

White Paper

Analysis of the Secondary Gift Card Market

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Introduction

The secondary gift card market is a developing phenomenon. Having come into existence within the past 12 years, it has flourished and grown as a function of the overall growth in Internet services. The secondary gift card market can be defined simply as the total dollar value of unwanted gift cards being liquidated by their current owners at any point in time. The secondary market is a function of the overall gift card issuing market (primary market), reflecting the unused and unwanted cards that were previously issued, and its growth has followed the trajectory present in the issuing market. TowerGroup, a leading research and advisory organization that focuses on the financial services industry, projected total retail gift card spending in 2009 to be \$87 billion¹. Although gift card sales have slightly decreased in 2009, due to a soft economy, they still remain a popular gift for gift givers. As opposed to cash, gift cards are viewed as a more personal gift, allowing the recipient to purchase what they want; but given in a form that can be more sentimental and creative. Retailers like gift cards for a host of reasons – the most evident of which are:

- Virtually no inventory to carry – other than mass-produced plastic cards.
- Gift cards incent consumers to continue coming back to their stores until card balances are depleted.
- Gift cards typically provide a purchasing “lift” of between 20%-50% at the time of purchase, with the consumer buying more than the amount stored on the gift card.
- The extended holiday shopping season they have created extends into January and February as shoppers rush to the stores to pick up great deals and spend their holiday gift cards.

Even with the tremendous popularity and growth in the gift card market, a significant amount of gift card stored value still goes unused for a number of reasons:

- The gift card is for a store or restaurant that the recipient doesn't frequent
- The store or restaurant is not within a convenient proximity to the recipient
- The gift card is stored away and simply forgotten

TowerGroup projected the percentage of unused gift cards for 2009 to be 6% - implying that the size of the unused gift card market is approximately \$5 to \$10 billion². The unused market is comprised of lost cards as well as cards that are never used. The secondary market strictly focuses on the unused cards and tries to get those cards back in the hands of motivated buyers.

So what happens if a consumer never uses a gift card? The answer is that it depends primarily on the state in which the retailer is incorporated in combination with the retailer who issued the card. Some states have unclaimed property laws which require the property be turned over to the state treasury to hold on behalf of the intended recipient. These unclaimed property laws are commonly referred to as escheat laws, and in recent years, the popularity of gift cards has made state treasuries re-examine state escheatment regarding gift cards due to the huge potential revenue windfall.

Some merchants have setup third party subsidiaries in favored states to try to capture the unclaimed property. And unlike revenue from an actual sale of a product, the revenue from the conversion of a gift card is pure profit, because no goods or services were really provided relative to the unused gift card. Despite the problem created by the billions in unused gift cards, there have not been GAAP approved

accounting standards that specifically address the issue of unredeemed gift cards. Users of retail financial statements are relying upon the good judgment of management to determine how much should be recognized as income.

The Secondary Market

Selling used or unwanted gift certificates (prior to gift cards) over the internet dates back to 1995 with the launch of eBay, the largest marketplace for the sale of goods and services. Within eBay, buyers and sellers are brought together in a manner where sellers are permitted to list items for sale and buyers bid on items of interest. The marketplace for products was endless with no one specific product focus. Through 2003, eBay acted as the de facto standard for secondary gift card market transactions.

An exclusive market for unused gift cards was relatively undefined as late as 2003. The National Retail Federation forecasted gift card sales of \$17.2 billion for 2003. With no particular entrants trying specifically to capture a percentage of this multi-billion dollar market, the internet's first secondary gift card marketplace was launched by Swapagift.com.

In an article dated January 18, 2005 the Wall Street Journal coined the phrase "The Secondary Market for Gift Cards"³. At that point in time, the market was formally recognized, and competitors began to enter this billion dollar marketplace.

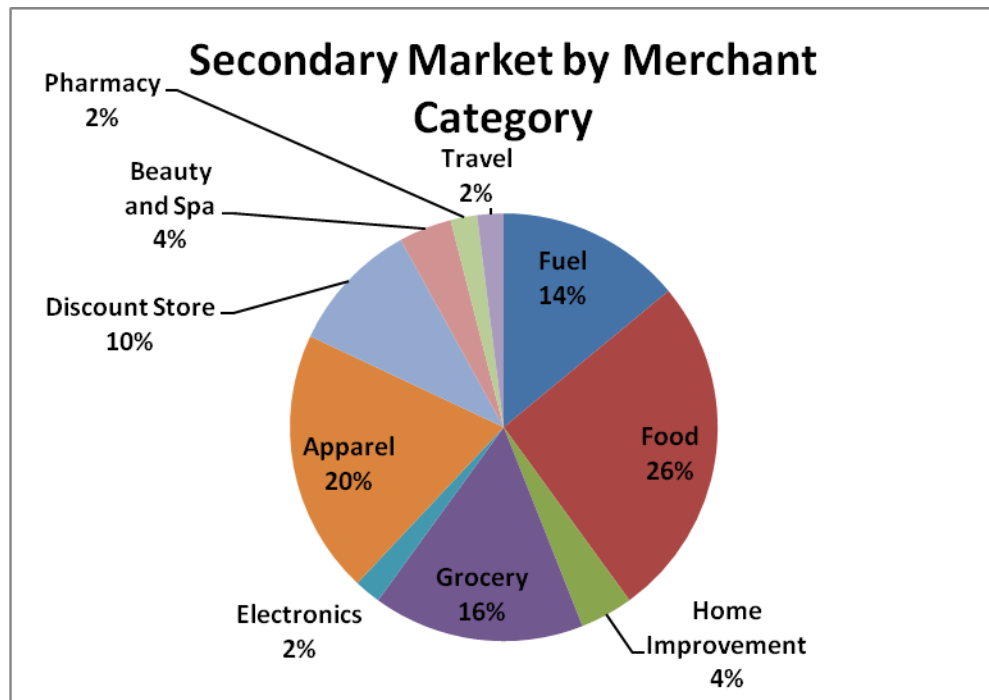
The Swapagift.com model focused exclusively on the buying, selling and trading of merchant gift cards. The three-tier model ensured that consumers had an active exchange for liquidating and trading cards in the secondary gift card market - along with standards that could be supported by such an exchange.

1. **Purchasing Gift Cards.** Swapagift.com offered to purchase merchant gift cards from consumers at a discount to their remaining balance. The customer would simply mail the unused gift card to Swapagift.com and then receive a check for a percentage of the gift card balance. This component was really a "hunch" on the part of the co-founders. They assumed that people would be willing to take a discount for a gift card that they would never use. The hunch was proven to be correct as competing sites tried to emulate this service over the next several years.
2. **Selling Gift Cards.** The inventory of unused gift cards that was purchased was then sold at a discount to bargain-seeking consumers. In this model and to this day, demand for discounted gift cards always exceeds supply. Discounted gift cards are like "free cash". Customers can receive discounts from 5% to 30% on merchant cards. Gift card prices are based on supply and demand.
3. **Swapping Gift Cards.** At its launch and for several years following, Swapagift.com allowed for the swapping of gift cards. The company never took possession of the gift cards - they simply facilitated a secure transaction. This component was always appealing to the main stream media and brought the website enormous media attention over the years. However, since the trading transaction volume did not support the costs of offering the service, it was subsequently dropped in 2008.

Gift Card Inventory Turn Around Time

Gift cards are purchased from customers who have no current or future use for the gift card. These gift cards are then sold at a discount on secondary gift card websites. The demand for discounted gift cards far exceeds the supply. Chart 1.1 shows the composition of the secondary gift card market by merchant category. The data was taken from GiftCards.com from August 2009 to July 2010. The chart displays the category for the top 50 merchant gift cards with the shortest shelf life.

Chart 1.1



In trying to better understand the shelf life of cards in the secondary market, Swapagift.com conducted a customer survey in 2007. The results from the customer survey on buying habits indicated that 96% of the buyers who frequented the site planned on using the card for their own personal use. The insight into this behavior was significant, as it demonstrated that consumers tended to view the discounted gift cards as a coupon and another means of savings.

Fraud in the Secondary Gift Card Market

A discussion of the secondary gift card market would not be complete without understanding the potential for fraud. Only companies that can detect and prevent fraud can survive in the secondary marketplace. Many websites have shut down in the past several years because they failed to implement fraud controls, react to this fraud or understand the significance of the fraud.

A common fraud trend in the secondary gift card market occurs when fraudulent users redeem gift cards that are purchased with illegally obtained funds. The gift card merchant eventually realizes that their issued gift card was purchased illegally, and consequently deactivates the gift card. Of course by the time

this occurs, the secondary gift card company has already paid the fraudster, and has likely sold the merchant gift card to another customer.

As a result, secondary gift card companies are forced to either refund the customer, or wait for the impending chargeback. Either way, the secondary gift card company takes a loss and is left with the arduous task of collecting from the redeemer. Another form of fraud occurs when an individual redeems a gift card, but retains the gift card code in order to continue using the funds on-line at a later date. In essence, the scammer continues to use the gift card they sold after they have been paid for its value load.

In 2004, understanding that the ability to survive and grow in the secondary gift card marketplace could not occur without substantial fraud detection capabilities, Swapagift.com developed fraud detection IP to minimize its occurrence. The rules for fraud detection were continuously improved over the years, and are enforced in every transaction conducted. The Swapagift.com fraud loss percentage for 2009 was 0.002%.

Challenges in the Gift Card Market

1. Ongoing legislation with extensive requirements. In May 2009 President Obama signed the Credit Card Accountability Responsibility and Disclosure Act of 2009 (also called the CARD Act). The final rule amends Regulation E to implement the gift card provisions of the Credit Card Accountability Responsibility and Disclosure Act of 2009. The rules affecting retail gift cards were effective August 22, 2010⁴. The rule placed the following restrictions on gift cards:

- Gift cards cannot expire within five years from the date and it must be clearly disclosed when the card is purchased.
- If the card expires after 5 years it must be clearly disclosed to the buyer.
- No inactivity fess on gift cards except in certain circumstances, such as if there has been no activity for at least 12 months.
- If there are inactivity or dormancy fees they must be disclosed at the time of purchase.
- No more than one fee can be charged in any given month, after inactivity.

2. Government revenue shortfalls add demand on unused balances. Some states facing high debt and revenue shortfalls have been tapping unused property. This can be anything from unused gift cards to dormant bank accounts. Most states are unable to attribute more than a small fraction of the abandoned property. Gift card owners are particularly difficult to track because retailers usually sell them anonymously to protect consumer privacy.⁵

3. Industry-wide dormant balances are estimated at \$5 to \$10 billion. The percentage of unused gift cards for 2009 was predicted to be 6% and represents approximately \$5 to \$10 billion of unused gift cards. The most popular reasons for not using the cards is the people forgot about them, have lost them, or the cards have expired. Some people admit that they did not have time to shop, or couldn't find anything that they wanted to buy.

4. Escheatment liabilities and reporting. In some states, companies can convert the gift card liability into income after a period of time. However, some states have unclaimed property laws which require the property be turned over to the state government. Table 1.1 displays the three models of escheat laws.

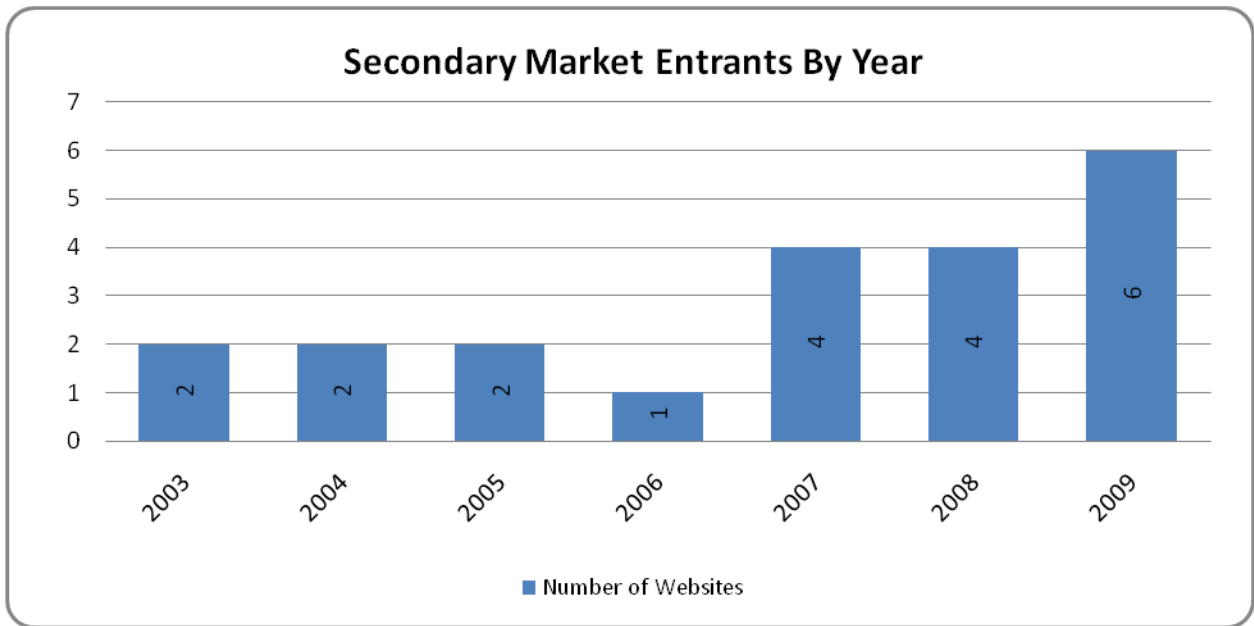
Table 1.1

No expiration or escheat model	This is a very consumer-friendly model used in several states including California, Washington and Massachusetts. This model never gives up the money to the state. The gift card is good from now until eternity. In this model, there is a reserve fund specifically for redemptions set up by the retailer. By setting up this reserve fund, the retailer recognizes that the consumer can eventually redeem the gift card for merchandise. Retailers in these states are not required to have the money escheat to the state.
60/40 model	This is a more traditional model stating that gift cards can come with expiration dates and when they do expire (usually between three and five years) retailers are responsible for having 60 percent of the value of the card escheat to the state. The retailers are allowed to keep the other 40 percent. The state acknowledges that retailers have costs that come with gift cards and allows them to keep a portion of the leftover money. Indiana and Iowa use this law.
No gift-card expiration dates, escheat laws apply	This model is somewhat confusing since the states involved, such as Connecticut, have eliminated expiration dates on gift card and certificates. However, even though consumers will not find expiration dates on their gift cards, they are expected to use their gift cards within three years. Otherwise the state views the gift card as abandoned and the money escheats to the state. However, if a customer comes in after three years and obtains merchandise from the store using their unexpired gift card, the retailers can apply to get the money back from the state.

Table from Bankrate.com⁶

- 5. Gift card websites in the Secondary Market are rapidly growing.** Selling used or unwanted gift cards on the internet dates back to 1995 with the launch of eBay. Craig's list joined the trend in 1997, and since then numerous sites have launched. The first gift trading sites launched in 2003. Swapagift.com was the first gift card trading site that allowed for the buying, selling and swapping of gift cards. Other websites have launched and many have failed. Chart 1.2 displays the number of websites that entered the secondary market and are still in operation today. There are approximately 21 websites focused on selling gift cards in the secondary market in the US.

Chart 1.2



*There are 21 websites in operation today.

- 6. Lack of visibility and control of secondary card sales.** Retailers have little or no control over the cards that are sold on secondary gift card websites. They also do not see or receive any information about these transactions to help them with their business.

The Future of the Secondary Gift Card Market

The secondary gift card market continues to grow, as evidenced by the 6 new entrants into this space this past year. With more than 21 websites operating in the US now, more companies are likely to enter in the near term. Michael Hursta, Vice President of gift card products for First Data, one of the world's largest providers of merchant processing services, talked about the future of gift cards and exchange sites in a recent press release. Hursta said, "As merchants, exchange sites and processors partner to create new value for the holders of gift cards, we expect that the gift card exchange business model and the wide appeal of gift cards will continue to grow."

The secondary gift card market as we know it will continue to evolve rapidly. The technology is already in place to allow for the electronic exchange of gift cards and gift codes. This new world of electronic exchange, coupled with the strategic merchant and card processing partnerships will far surpass the days of exchanging plastic, and will eliminate many of the smaller, under-capitalized players in the space.

Companies who will succeed in this new market will have the following characteristics:

Fraud Measures: Companies wanting to participate in the secondary gift card market will need to have extensive fraud detection and prevention measures in place.

Ability to resell cards on line: As this secondary market grows and more consumers trade in cards, companies participating in this space will need a web site with a lot of traffic to sell the large inventory of cards that have been traded in. These companies will either need to invest millions of dollars to drive enough traffic to a site to sell this inventory or partner with a web site with sufficient traffic to sell this inventory.

PCI Compliant: The Payment Card Industry Data Security Standard (PCI DSS) is a worldwide information security standard defined by the Payment Card Industry Security Standards Council. The standard was created to help organizations that process card payments and hold sensitive financial information (like consumer and gift card information) prevent fraud through increased controls around data and its exposure to compromise. The standard applies to all organizations which hold, process, or exchange cardholder information from any card branded with the logo of one of the card brands. PCI compliance will need to be achieved and maintained in any organization looking to participate in the evolving secondary gift card market.

In-House Print on Demand Capability: This new technology, offered within an organization's PCI compliant processing facility, will allow for the deactivation of unwanted gift cards and the creation of new gift codes or gift cards. Since new cards will be sold, a print-on-demand service will be necessary to handle new gift card sales.

Established Customer Base: Customer loyalty is a long-term challenge that all businesses strive for. Having established, proven, customer service procedures, as well as a staff dedicated to issue resolution will be a key success factor for participating in the secondary gift card market.

Well Capitalized: This secondary market will take time to mature and requires large amounts of capital for web site promotion, security, IT infrastructure and fraud prevention. Companies in this space will need to invest a lot of money to survive and thrive in this market.

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