# Ca$hing In

## Positioning to Sell your Debt Buying Company

By Thomas M. Edens

*It is estimated that there is between $50 and $60 billion of consumer debt sold on an annual basis in North America. The debt buying business has evolved from a few entrepreneurs in the early stages of the industry to a point where there are now hundreds of participants. Many firms are now focusing on profitability and sustainable growth.*

As the debt buying industry further develops, and individual debt buying companies mature, equity holders of these debt buying companies will naturally want to harvest their gains through the execution of their succession plans or the realization of the increase in the equity value that they have created. Most exits will be through a sale of the company or liquidation of their asset holdings. Other liquidity or change of control events may be in the form of an IPO, ESOP or MBO (management buy-out). The purpose of this article is to present some ideas that may benefit stakeholders of debt buying companies in these important decisions.

Some of the issues addressed herein will be applicable to stand-alone debt buying companies; other comments are more suitable for collection agencies or law firms which have started purchasing portfolios on a gradual ramp-up basis. The topics this article will address include:

- Positioning your debt buying company to be acquired.
- Strengthening goodwill valuation drivers to enhance value.
- Valuation methodologies of debt buying companies.

## Positioning your company

The primary and probably most beneficial reason for planning your sale is to maximize the net proceeds that you realize from a transaction. It is well documented that properly planning the timing of a sale of a business will lead to greater benefits than not taking certain steps that could have enhanced value.

Even if a business owner has no immediate plans to sell, but will likely sell sometime in the near future, preparation has benefits. For example, suppose you have established a three-year time horizon as the proper timeframe for both you as a shareholder and the company as a well-positioned entity to exit the business. However, in the second year, a strategic buyer approaches you and delivers an unsolicited offer. By having planned for an eventual sale, you may be in a better valuation position than you would have been had you undertaken no planning. You cannot predict when opportunistic situations will present themselves. Said differently, even if you don't have plans to sell your company today, a very advantageous acquirer may appear tomorrow. We know there are three primary types of buyers—strategic, financial and irrational. Strategic and irrational acquirers almost always pay more than fair market value. If they appear, be prepared.

## Strengthening goodwill valuation drivers

Debt buying companies have an especially challenging objective regarding company valuations. Specifically, debt buying companies will often face the obstacle of obtaining an enterprise value that is greater than the net assets (after subtracting liabilities) of the company. Said differently, the challenge is to increase the valuation from capturing not only the net asset value of the company, but also the goodwill value.

Goodwill in a valuation framework translates to economic value greater than the fair market value of the net assets. As specifically applied to debt buying companies, the goal would be to achieve an enterprise value greater than the liquidation value of the debt portfolios of the company (less company liabilities).

The following equation is applicable to debt buying companies and illustrates this point: Enterprise Value = Tangible Asset Value + Goodwill – Liabilities.

This equation is a rather universal valuation equation, and it specifically can be applied to debt buying companies. This equation establishes a framework which we will explore in more detail in this article.

If you further expand the right side of this equation, you would have the debt buying components shown in Chart A (page 31).

The tangible assets of debt buying companies as illustrated in Chart A are:

1. Company-owned portfolios.

2. Furniture, fixtures and equipment.
3. Net working capital (current assets less current liabilities).

Chart B captures the typical goodwill valuation drivers.

There can be value in the intangible (or goodwill) attributes of debt buyers; the challenge is to educate the market of their economic worth. For each valuation driver, the more favorable or stronger the driver, the more value that accrues to the business enterprise. Positioning the company to strengthen as many of the valuation drivers as possible should translate into additional value. The measurement of the increased value will be both direct and indirect. The indirect measure will be increased profitability of the company contributed by each of the valuation drivers. The typical valuation drivers of debt buying companies are:

- Management team with specific profit and loss success with debt buying operations.
- Sustainability of cashflow.
- Sources of paper.
- Infrastructure and systems in place.
- Capital availability.

**Management team**

The primary asset of most companies is its management team and human capital. A debt buying company is no different. A debt buying company's executive requirements are multi-faceted. The management team should have demonstrated profit and loss experience in the debt buying industry. It is not enough to only have accomplished top-line (revenue) growth, but bottom-line as well. The CEO must have above average skills at allocating capital to the right debt portfolios. It is one thing to recover a credit grantor's debt on a contingency basis and a totally different risk profile to advance cash for your own paper and then initiate recovery operations on your behalf. The management team must also have superior due diligence skills in order to be able to analyze the prospective portfolios and assign proper values for purchase price requirements. The executive team with the above attributes should enhance value if it remains after a sale continuing to drive the successful business model.

An important benchmark for management's effectiveness is its ability to increase the value of the portfolios purchased. This value accretion starts with effective due diligence leading to purchasing the portfolios at favorable rates and then systematically converting nonpaying debtors to paying debtors. Effectively utilizing the legal system to increase the value of the company's various portfolios by obtaining judgments must be balanced with the investment made in advanced legal and court costs. Value accretion is clearly demonstrated by elevating the value of paper purchased at 2 to 4 cents, and converting it to 8 to 40 cents paper by obtaining a judgment or having the debtor initiate payments within the last 60 or 90 days.

Acquirers will also be looking at turnover rates of nonexecutive personnel. Many credit and collection companies have on-going challenges retaining their collector staff. Annual turnover rates of 100 percent or greater for collection personnel are not uncommon in the industry.

**Sustainability of cashflow**

The ability to prove the sustainability of cashflow is of utmost importance to capturing the value of a debt buying company. Sustainability involves the ability to demonstrate that debt can be purchased consistently at commercially viable prices and the company has the collection, recovery and legal staff—in-house or through an established network of collection agencies—to reliably collect its paper on a profitable basis. There will be little substitute for a substantiated track record of these proven results and the ability to demonstrate why these results (or better) will continue in the future. What acquirers will be looking for is persistence of cashflow. Persistence refers to the length of time that cashflow has been generated and the likelihood of the cashflow continuing. A company that has only two years of operations is not considered to have demonstrated cashflow persistence. A company with five years of increasing cashflow supported by substantial income generated from judgments will be deemed to have persistence.

The growth trends of cashflow should be both positive (upward) and accelerating. Historical and projected growth rates are valuation drivers. Acquirers will usually want to continue growth. High growth rates are not sustainable perpetually, but in the short term credible projections are important.

**Sources of paper to acquire**

The lifeblood of a debt buying company is its source of quality debt to purchase on a renewable basis. This attribute is easier said than done because of the nature of this business, which is often feast or famine. There is always the risk of not being able to purchase future portfolios at prices meeting the required return on investment criteria of investors. Most debt buyers have good sources of debt; it's the predictability that is the challenge. With the amount of debt increasing and credit grantors being more receptive to selling charge-offs, this risk is being mitigated.

If a debt buying company is dependent upon one or two sources of paper, this concentration naturally increases risk to an acquirer. If everything else is equal, it is better to have numerous quality portfolio acquisition sources rather than only one or two. If one of your debt sources decides to cease selling the paper, or if key management changes at the credit grantor and the new management prefers to use their own sources of buyers, this could have a severe negative impact on your future outlook if you are overly dependent on one debt source.

Obviously, there are several keys to having good sources of paper to purchase. A primary ingredient to continued debt purchases is your company's integrity of past performance. Another factor that

contributes to good relations with debt sellers is being a buyer with a quality recovery operation. A quality operator is typically a buyer viewed by the credit grantor as someone who generates few complaints (from debtors and/or their own employees), and delivers on promises as the new owners and stewards of their portfolios. This involves continuous professional communication with the credit grantor's staff. Credit grantors are very concerned about their reputation being preserved, even in the eyes of prior customers whose debt obligations have been written off. Credit grantors are also always concerned about litigation (class action or otherwise).

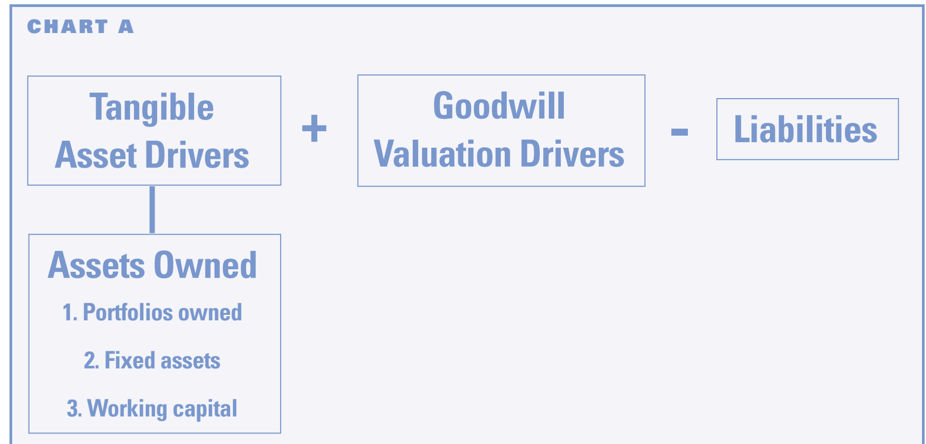
**Infrastructure**

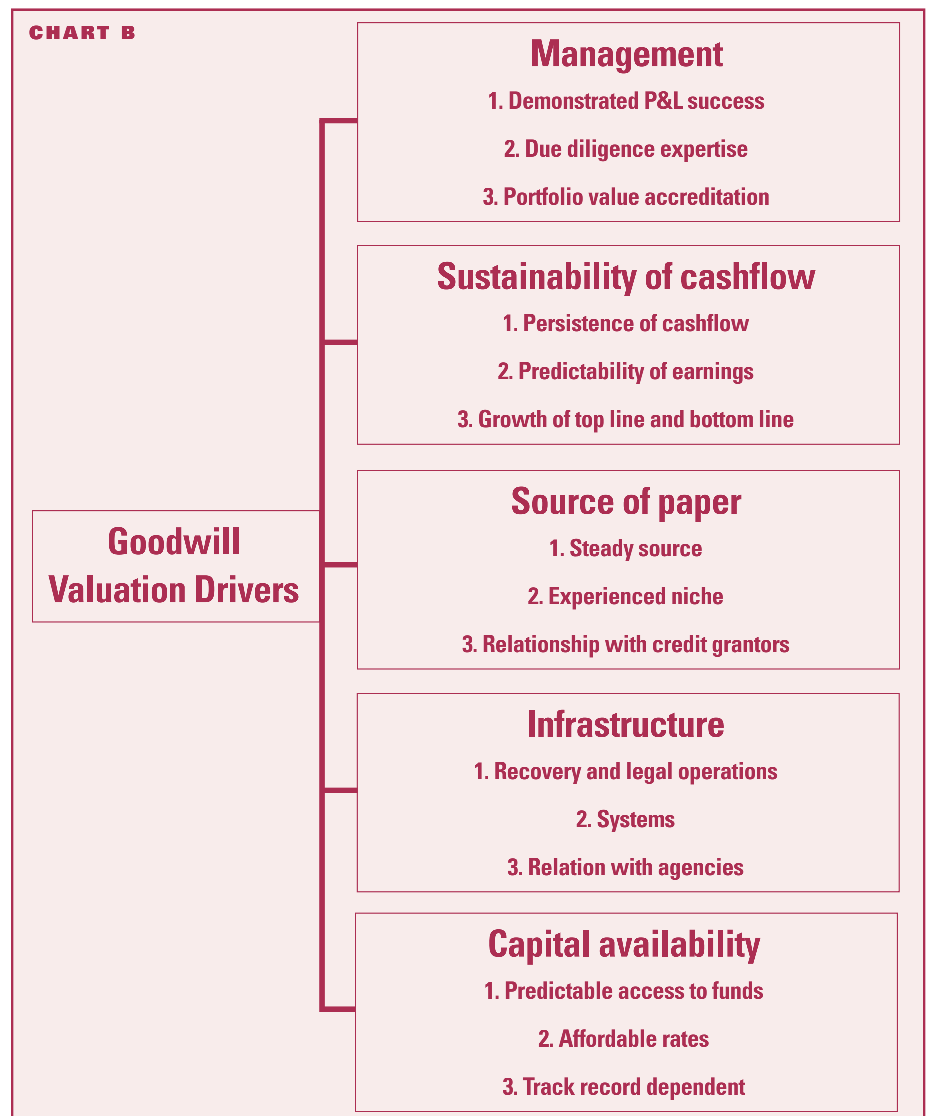
There are several recovery models utilized by debt buying companies. The three primary recovery models are: using the company's in-house collection and legal staff, outsourcing recoveries to third party collection agencies and law firms, or a combination of both. Debt buyers who have their own recovery and legal operations usually have the most effective recovery model.

We know that any given portfolio can be trusted to two different management teams, and the performance of that portfolio can be very different. The collection and recovery results depend on the strength of the recovery model and how management's tools score or prioritize the accounts and appropriately set their work standards. One of the most important tools of debt buyers is the implementation of a legal strategy that includes cost effective advancement of legal costs.

For higher balance purchased accounts (such as credit card debts), collectors are often more sales representatives than collectors due to the task of convincing a debtor who hasn't made a payment in over a year to initiate payment today.

For continuous and replicable results, systems are needed to monitor the overall recovery efforts, recovery results of specific collection units and the ranking of different



collection agencies if several agencies are used. Reports are also needed to monitor the performance of individual portfolios. If collections are performed in-house, the utilization of scalable collection software is important because most acquirers want to ensure continued growth after a sale.

### Capital availability

The debt buying industry utilizes significant amounts of capital. The companies with low cost sources of capital are at an advantage over companies with higher capital costs. Obviously, companies with low interest rate credit lines are at an advantage over companies with high interest rate lending sources. Companies with sources that allow the majority of the net recoveries to be reinvested in new debt purchases versus being required to make full payouts to capital sources are also a plus. High rate of return driven investors with 100 percent payout requirements do not allow the compounding effect of reinvesting capital.

The cost and availability of a company's capital is very track-record dependent. Companies with proven histories of successful and dependable returns to their capital stakeholders (debt and equity providers) are at an advantage when seeking larger amounts of capital. Reliable sources of capital are also important when opportunistic portfolios are made available for purchase. Securitizations have been a useful financial tool for some larger debt buyers.

## Other considerations

There are additional steps that can be taken to better position a company to maximize sale proceeds. The additional steps might include the following:

**Transferability of Relationships:** Relationships are the hallmark of the debt buying industry. To capture value resulting from relationships, they must be transferable. Relationships are earned over a long period of time and are secured and extended with trust. The value of debt buying companies is enhanced with solid relationships that encompass credit grantors, debt brokers and resellers, other debt buyers (to resell portions of purchased portfolios), capital sources and a network of collection agencies (if collections are not done in-house) and collection attorneys.

**Segregate Debt Buying Operations:** There are a number of collection agencies or law firms with debt buying operations. It would be beneficial at the time of a transaction to have the debt buying operations clearly identified from third-party contingency collection activities. This can generally be accomplished by having a separate subsidiary (or stand alone entity with common ownership). Financial statements would then portray revenues, overhead and operating income of the debt buying activity.

**Audited Financial Statements:** Debt buying companies should have their financial statements audited each year. With the notable collapses of several debt buying companies, it is best to eliminate the fear of inaccurate financial statements and invest in the cost of having them audited. You will also want to clearly demonstrate a high level of internal controls through the integrity of your accounting records. We know there is a correlation between the size of companies and whether their financial statements are audited, reviewed or simply compiled. Larger companies are usually audited and smaller businesses usually have their financials compiled. An audit not only benefits you if you eventually want to sell, but also benefits your source of capital as a confidence enhancer.

**Revenue Recognition:** There are two primary accounting treatments for revenue recognition of purchased debt portfolios, namely the Cost Recovery Method and the Interest Method (or Effective Yield Method). Utilizing the Cost Recovery Method requires that all receipts recovered from purchased portfolios be recorded as a reduction of the carrying value of the portfolios until the total acquisition costs have been recovered. Accordingly, no income will be recognized until the total cost of the portfolio has been recovered. This will result in losses in the early periods of a portfolio's life, and the reverse is true later (after the company reaches a normalized growth rate). If a company's portfolio acquisitions are growing, then the losses will accelerate as well. The Cost Recovery Method is typically used when the collection probability as it relates to the amounts and timing of recoveries are not estimatible and the company has not established a track record of collections in substantially the same asset class.

The Interest Method utilizes an effective interest rate that is determined for each portfolio or static pool of accounts with similar attributes. Once the pool of accounts has been established, the accounts in the pool remain unchanged. The effective interest rate (or yield) is the internal rate of return determined based on estimated future collections for the economic life of the portfolio as compared to the cost basis of the portfolios. Revenue is accrued monthly based on this effective interest rate applied to the monthly beginning carrying value. The Interest Method is only allowed if a company has the experience and data to reasonably estimate the amount and timing of anticipated recoveries. The accrual of the interest mechanism in the Interest Method allows the company to more accurately match revenues with costs associated to produce those revenues.

Many companies utilize the Interest Method for book purposes, and utilize the Cost Recovery Method for tax purposes. The Cost Recovery Method would defer cash tax payments and benefit the company's cashflow. The utilization of either accounting method should not have an impact on a privately held company's value. This is because the valuation of your company is more than likely based on net cashflow or adjusted net asset value, which are not accounting-sensitive valuation methods. Public companies may have a different perspective where public markets have a fickle obsession with short-term

earnings (of which revenue recognition could have a material effect).

**Concentration Risk:** Concentration risk would be present if a company is buying from only one credit grantor or having only one collection agency perform all of its recoveries. Reduce concentration risk due to credit grantors or collection agencies. These steps take time to implement but should prove worth the investment when you want to sell.

## Valuation methodologies

Establishing valuation metrics for debt buying companies is a work-in-progress and will become more refined as time progresses. A complete discussion of the valuation mechanics applicable to debt buying companies is out of the scope of this article, but a cursory discussion follows. The current most appropriate valuation methods are:

- **Discounted Cashflow Method:** This method estimates the future cashflow stream and computes a net present value utilizing an appropriate discount rate. The most probable earnings stream will be net cashflow. The forecast period can range from two to ten years. This method and the Adjusted Book Value Method are currently the best proxy for value until comparable sales of debt buying companies are identified.
- **Adjusted Book Value Method:** This method restates all of the assets on the balance sheet up (or down) to their fair market value. This will typically involve categorizing your portfolios into different asset classes according to various credit and security attributes and factors such as: when the last payment was made, judgments obtained or feasibly obtainable, accounts in or out of statute, in probate, etc. The primary asset is, of course, the value of the portfolios owned. Added to this amount is the fair market value of the other assets, which is then reduced by the amount of total liabilities.
- **Transaction and Comparable Guideline Company Methods:** The identification of buy/sell transactions of debt buying companies that concluded under fair market value conditions has been elusive. There have been several sales of debt buying companies over the last several years, but each of the transactions appear to have been conducted when the target was not exposed to the market for a reasonable time period and the opportunity for several buyers to pursue the transaction at a fair market price was absent. Therefore, a valid historical statistical sampling of purchase and sale transactions of debt buying businesses does not exist, yet. There are several public debt buying companies, but they currently do not provide a good proxy for value due to the limited trading volumes for these companies and several of the companies did not have positive earnings during the past 12 months.

## Summary

The planning of strategic succession alternatives of debt buying companies will lead to greater values upon execution. The industry will continue to evolve and present opportunities to realize values for the shareholders of these companies.

Hopefully, the above thoughts will be beneficial to debt buying companies in positioning their entities to achieve greater value when they prepare to sell or execute a change of control transaction. CM

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