

Cover Story

Opportunity Knocks

By Michele Molnar

A steady stream of suitors is knocking on the door in the credit and collections market this year. Whether they are private equity investors, companies wanting to make their first foray into the space, or former industry executives waiting in the wings, they join those already on the “inside” who want to build and grow. Buoyed by a stronger economy, low interest rates and market forces, these players are creating a promising mergers and acquisitions environment.

In the first half of 2004, deal value totaled \$778 million in 25 transactions, according to statistics from Kaulkin Ginsberg Company, a Bethesda, Md.-based firm that brokers deals and tracks deal activity. By mid-year, deal volumes-by-dollar had already hit 72.6% of the 2003 total deal value, and almost 65% of 1999’s volume – the industry’s most prolific year when 64 transactions generated a \$1.199 billion total deal value.

“Today, most of the M&A activity is not with financial buyers; it’s with strategic,” says Michael Ginsberg, Kaulkin Ginsberg’s president and CEO. “From early 2000 until last year, the lender and IPO markets were not attractive. Therefore, the strategic buyers were able to complete deals that financial buyers were not able to complete.”

Among the 2004 deals industry insiders are talking most about:

- West Corp.’s acquisition of Worldwide Asset Management LLC, a 10-year-old Marietta, Ga.-based debt portfolio purchasing, government and contingency collections firm, for \$178 million in cash and debt or 8.5 to 9 times EBITDA;
- Convergys Corp.’s acquisition of Encore Receivable Management Inc. of Olathe, Kansas for \$68 million, contingent upon possible earn-out payments based on future performance; and
- U.K.-based Vertex’s acquisition of First Assurance Revenue in Denver for undisclosed terms. Founded in 1997, FRA was named the 125th fastest growing company in the U.S. five years later by Inc. magazine.

The most active strategic buyers of collections firms have been the large public call center companies. “While the infrastructure is similar, how you manage, hire, and compensate personnel is very different. That’s where the learning curve is,” points out Gregory F. Hagood, managing director of SunTrust Robinson Humphrey, an investment bank that advised Nationwide Credit on its recent recapitalization, and represented Equifax and Dun & Bradstreet in the sales of their collections operations several years ago.

West, a communication and conferencing services business, is applying what it learned from its 2002 acquisition of Attention LLC. In late July, West announced plans to purchase Worldwide Asset, which is more than three times the size of Attention. This second collections industry acquisition is a further execution of the Omaha, Neb.-based public company’s three-year-old strategy to find other uses for its outbound infrastructure, which had been languishing. “We think West Corp. can be a very large company in accounts receivable management. This is part of a long-term play for West to be one of the largest and most respected providers of outsourced services in every vertical market we participate in,” explains Tom Barker, West’s CEO.

Convergys, a Cincinnati-based public company that provides billing, employee care, and customer care services, is making its initial entry into the ARM market with its purchase of Encore, which has facilities in Las Vegas and near Kansas City.

Vertex, which already collects \$10 billion in the U.K. annually, creates a U.S. base in that arena through its acquisition of FRA. The Vertex strategy is to expand its North American presence in the utility and energy sectors, beyond the foundation created by a 10-year contract with a Canadian utility.

Methodically pursuing a strategy seems to be today’s norm in acquisitions. “We wanted to make sure we bought a business as a platform going forward, as opposed to a lot of acquisitions – which stall,” says Zachary J. Lewy, president of Vertex North America.

Vertex retained Kaulkin Ginsberg, which showed them 20 companies. Lewy describes the candidates as falling into one of two general categories: “someone else’s consolidation,” or “mom-and-pop shops that hadn’t gotten to the point of having national clients.” After 10 site visits, the Vertex team came up with a short list of four. Lewy says two things distinguished FRA from the other companies in the running: a first-rate management team, and an investment in a top-notch technology platform.

Negotiations with FRA proceeded cautiously. “We spent a bit of time working through it, because Judy [the owner] had been through three acquisitions in her career in the collections industry, and we’d been through three as well. We both had deep experience as to what you can do right, and what you can do wrong,” he says.

Indeed, Judy La Spada, who continues as FRA’s CEO since the sale closed, says it took months for Lewy to convince her to even consider selling her company. “I was very resistant. Quite frankly, I liked my job and liked the freedom associated with having my

own business,” she says. Ultimately, she decided the timing and offer were right – as much for the talented team she had put together, as they were for her. “Vertex was attractive,” she says, “because they didn’t already have a U.S. presence. They weren’t just going to absorb us.”

Sellers’ Market?

A supply-and-demand situation has been developing for the past six months to a year, according to Thomas M. Edens, president of Marion Financial Corp. “There’s still a good mix of potential acquirers, but we see more interested buyers than sellers of good companies,” he says. Edens, who founded his Houston-based M&A advisory firm to mid-market companies 16 years ago, identifies four groups currently showing an interest in buying collections firms. Among them:

- Financial buyers/private equity groups that would like to enter the industry;
- Former owners of companies who sold out five to seven years ago, whose non-compete contracts have lapsed, and who now want back “in”;
- Former executives of larger companies who have teamed with private equity firms to acquire and run a company;
- Existing mid-tier firms that want to grow by acquisition.

At the other end of the spectrum is the relative lack of motivated sellers. Charles D. “Chuck” Bertrand, principal at Marion, believes the seller “drought” comes from two sets of circumstances: Many sellers took their money and ran in the late 1990s, at the most generous time in the market; and those who are left may be “underwhelmed” by today’s potential yield on a post-sale investment.

“We are getting lots of calls from buyers asking for our help in finding candidates. That’s in contrast to the ’90s, when buyers were saying, ‘Oh, there are plenty of sellers.’ These days, buyers are much more willing to pay us to look for candidates,” he explains.

Michael Flock, chief executive of Flock Enterprises, an Atlanta-based firm that provides management consulting and M&A advisory services to collections companies and private equity firms, sees the same trend. “Even though things are better than they were three years ago, the relative supply of deals is still lower than it used to be. As a result, prices for these companies are somewhat higher. Sellers know it’s a sellers market. If they don’t have to sell, they’ll just hold out until they get the right price,” he says.

Flock should know. He’s one of several “CEOs-in-waiting,” with private equity backing. Formerly president of Dun & Bradstreet’s Receivables Management enterprise, Flock left in 2000 to do his own deal, then got caught in the downturn in the market. Over the past three years, he has looked at 40 to 50 companies, and is currently “eyeballing” three

healthcare deals and one consumer deal. His focus is on mid-market companies, from \$10 million to \$50 million, because they are easier to grow, \$1 million contract at a time.

Rather than acquiring, some former industry executives are starting new firms from scratch. In January, David Kreiss, one of the industry's original merger/acquirers who raised private capital to start OSI and Convergent Resources – two of the top 10 accounts receivable management firms in Collections & Credit Risk's revenue rankings – got back into the collections market. He partnered with two brothers, Glen Myers, who sold ECC Credit and Gary Myers, who sold East Coast Credit.

Their new venture is called KM2 Solutions, and it has set up operations in Minneapolis and St. Lucia. At press time, the firm had 100 employees but expected to double that within the first year, thanks to a major new contract. "We've also raised \$20 million from a private equity source to acquire paper when we feel the market is better," Kreiss says. "People are buying portfolios today who absolutely cannot make money."

Debt Purchasing

Speaking of debt buying, the industry is attracting substantial attention from investors. In April, Asset Acceptance Capital Corp. raised \$105 million in its initial public offering, making it the fifth debt-buying company to go public since 1995. Asset Acceptance's total revenues hit \$160.2 million for FY2003, a 59% jump from the prior year. Net income for 2003 was \$37.7 million, compared to \$27.9 million in 2002.

Over the past two years, there have also been five equity investments, including Barclays Private Equity providing \$182 million for a management buyout of Cabot Financial, a leader in the United Kingdom's fast-growing debt purchasing market, this year.

A new debt-buying company, Endeavor Financial Partners, opened in Alpharetta, Ga. In March. Led by three industry veterans, it is buying and liquidating portfolios through a network of outsourced collections agencies and attorneys. In April, Endeavor announced the purchase of \$80 million in charged-off consumer loans.

While demand is driving portfolio prices higher, Ginsberg says potential acquirers are taking notice of the public companies' good stock performance in this arena. "Management teams of sizeable operations have been around quite some time," he says, "and there's a lot more data available to them. People believe the debt purchasing industry is a growth industry, not just focused on financial [credit card debt], but on telecom, utility, medical, and commercial."

By contrast, the credit bureau sector has been less lively this year than last. In the first half of 2003, the credit bureau/reporting sector kept the M&A scene rocking, with Experian Inc. making seven of nine acquisitions in that category, as it moved to bring regional affiliates in-house.

This April, Experian's only acquisition was Marketswitch, a provider of optimization software. Two months later, the credit bureau announced the closing of a call center servicing third parties.

TransUnion, in the meantime, made two acquisitions: Visionary Systems Inc., an Atlanta-based enterprise decisioning solutions company, and RentPort Inc., a provider of online applicant scoring and decisioning solutions for the property management industry.

Wall Street Perspective

The \$9 billion accounts receivable industry attracts investor interest for several reasons, including consistent growth in consumer credit and gross charge-offs, according to Hagood from SunTrust Robinson Humphrey.

Another bright spot is the possibility of a bill passing that would allow the IRS to outsource federal tax collections. Observers say this year's \$167 million recapitalization of Diversified Collections Services Inc. by Parthenon Capital, a private equity firm, positioned the company for the potential IRS windfall.

Working against the industry is the increasing concentration of financial customers, as mega-banks like Bank One and JP Morgan Chase and Bank of America and Fleet continue to merge. The growth of debt purchasing is also disruptive to contingency collections firms; the amount of credit card debt sold is expected to grow by 15% for the next three years, Hagood says. Offshore servicing is also impacting margins.

Investors are looking for projected organic growth of more than 10%, as well as a history of steady growth and a stable client history, Hagood says. Diversification is key, too – geographically, on its management team, and in a company's client base, where no more than 10% of revenue comes from a single client.

Hot Target

Healthcare is "hot" as a target for collections, as companies eye a 5,000-hospital marketplace in the U.S. Hospital receivables are generally fresh, and the margin potential is high, says Flock, who is looking closely at this market.

Strategic buyers and private equity are both showing a lot of interest in healthcare collections opportunities, says Hagood, where there's a chance to take lessons learned in bankcard collections and apply them to healthcare.

Industry insiders aren't expecting much activity from such previously active players as OSI, IntelliRisk, and Nationwide Credit – all formerly big consolidators that have been preoccupied with their own restructuring.

NCO Group Inc., though, is making inroads by diversifying. The Horsham, Pa.-based company completed two transactions in the second quarter: the mergers of RMH

Teleservices Inc., a customer relationship services provider, and NCO Portfolio Management, its debt-buying arm which had traded publicly as a separate entity.

AllianceOne, the sixth largest provider of accounts receivable services, became a player fairly late in the game, with the simultaneous acquisition of five companies in 1999. Last year, the Exton, Pa.-based firm took on another three. And it's still in the hunt.

Robert Mauch, chairman and CEO of AllianceOne, has been involved in more than 90 acquisitions – including 77 for one company outside the collections industry. AllianceOne is actively pursuing several candidates now. “However, we are very selective in the businesses we target,” he says. “We focus on acquiring core competencies or market segments we don't possess, or companies that offer capabilities or expertise that we can leverage through our organization.

“It's easy to buy companies,” he adds. “It's easy to get financial backing and acquire companies. In other industries, I've seen companies that have grown very rapidly through acquisition, only to stumble in a major way because they weren't selective in the companies they acquired, or they didn't invest in the infrastructure needed to support the growing entity.”

Future Prospects

Mauch believes that the industry drivers – its highly fragmented nature, economies of scale for consolidators, and the technologies and best practices available – make it likely the industry will continue to see an active M&A environment.

He is not alone. “We believe M&A activity for the remainder of the year at least, if not 2005, will be very strong,” says Ginsberg. Edens agrees. So does Flock, who predicts: “2004-2005 will be good years.” New strategic buyers, including other CRM companies, and venture capitalists are interested in the receivables management space, he says.

Furthermore, Ginsberg expects that, by the end of 2004, at least one more large debt purchaser will position itself for an IPO. “We'll see a number of significant M&A events in the debt-buying arena,” he predicts. Ginsberg expects to see more international buyers, and some offshore service providers, trying to make their way into the U.S. debt collections market. “The goal there,” he says, “would be to have a beachhead, providing inroads to U.S. creditors, with the intention to ‘offshore’ some portion of the growth.”

Some excitement has emerged since the U.S. Senate passed a bill that would permit outsourcing of the IRS's tax collections. But the provision is tacked onto a corporate tax bill and the House of Representatives must agree, so it's anyone's guess in what year we might see movement on this front. Still, companies are beginning to position themselves for the bill's passage – and for the opportunity that would represent.

In the meantime, major credit grantors are mandating that their agencies have offshore availability – a factor that will surely drive future movement in the M&A marketplace.

Continual change seems to be a constant for the receivables management industry. With changes come suitors – and more knocks on the door.