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	**6153**	**22-3755714**
(State or other jurisdiction of incorporation or organization)	(Primary Standard Industrial Classification Code)	(I.R.S. Employer Identification No.)

47 Hulfish Street, Suite 400
Princeton, New Jersey 08542
(609) 683-3831

(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.

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. o

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. o

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. o

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. o

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

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.

	Per Share	Total
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.

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.

	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

	Year Ended December 31,			Three Months Ended March 31,	
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.

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 adverserly 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 $2^1/_2$ 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	
Pro forma net tangible book value per share after this offering		1.26
Dilution per share to new investors		$ 13.74

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
Total	32,406,460	100%	$ 48,159,378	$ 1.49

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 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.

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)

	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

* 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.

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

	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		
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.

* 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.

** 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.

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.

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	
					Amount	%
	(unaudited)		(unaudited)			
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 %

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

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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 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.

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	Change %
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.

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

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):

					Change	
	2002	% of Total Net Revenue	2003	% of Total Net Revenue	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)%

					Change	
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)%
Total other income (expense)	(1,582)	(0.5)%	(2,697)	(0.6)%	(1,115)	(70.5)%
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)%
Net income	$ 4,907	1.4 %	$ 20,133	4.8 %	$ 15,226	310.3 %

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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 captial 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

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.

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 fulfulling 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