

HEARTLAND PAYMENT SYSTEMS INC
Form 10-K
February 28, 2014
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UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

FORM 10-K

(Mark One)

ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the fiscal year ended December 31, 2013

OR

TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the transition period from _____ to _____

Commission File No. 001-32594

HEARTLAND PAYMENT SYSTEMS, INC.
(Exact name of registrant as specified in its charter)
Delaware
(State or other jurisdiction of incorporation or organization)
90 Nassau Street, Princeton, New Jersey 08542
(Address of principal executive offices) (Zip Code)
(609) 683-3831
(Registrant's telephone number, including area code)

22-3755714
(I.R.S. Employer Identification Number)

Securities registered pursuant to 12(b) of the Act:

Title of each class	Name of each exchange on which registered
Common Stock, \$0.001 par value	New York Stock Exchange

Securities registered pursuant to 12(g) of the Act:

(NONE)
(title of Class)

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. YES NO

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. o YES x NO

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Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.

YES NO

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T (§232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). YES NO

Indicate by check mark if disclosure of delinquent filer pursuant to Item 405 of Regulation S-K (§229.405 of this chapter) is not contained herein, and will not be contained, to the best of registrant's knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. []

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See definitions of "large accelerated filer," "accelerated filer," and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer Accelerated filer

Non-accelerated filer (Do not check if a smaller reporting company) Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act). YES NO

The aggregate market value of the voting and non-voting common stock held by non-affiliates computed by reference to the price at which the common stock was last sold on the New York Stock Exchange on June 30, 2013 was approximately \$1.3 billion.

As of February 24, 2014, there were 36,701,106 shares of the registrant's Common Stock, \$0.001 par value, outstanding.

DOCUMENTS INCORPORATED BY REFERENCE

Specifically identified portions of the registrant's definitive proxy statement to be filed with the Securities and Exchange Commission pursuant to Regulation 14A in connection with the 2014 annual meeting of shareholders are incorporated by reference into Part III of this Annual Report on Form 10-K for fiscal year ended December 31, 2013.

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FORWARD LOOKING STATEMENTS

Unless the context requires otherwise, references in this report to “the Company,” “we,” “us,” and “our” refer to Heartland Payment Systems, Inc. and our subsidiaries.

Some of the information in this Annual Report on Form 10-K may contain forward looking statements 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, financial condition and prospects, 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 “anticipate,” “believe,” “estimate,” “expect,” “intend,” “plan,” “predict,” “will be,” “will continue” or similar expressions.

Forward-looking statements involve risks, uncertainties and assumptions. Actual results may differ materially from those expressed in the forward-looking statements. You should understand that many important factors, in addition to those discussed elsewhere in this report, could cause our results to differ materially from those expressed in the forward-looking statements. Certain of these factors are described in Item 1A. Risk Factors and include, without limitation, unauthorized disclosure of user data through breaches of our computer systems or otherwise, our competitive environment, the business cycles and credit risks of our merchants, chargeback liability, merchant attrition, problems with our sponsor banks, our relationships with third-party bankcard payment processors, our inability to pass increased interchange fees, assessments, and transaction fees along to our merchants, economic conditions, systems failures and government regulation.



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PART I.

ITEM 1. BUSINESS

Overview of Our Company

Heartland Payment Systems, Inc.
90 Nassau Street, Princeton, NJ 08542
(609) 683-3831

Our primary business is to provide Card Payment Processing services to merchants throughout the United States. This involves providing end-to-end electronic payment processing services to merchants by facilitating the exchange of information and funds between them and cardholders' financial institutions. To accomplish this, we undertake 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 sell and rent point-of-sale devices. Our card-accepting customers primarily fall into two categories: small and mid-sized merchants (referred to as "Small and Midsized Enterprises," or "SME merchants") and Network Services merchants, which are predominately petroleum industry merchants of all sizes (referred to as "Network Services merchants").

We provide additional services in our other business segments such as:

• School nutrition, point-of-sale solutions, and associated payment solutions, including online prepayment solutions, to K-12 schools through Heartland School Solutions,

• Full-service Payroll Processing and related tax filing services, through Heartland Ovation Payroll,

• Payment processing, higher education loan services and open- and closed-loop payment solutions to colleges and universities through Campus Solutions,

• Prepaid and stored-value card solutions through Micropayments, and marketing solutions including loyalty and gift cards which we provide through Heartland Marketing Solutions.

We were incorporated in June 2000, in the state of Delaware. As of December 31, 2013, we employed 3,184 full- and part-time personnel, including 951 sales professionals, 722 customer service, risk management, financial and operations support and underwriting employees, 458 systems and technology employees, 328 Heartland Ovation Payroll employees, 204 Heartland School Solutions employees, 195 Campus Solutions employees, 250 accounting and administration employees, 31 Micropayments employees and 45 Leaf employees (which were part of our acquisition of Leaf Holdings, Inc, further discussed below). Our sales professionals include 844 Relationship Managers and Territory Managers and 58 Senior Product Advisors, primarily payroll specialists. None of our employees are represented by a labor union, and we have experienced no work stoppages. We consider our employee relations to be good.

General Business Developments

Acquisitions

On September 11, 2013, we purchased 66.67% of the outstanding capital stock of Leaf Holdings, Inc. ("Leaf") for a \$14.5 million cash payment. Leaf provides us with a cloud-based, software-as-a-service (SaaS), Point-of-Sale (POS) system to deliver an open-architecture platform supporting numerous vertical-specific business applications. Leaf products provide a mobile payment platform built for local commerce helping retail stores, restaurants, and other local merchants improve the speed and ease of checkout and offering easy-to-use business management, analytics, and customer engagement. Leaf is currently included in our core Card Payment Processing business.

On December 31, 2012, we purchased for a \$44.2 million cash payment the stock of Ovation Payroll, Inc. ("Ovation"). The acquisition expanded our existing payroll processing business. Ovation provides payroll processing, payroll tax preparation, Internet payroll reporting, and direct deposit to over 10,000 clients in 48 states. With this acquisition the Company added scale to its HOP payroll platform (formerly PlusOne Payroll), leveraging operating costs, and also

added management, a new specialized payroll sales approach, an affinity partner referral network and enhanced product and servicing capabilities.

On December 14, 2012, we purchased for a \$37.6 million cash payment the stock of Educational Computer Systems, Inc. ("ECSI") and net assets of related entities. The acquisition expanded our Campus Solutions business. ECSI supports the

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entire life cycle of higher education and post-graduation school/student services, including student loan payment processing, electronic billing and payment, default solutions, refund services, tuition payment plans, tax document services, and business outsourcing to more than 1,800 colleges and universities nationwide. With this acquisition, our Campus Solutions business gained ECSI's client portfolio, boosting its number of higher education clients to more than 2,000 colleges and universities throughout North America.

On June 29, 2012, we purchased for a \$26.0 million cash payment the net assets of Lunch Byte Systems, Inc. (a.k.a. "Nutrikids"). This acquisition added approximately 10,000 schools to our Heartland School Solutions business providing school nutrition, point-of-sale solutions, and associated payment solutions.

Divestiture

In the fourth quarter of 2012, we, along with the 30% non-controlling shareholders of Collective Point of Sale, Ltd. ("CPOS"), entered into an agreement to sell CPOS to a third party. CPOS, which operates as a provider of payment processing services in Canada, was not a significant subsidiary and we have no continuing involvement in its operations. After receiving regulatory approval, the buyer settled this sale on January 31, 2013. The total sales price was \$30.3 million in cash including net working capital, of which we received \$20.9 million for our 70% ownership position. During the first quarter of 2013, we recorded a gain on sale of \$3.8 million, net of income taxes of \$2.1 million. This gain and prior period earnings are reported as income from discontinued operations in our consolidated statements of income.

Business Segment Overview

Card Payment Processing

Performance Update

At December 31, 2013, we provided card payment processing services to 166,697 active SME merchants located across the United States. This compares to 169,994 active SME merchants at December 31, 2012. At December 31, 2013, we provided card payment processing services to 1,024 Network Services merchants with approximately 42,669 locations, compared to 396 Network Services merchants with approximately 47,064 locations at December 31, 2012. Our total card processing volume for the year ended December 31, 2013 was \$102.3 billion, a 2.0% increase from the \$100.4 billion processed during the year ended December 31, 2012. Our 2013 SME card processing volume was \$74.6 billion, a 4.0% increase over \$71.7 billion in 2012. Total card processing volume for 2013 includes \$27.7 billion of settled volume for Network Services merchants, compared to \$27.9 billion for 2012.

In addition to settling card transactions, Network Services processes a wide range of payment transactions for its predominantly petroleum customer base, including providing 2.3 billion transaction authorizations (primarily for Visa and MasterCard) through its front-end card processing systems in 2013.

According to The Nilson Report, in 2012 we were the 5th largest merchant acquirer in the United States ranked by transaction count and the 9th largest merchant acquirer by processed dollar volume, which consisted of Visa, MasterCard, and Discover signature debit cards, and Plus, Nyce, Pulse, STAR, ACCEL/Exchange and other PIN-based debit cards, in addition to Visa, American Express, MasterCard, Discover, Diners Club, Union Pay, and JCB credit cards. These rankings represented 3.3 billion transactions and 4.5% of the total U.S. bankcard processing market, respectively.

Business Structure

Our Card Payment Processing revenue from SME merchants and Network Services merchants is recurring in nature. We typically enter into three-year service contracts with our SME merchants and three-to-five-year agreements with Network Services merchants.

Most of our SME revenue is from fees for processing transactions, which are primarily a combination of a percentage of the dollar amount of each card transaction we process plus a flat fee per transaction. We make mandatory payments of interchange fees to card issuing banks through card networks and dues, assessments and transaction authorization fees to Visa, MasterCard and Discover, and we retain the remainder as net revenue. For example, in a transaction using a Visa or MasterCard credit card, the allocation of funds resulting from a \$100 transaction follows.

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In contrast, our processing revenues from Network Services merchants generally consist of a flat fee per transaction and thus revenues are driven primarily by the number of transactions we process (whether settled, or only authorized), not card processing volume.

We also provide card processing services for DFS Services, LLC ("Discover") and American Express Travel Related Services Company, Inc. ("American Express").

Our Merchant Base

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 include:

- Restaurants
- Brick and mortar retailers
- Hotel and lodging
- Automotive sales and repair shops
- Convenience and liquor stores
- Professional service providers
- Gas stations

Generally, we define SME merchants as generating annual Visa and MasterCard card processing volume between \$50,000 and \$5,000,000. However, with the added functionality and cost benefits that our in-house processing platforms afford us, we also market to merchants with annual processing volume above \$5,000,000.

The following table summarizes our SME processing volume by merchant category for the month of December 2013, compared to the months of December 2012 and December 2011.

	Month of December			
	2013	2012	2011	
Restaurants	34.6%	36.0%	34.8%	
Retail	17.5%	18.0%	18.2%	
Convenience, Fast Food & Liquor	12.3%	11.2%	10.9%	
Automotive	6.4%	6.5%	7.5%	
Professional Services	7.1%	7.3%	7.1%	
Lodging	4.8%	4.5%	4.3%	
Petroleum	1.8%	1.9%	1.9%	
Other	15.5%	14.6%	15.3%	
Total SME processing volume		\$5.9 billion	\$5.7 billion	\$5.6 billion

No single SME merchant accounted for more than 0.81% of our total SME Visa and MasterCard card processing volume in 2013, and during 2013, our top 25 SME merchants represented only 3.54% of our SME Visa and MasterCard card processing volume and 2.93% of our SME Visa and MasterCard gross processing revenue.

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In December 2013, SME merchants located in the following states represented the following percentages of our SME card processing volume: California represented 9.6%, Texas represented 6.6%, New York represented 4.8%, Florida represented 4.7%, and Pennsylvania represented 4.2%, respectively. No other state represented more than 4% of our total SME card processing volume. Our geographic concentration tends to reflect the states with the highest economic activity, as well as certain states where we have historically maintained a stronger sales force. This merchant and geographic diversification makes us less sensitive to changing economic conditions in any particular industry or region. We believe that the loss of any single SME merchant would not have a material adverse effect on our financial condition or results of operations.

Payment Processing Platforms

We have developed a number of proprietary payment processing systems to increase our operating efficiencies and customize our product offerings. These include:

HPS Exchange, VAPS and NWS, our internal front-end authorization systems, provide authorization and data capture services that distribute processing and merchant data to card networks, merchants, and our sales force and customer service staff. These systems provide us greater control of the electronic transaction process, allow us to offer our merchants a differentiated product offering, and offer economies of scale that we expect will increase our long-term profitability.

HPS Exchange, VAPS and NWS enable us to provide more customized solutions to merchants that demand customized front-end solutions and take advantage of new terminal hardware platforms and technology like our End-to-End Encryption solution (known as "E3"), as well as near field communication ("NFC") and Europay, MasterCard and Visa ("EMV") authentication standards. HPS Exchange, VAPS and NWS offer our merchants authorization and capture services in multiple industry verticals to a variety of point-of-sale systems including legacy terminals, petroleum pumps, middleware technologies, PC-integrated POS systems and a web-based virtual terminals. In addition, HPS Exchange, VAPS and NWS offer third-party point-of-sale developers multiple protocols to meet their needs for integration.

During 2013, approximately 96% of the transactions of our SME merchants were processed on HPS Exchange, and 96% of all merchant accounts established in 2013 were placed on the system. During 2013, 100% of the transactions for our Network Services merchants were processed on VAPS or NWS.

Passport, our internally-developed back-end processing system, provides one settlement platform for SME merchants and Network Services merchants, providing value-added features such as Optimized Funding, multi-bank Next Day Funding, automated dispute resolution, advanced interchange management and single portal integration via InfoCentral. In addition, Passport generates significant cost savings and allows us greater economies of scale, by replacing third party processors' per-transaction charges with more of a fixed-cost structure. This structure allows per-transaction savings as increasing numbers of transactions are processed on Passport. In addition, Passport provides us the opportunity to offer our merchants significantly greater amounts of information regarding their processing characteristics, in more usable formats, and to offer our services to larger merchants. At December 31, 2013 and 2012, substantially all of our SME merchants were processing on Passport, and all of our Network Services settlement merchants were on Passport.

Security, Disaster Recovery and Back-up Systems

In the course of our operations, we compile and maintain a large database of information relating to our merchants and their transactions, and large amounts of card information cross our network as we authorize transactions. We have placed significant emphasis on maintaining a high level of security in order to attempt to protect the information of our merchants and their customers. We maintain current updates of network and operating system security releases and virus definitions, and have engaged a third party to regularly test our systems for vulnerability to unauthorized access. Further, we encrypt the cardholder numbers and merchant data that are stored in our databases using the strongest commercially available encryption methods.

Our internal network configuration provides multiple layers of security to isolate our databases from unauthorized access and implements detailed security rules to limit access to all critical systems.

Visa, STAR, NYCE and other debit card networks have established security guidelines for PIN-based debit transaction processing that is based upon ANSI standards that are published as the “ASC X9 TG-3 PIN Security Compliance Guideline.” We have a regularly scheduled Security Review of our Key Management Procedures against this standard that is performed by an external auditor.

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We also have engaged external auditors to perform an annual Standards for Attestation Engagements No. 16 ("SSAE 16") review and publish our "Report on Controls Placed in Operation and Tests of Operating Effectiveness."

We operate our front-end processing, back-end processing, and other product platforms in two geographically dispersed outsourced data centers located in Texas and California. We establish system service level operational thresholds based on our large national merchants' requirements, and regularly exceed those levels, with system availability of greater than 99.9%. To achieve this standard, transactions are mirrored between the two data centers, and each center has the capacity to handle our full merchant transaction load. This duplicate processing capability ensures uninterrupted transaction processing during maintenance windows and other times processing may not be available. We regularly process through both data centers.

Sponsor Banks

Because we are not a "member bank" as defined by Visa and MasterCard, in order to process and settle these bankcard transactions for our merchants, we have entered into sponsorship agreements with member banks. Visa and MasterCard rules restrict us from performing funds settlement or accessing merchant settlement funds and require that these funds be in the possession of the member bank until the merchant is funded.

A sponsorship agreement permits us to route Visa and MasterCard bankcard transactions under the member bank's control and identification numbers to clear credit and signature debit bankcard transactions through Visa and MasterCard. A sponsorship agreement also enables us to settle funds between cardholders and merchants by delivering funding files to the member bank, which in turn transfers settlement funds to the merchants' bank accounts. These restrictions place the settlement assets and liabilities under the control of the member bank.

The sponsorship agreements with the member banks require, among other things, that we abide by the bylaws and regulations of the Visa and MasterCard networks. If we were to breach a sponsorship agreement, the sponsor banks can terminate the agreement and, under the terms of the agreement, we would have 180 days to identify an alternative sponsor bank. As of December 31, 2013, we have not been notified of any such issues by our sponsor banks, Visa or MasterCard.

At December 31, 2013, we were party to three bank sponsorship agreements.

Our primary sponsor bank for SME merchant processing is Wells Fargo Bank, N.A. ("Wells Fargo"). Either Wells Fargo or we can terminate the agreement if the other party materially breaches the agreement, including non-payment of fees due for processing our monthly settlement of transactions. The agreement may also be terminated if the other party files for or enters bankruptcy, if either party is required to discontinue performing its services under the agreement based upon a final order of a state or federal court or regulatory body or if there is a change in the majority ownership of the other party. Wells Fargo may terminate the agreement with us if we breach the by-laws and regulations of Visa or MasterCard, if either our registration or Wells Fargo's membership with Visa or MasterCard terminates, if any federal or state regulatory authority requests that the agreement be terminated or that Wells Fargo terminate its services or if applicable laws or regulations change to prevent Wells Fargo from performing its services under the agreement. Upon termination of the agreement for any reason, we will have 180 days to convert to another sponsor bank. The agreement, which we entered into with Wells Fargo on February 8, 2012, expires on February 8, 2016 and will automatically renew for successive three-year periods unless either party provides six months' prior written notice of non-renewal to the other party. The sponsorship agreements we have with our other two sponsor banks involve substantially the same terms as apply with Wells Fargo.

In November 2009, we entered into a sponsorship agreement with The Bancorp Bank ("TBB") to sponsor processing for our Network Services merchants. The agreement with TBB expires in February 2015 and will automatically renew for successive one-year periods unless either party provides six months written notice of non-renewal to the other party.

On October 1, 2013, we transferred sponsorship and processing for a portfolio of SME merchants from Heartland Bank to TBB. We were party to a prior sponsorship agreement with Heartland Bank, an unrelated third party, to sponsor SME merchant processing. In March 2013, we notified Heartland Bank of our intention to terminate the sponsorship agreement and made arrangements for continuing sponsorship with TBB under the terms of the November 2009

sponsorship agreement.

On March 24, 2011, we entered into a sponsorship agreement with Barclays Bank Delaware to sponsor processing for certain of our Network Services merchants. The agreement with Barclays Bank Delaware expires in March 2016 and will automatically renew for successive one-year periods unless either party provides six months written notice of non-renewal to the other.

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Following is a breakout of our total Visa and MasterCard settled card processing volume for the month of December 2013 by percentage processed under our individual bank sponsorship agreements:

Sponsor Bank	% of December 2013 Card Processing Volume
Wells Fargo Bank, N.A.	67%
The Bancorp Bank	22%
Barclays Bank Delaware	11%

Customer Acquisition

Unlike many of our competitors who rely on Independent Sales Organizations or salaried salespeople and telemarketers, we have built a direct, commission-based sales force. Our sales model divides the United States into six primary markets overseen by Executive Directors of Business Development. These Executive Directors are responsible for hiring Relationship Managers and increasing the sales of our products in their markets.

As of December 31, 2013, we employed 844 Relationship Managers and Territory Managers in 50 states plus the District of Columbia. This compares to a Relationship Manager and Territory Manager count of 739 at December 31, 2012. In addition, as of December 31, 2013, we employed an additional 58 Senior Product Advisors ("SPAs"), primarily payroll specialists, who have augmented our