

INTRODUCTION

In recent years, both credit fraud and identity theft have quickly become top concerns of consumers, driven by an environment that relies on the Internet and information stored online. According to Gartner Research and Harris Interactive, there are an astounding seven million victims of identity theft annually, or 20,000 per day. In fact, “the [United States] Federal Bureau of Investigation calls identity theft the fastest-growing white-collar crime in the nation” according to a report by ABC News. However, there is no doubt that the public threat is international in scope, with the Internet providing opportunities for individuals throughout the world to steal and often sell personal information. As a result, a whole industry has developed to protect consumers and Victory Partners believes this industry will experience double-digit growth over the next 18-24 months.



INDUSTRY OVERVIEW

There is no uncertainty surrounding the fact that the typical consumer is very concerned about the security of their personal information. Erik Olson, in his ABC News report, states, “Privacy has emerged as one of the hot-button issues in the Internet sector and beyond, and perhaps no other topic has recently captured the public’s fears about the Information Age as forcefully as identity theft.”

For the fifth straight year, grievances regarding identity theft topped the list of complaints with the Federal Trade Commission, as reported by ABC News. Most cases involved credit cards and 25% are related to online fraud. The number of complaints related to identity theft or fraud has multiplied by ten since 1999. According to a press release from LifeLock, an identity theft prevention company, it was predicted that fifteen million (or one in twenty) people in the United States alone would be victims of identity theft, the fastest growing crime in the nation.

Credit Card Fraud: The International Card Manufacturers Association estimates an 11.5% global dollar growth of plastic card transactions to \$9.1B as of October 2006. Meanwhile, bankrate.com explains that companies write off nearly \$50B per year as a result of losses from credit card fraud. The online fraud rate (as a percent of online credit sales) for both Visa and

MasterCard is about three times higher than that of offline fraud (as a percent of offline credit sales). According to a Celent Communications survey, “credit-card payment fraud will cost online merchants a minimum of \$1.0B a year...” According to a national poll by Rasmussen Reports, “The mean fraud amount per victim rose from \$5,249 in 2003 to \$6,383 in 2006.”

Identity Fraud Volume Unchanged Declining Victims, Increasing Amounts			
	Survey Report		
	2003*	2005*	2006
US adult victims of identity fraud***	10.1 M	9.3 M	8.9 M
Fraud victims as % of US population	4.70%	4.25%	4.00%
Total one year fraud amount	\$53.2 B	\$54.4 B	\$56.6 B
Mean fraud amount per fraud victim	\$5,249	\$5,885	\$6,383
Mean consumer cost	\$555	\$675	\$422
Mean resolution time	33 hours	28 hours	40 hours

[*] 2003 survey dollar costs have been adjusted for inflation by 0.075 for the period beginning April 2003 and ending Nov.2005
 [**] 2005 survey dollar costs by 0.035 for the period beginning Nov.2004 and ending Nov.2005
 [***] Based on US population age 18 and over of 215.47 million as of July 1, 2002, of 217.8 million as of July 1, 2003, and of 221.9 million as of July 1, 2005.

Source: Javelin Strategy & Research survey of 2005 ID fraud.

REGULATORY ENVIRONMENT

Unfortunately, opportunities for fraud are created often, as breaches of databases with personal information of thousands are not an uncommon occurrence. Meanwhile, data companies are lobbying to prevent citizens from having any control over their personal data or knowledge of how it is used. While some positive steps have been taken by the government, further intervention creating real results is needed.

President Bush established the President’s Identity Theft Task Force to help push appropriate legislation. As a part of the program, Bush signed the Fair and Accurate Credit Transactions Act of 2003 (FACT Act), which created a national system of fraud detection. The act includes the provision for the right to one free credit report from each of the major credit reporting agencies every year.

Several states have also recently passed laws requiring companies to inform individuals if their information has been breached. Luckily for consumers, the company is required to give all individuals the same notification, even if not required by their home state. While the states are shown to have the best disclosure laws, the trend of the states to adopt the law has caused Congress to consider a federal disclosure standard. The House and Senate bills in

discussion relating to a breach notification would supersede state laws and only notify the consumer if there is evidence that harm can come as a result of the breach. (Vlahos, *Fox News*)

FRAUD PROTECTION SERVICES

Individuals are recognizing that they cannot rely on the government for protection. As a May 2006 Wall Street Journal article explains, "Most Americans are taking steps to prevent identity theft," whether those steps are self-driven or sought out in the products and services of fraud protection companies.

While the Wall Street Journal article indicates that the debit or credit cards of 16% of those polled had been used by someone they did not know, 30% choose to limit online purchases and 24% limit online banking transactions to protect themselves. To further protect their security, consumers should frequently check their credit report, keep their computers clean from cookies and saved passwords, maintain both an anti-virus and firewall program on the computer, only disclose personal information on secure web sites (<https://> rather than <http://>), and perhaps consider purchasing credit monitoring. (Hobson, *ABC News*)

Credit monitoring services will alert a customer if information is added to your profile at one of the three major credit bureaus. My Public Info launched its Public Information Profile service in 2005, which allows consumers to see what personal information is public knowledge and to review for accuracy. (Ulanoff, *PC Magazine*)

THE FUTURE FOR THE FRAUD PREVENTION INDUSTRY

The above options may require action, but they are mainly reactionary in nature, lessening the damage done by a threat instead of actually removing the potential for a threat. While there is no way to fully prevent fraud or identity theft, the problem requires greater attention than the Band-Aid type fixes of the above "solutions". Fortunately, the statements of concern from the public are being met with a response of proactive consumer-driven solutions that are more sophisticated in quelling opportunities for fraud.

The integration of credit and debit cards and even bank accounts with cell phones is a trend in payment systems. For example, Motorola's M-Wallet would allow subscribers to carry out banking and credit transactions from their phone. (Silver, *Wall Street Journal*) Phone manufacturers are also creating a phone with capabilities to execute contactless payment through RFID type technology. At this point, systems for secure mobile payments are neither proven nor widely available. Moreover, these systems make purchases more secure, but do not necessarily create

systems for identity verification- which offers the best solution to prevent identity theft and credit fraud.

One form of identity verification is biometrics, which tests facial features, fingerprints, retinas, keyboard typing patterns, or voice patterns to verify identity. The use of biometric security measures is spreading quickly with a current market size of \$2.2B according to International Biometrics, but its current viability is questionable as the devices are shown to be tricked in some instances. (Bulkeley, *Wall Street Journal*)

Another, called the CreditWall™ system, verifies purchases with the customer by sending a text message to their cell phone. Once a positive response is sent by the consumer, the transaction can be consummated. While following the trend to integrate with phones, this type of service helps to prevent fraud and identity theft for traditional or innovative payment systems. This solid solution also gives the consumer more control and protection through easy proactive steps.

RISK FACTORS AND CURRENT CHALLENGES

A prodigious level of risk is inherent in this industry as it is significantly based on technology and the technology is constantly changing. The speed and evolution of the technological change demand that the business plans of industry players are flexible in their ability to adopt and implement new technologies into their product and service offerings.

Threats to the industry are found in services offered for monthly or large one time fees that can otherwise be found free, as with credit reports. For example, identity insurance is often included in homeowner's insurance, preventing the need to purchase additional insurance. Furthermore, in ten states, consumers have the ability to put a security freeze on their credit reports, prohibiting lenders from ordering the information unless the report is unlocked first with a call by the consumer. (Regnier, *MONEY Magazine*)

RECENT M&A TRANSACTIONS IN THE FRAUD PREVENTION MARKET

As one can see, the fraud prevention industry is currently fragmented, with many competing products and services offered by hundreds of companies. Victory believes that, over the next ten years, a more uniform platform will be adopted that brings about more refined and widespread technology. In addition, the legal response to fraud- particularly online fraud- is expected to be more solidified, helping to prevent database breaches.

Regardless of legal changes, Victory Partners expects that a continued fragmented market and demand from concerned proactive consumers in the near to intermediate term will drive a moderate to high level of capital flow and Merger and Acquisition activity into this industry.

M&A transactions in the fraud and identity theft protection market include the private placement of Lifelock, Inc. with Bessemer Venture Partners for \$6.0M and the purchase of the display card assets of nCryptone by Innovative Card Technologies (OTCBB: INVC) for \$16.5M in June 2006. In addition, Internet security company Verisign Inc. (NasdaqNM: VRSN) closed a buyback of its stock for \$455.3M.

Transactions in the market for mobile payment and verification systems include the purchase of Gemplur International SA (ENXTPA:GEM) by Gemalta N.V (ENXTPA:GTO) for 7.65 X EBITDA and 0.88 X revenue (\$1.4B) as well as the purchase of Turkcell (NYSE:TKC) by Altimo for 9.93 X EBITDA and 3.61 X revenue (\$1.6B).

Victory Partners, LLC is actively involved in analyzing and representing companies in the Fraud Prevention Industry, having provided financial advisory services, performed recapitalizations, and completed M&A transactions for middle market companies.

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