presented:

	Three months ended June 30,		Six months ended June 30,	
	2012 (in thousands)	2011 (in thousands)	2012 (in thousands)	2011 (in thousands)
Maintenance capital expenditures	\$ 937	\$ 1,445	\$ 1,835	\$ 3,204
Expansion capital expenditures	4,157	3,714	7,026	6,120
Total capital expenditures	\$ 5,094	\$ 5,159	\$ 8,861	\$ 9,324

Pursuant to our partnership agreement, in connection with determining operating cash flows available for distribution, costs to construct mausoleum crypts and lawn crypts may be considered to be a combination of maintenance capital expenditures and expansion capital expenditures depending on the purposes for construction. Our general partner, with the concurrence of its conflicts committee, has the discretion to determine how to allocate a capital expenditure for the construction of a mausoleum crypt or a lawn crypt between maintenance capital expenditures and expansion capital expenditures. In addition, maintenance capital expenditures for the construction of a mausoleum crypt or a lawn crypt are not subtracted from operating surplus in the quarter incurred but rather are subtracted from operating surplus ratably during the estimated number of years it will take to sell all of the available spaces in the mausoleum or lawn crypt. Estimated life is determined by our general partner, with the concurrence of its conflicts committee.

Seasonality

The death care business is relatively stable and predictable. Although we experience seasonal increases in deaths due to extreme weather conditions and winter flu, these increases have not historically had any significant impact on our results of operations. In addition, we perform fewer initial openings and closings in the winter when the ground is frozen.

Item 3. Quantitative and Qualitative Disclosure About Market Risk

The information presented below should be read in conjunction with the notes to our unaudited condensed consolidated financial statements included under Part I Item 1 Financial Statements in this Quarterly Report on Form 10-Q.

The market risk inherent in our market risk sensitive instruments and positions is the potential change arising from increases or decreases in interest rates and the prices of marketable equity securities, as discussed below. Our exposure to market risk includes forward-looking statements and represents an estimate of possible changes in fair value or future earnings that would occur assuming hypothetical future movements in interest rates or debt and equity markets. Our views on market risk are not necessarily indicative of actual results that may occur and do not represent the maximum possible gains and losses that may occur, since actual gains and losses will differ from those estimated, based on actual fluctuations in interest rates, equity markets and the timing of transactions. We classify our market risk sensitive instruments and positions as other than trading.

Interest-Bearing Investments

Our fixed-income securities subject to market risk consist primarily of investments in our merchandise trusts and perpetual care trusts. As of June 30, 2012, the fair value of fixed-income securities in our merchandise trusts represented 2.3% of the fair value of total trust assets while the

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fair value of fixed-income securities in our perpetual care trusts represented 9.0% of the fair value of total trust assets. The aggregate quoted fair value of these fixed-income securities was \$7.9 million and \$24.2 million in merchandise trusts and perpetual care trusts, respectively, as of June 30, 2012. Each 1% change in interest rates on these fixed-income securities would result in changes of approximately \$79,000 and \$242,000 in the fair market value of the assets in our merchandise trusts and perpetual care trusts, respectively, based on discounted expected future cash flows. If these securities are held to maturity, no change in fair market value will be realized.

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Our money market and other short-term investments subject to market risk consist primarily of investments in our merchandise trusts and perpetual care trusts. As of June 30, 2012, the fair value of money market and short-term investments in our merchandise trusts represented 8.9% of the fair value of total trust assets while the fair value of money market and short-term investments in our perpetual care trusts represented 5.9% of the fair value of total trust assets. The aggregate quoted fair value of these money market and short-term investments was \$30.9 million and \$15.8 million in merchandise trusts and perpetual care trusts, respectively, as of June 30, 2012. Each 1% change in interest rates on these money market and short-term investments would result in changes of approximately \$309,000 and \$158,000 in the fair market value of the assets in our merchandise trusts and perpetual care trusts, respectively, based on discounted expected future cash flows.

Marketable Equity Securities

Our marketable equity securities subject to market risk consist primarily of investments held in our merchandise trusts and perpetual care trusts. These assets consist of both individual equity securities as well as closed and open ended mutual funds. As of June 30, 2012, the fair value of marketable individual equity securities in our merchandise trusts represented 18.5% of the fair value of total trust assets while the fair value of marketable individual equity securities in our perpetual care trusts represented 10.4% of total trust assets. The aggregate quoted fair market value of these marketable individual equity securities was \$63.9 million and \$28.1 million in merchandise trusts and perpetual care trusts, respectively, as of June 30, 2012, based on final quoted sales prices. Each 10% change in the average market prices of the individual equity securities would result in a change of approximately \$6.4 million and \$2.8 million in the fair market value of securities held in merchandise trusts and perpetual care trusts, respectively. As of June 30, 2012, the fair value of marketable closed and open ended mutual funds in our merchandise trusts represented 65.7% of the fair value of total trust assets while the fair value of closed and open ended mutual funds in our perpetual care trusts represented 73.6% of total trust assets. The aggregate quoted fair market value of these closed and open ended mutual funds was \$227.3 million and \$198.2 million in merchandise trusts and perpetual care trusts, respectively, as of June 30, 2012, based on final quoted sales prices. Each 10% change in the average market prices of the closed and open ended mutual funds would result in a change of approximately \$22.7 million and \$19.8 million in the fair market value of securities held in merchandise trusts and perpetual care trusts, respectively.

Investment Strategies and Objectives

Our internal investment strategies and objectives for funds held in merchandise trusts and perpetual care trusts are specified in an Investment Policy Statement which requires us to do the following:

State in a written document our expectations, objectives, tolerances for risk and guidelines in the investment of our assets;

Set forth a disciplined and consistent structure for managing all trust assets. This structure is based on a long-term asset allocation strategy, which is diversified across asset classes, investment styles and strategies. We believe this structure is likely to meet our stated objectives within our tolerances for risk and variability. This structure also includes ranges around the target allocations allowing for adjustments when appropriate to reduce risk or enhance returns. It further includes guidelines for the selection of investment managers and vehicles through which to implement the investment strategy;

Provide specific guidelines for each investment manager. These guidelines control the level of overall risk and liquidity assumed in each portfolio;

Appoint third-party investment advisors to oversee the specific investment managers and advise our Trust and Compliance Committee; and

Establish criteria to monitor, evaluate and compare the performance results achieved by the overall trust portfolios and by our investment managers. This allows us to compare the performance results of the trusts to our objectives and other benchmarks, including peer performance, on a regular basis.

Our investment guidelines are based on relatively long investment horizons, which vary with the type of trust. Because of this, interim fluctuations should be viewed with appropriate perspective. The strategic asset allocation of the trust portfolios is also based on this longer-term perspective. However, in developing our investment policy, we have taken into account the potential negative impact on our operations and

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financial performance of significant short-term declines in market value.

We recognize the challenges we face in achieving our investment objectives in light of the uncertainties and complexities of contemporary investment markets. Furthermore, we recognize that, in order to achieve the stated long-term objectives, we may have short-term declines in market value. Given the need to maintain consistent values in the portfolio, we have attempted to develop a strategy which is likely to maximize returns and earnings without experiencing overall declines in value in excess of 3% over any 12-month period.

In order to consistently achieve the stated return objectives within our tolerance for risk, we use a strategy of allocating appropriate portions of our portfolio to a variety of asset classes with attractive risk and return characteristics, and low to moderate correlations of returns. See the notes to our unaudited condensed consolidated financial statements for a breakdown of the assets held in our merchandise trusts and perpetual care trusts by asset class.

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Debt Instruments

Our Credit Facility bears interest at a floating rate, based on LIBOR, which is adjusted quarterly. This subjects us to increases in interest expense resulting from movements in interest rates. As of June 30, 2012, we had \$62.0 million of borrowings outstanding under our Credit Facility. After borrowings, our unused line of credit under the Credit Facility is \$68.0 million. The interest rate on amounts outstanding under the Credit Facility was approximately 3.7% at June 30, 2012.

Item 4. Controls and Procedures **Disclosure Controls and Procedures**

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in the reports that we file or submit under the Securities Exchange Act of 1934, as amended, is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate, to allow timely decisions regarding required disclosure.

As of the end of the period covered by this report, we carried out an evaluation, under the supervision and with the participation of our Disclosure Committee and management, including our Chief Executive Officer and our Chief Financial Officer, of the effectiveness of our disclosure controls and procedures pursuant to Exchange Act Rule 13a-15(b). Based upon, and as of the date of this evaluation, our Chief Executive Officer and our Chief Financial Officer concluded that our disclosure controls and procedures were effective to provide reasonable assurance that information we are required to disclose in our reports under the Securities Exchange Act of 1934 as amended is recorded, processed, summarized and reported within the time periods specified in the SEC's rules and forms, and that such information is accumulated and communicated to our management, including our Chief Executive Officer and Chief Financial Officer, as appropriate to allow timely decisions regarding required disclosure.

Changes in Internal Control over Financial Reporting

There have been no changes in our internal control over financial reporting that occurred during our fiscal quarter ended June 30, 2012 that have materially affected, or are reasonably likely to materially affect, our internal control over financial reporting.

Part II Other Information

Item 1. Legal Proceedings

We and certain of our subsidiaries are parties to legal proceedings that have arisen in the ordinary course of business. We do not expect these matters to have a material adverse effect on our consolidated financial position, results of operations or cash flows. We carry insurance with coverage and coverage limits that we believe to be customary in the funeral home and cemetery industries. Although there can be no assurance that such insurance will be sufficient to protect us against all contingencies, we believe that our insurance protection is reasonable in view of the nature and scope of our operations.

Item 1A. Risk Factors

In addition to the other information set forth in this Quarterly Report on Form 10-Q, you should carefully consider the risk factors discussed in Part I, Item 1A. Risk Factors in our Annual Report on Form 10-K for the fiscal year ended December 31, 2011, and in other reports filed with the SEC which could materially affect our business, financial condition or future results.

The risks described in the Annual Report on Form 10-K for the fiscal year ended December 31, 2011 and in other reports filed with the SEC are not the only risks we face. Additional risks and uncertainties not currently known to us or that we currently deem to be immaterial also may materially adversely affect our business, financial condition and/or operating results.

This Quarterly Report on Form 10-Q contains forward-looking statements that involve risks and uncertainties. Our actual results could differ materially from those anticipated in the forward-looking statements as a result of many factors, including the risks faced by us described in our

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Annual Report on Form 10-K for the fiscal year ended December 31, 2011 and in other reports filed with the SEC.

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Item 2. Unregistered Sales of Equity Securities and Use of Proceeds

On June 6, 2012, certain subsidiaries of the Company acquired the stock of Lodi All Faiths Cremation, a California corporation, and certain assets and liabilities of Lodi Funeral Home, Inc., a California corporation. In consideration for obtaining an option to purchase real property owned by Samuel D. Salas Properties, a California general partnership, on which Lodi Funeral Home, Inc. operates a funeral home and related business, the Company issued 13,720 units to the partnership. See Note 13 to the Unaudited Condensed Consolidated Financial Statements included in Part I, Item 1 of this Quarterly Report on Form 10-Q for a description of this acquisition.

The Company offered and issued the units in reliance upon the exemption from registration contained in Section 4(2) of the Securities Act of 1933, as amended, and Regulation D promulgated thereunder. The Company relied on this exemption from registration based in part on representations made by the investor in the Purchase Agreement.

Item 3. Defaults Upon Senior Securities

None.

Item 4. Mine Safety Disclosures

None.

Item 5. Other Information

None.

Table of Contents**Item 6. Exhibits**

Exhibit Number	Description
10.1	Employment Agreement, effective April 1, 2012, by and between StoneMor GP LLC and William Shane (incorporated by reference to Exhibit 10.1 to the Registrant's Current Report on Form 8-K filed on April 2, 2012).
10.2	Form of the Unit Appreciation Rights Agreement under the StoneMor Partners L.P. Long-Term Incentive Plan, dated as of April 2, 2012.
31.1	Certification pursuant to Exchange Act Rule 13a-14(a) of Lawrence Miller, Chief Executive Officer, President and Chairman of the Board of Directors.
31.2	Certification pursuant to Exchange Act Rule 13a-14(a) of Timothy K. Yost, Chief Financial Officer and Secretary.
32.1	Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350) and Exchange Act Rule 13a-14(b) of Lawrence Miller, Chief Executive Officer, President and Chairman of the Board of Directors (furnished herewith).
32.2	Certification pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (18 U.S.C. § 1350) and Exchange Act Rule 13a-14(b) of Timothy K. Yost, Chief Financial Officer and Secretary (furnished herewith).
101	Attached as Exhibit 101 to this report are the following Interactive Data Files formatted in XBRL (eXtensible Business Reporting Language): (i) Condensed Consolidated Balance Sheets as of June 30, 2012, and December 31, 2011; (ii) Condensed Consolidated Statements of Operations for the three and six months ended June 30, 2012 and 2011; (iii) Condensed Consolidated Statement of Partners' Capital; (iv) Condensed Consolidated Statement of Cash Flows for the six months ended June 30, 2012 and 2011; and (v) Notes to the Condensed Consolidated Financial Statements. Users of this data are advised pursuant to Rule 401 of Regulation S-T that the information contained in the XBRL documents is unaudited and these are not the official publicly filed financial statements of StoneMor Partners, L.P.

Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

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SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

STONEMOR PARTNERS L.P.

By: StoneMor GP LLC
its general partner

August 7, 2012

/s/ Lawrence Miller
Lawrence Miller
Chief Executive Officer, President and Chairman of the Board of
Directors (Principal Executive Officer)

August 7, 2012

/s/ Timothy K. Yost
Timothy K. Yost
Chief Financial Officer and Secretary (Principal Financial Officer)

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