

The State of the Industry: What's Next for ARM?

Every year at Kaulkin Ginsberg, we kick off the New Year with a retrospective on the past year's milestone events and take a careful look at what we believe lies ahead for the accounts receivable management industry (ARM). Our goal as a firm has always been to share our perspective to support credit and collection professionals in their strategic business planning.

In over 16 years, we've lived through many highs and lows of the ARM industry, from the emergence of debt buying as an industry segment in the late 1990's to the lean recovery months after 9/11 and hurricane Katrina. Like many of you who are also industry veterans, we've learned from each market cycle. All indications are that the U.S. economy has already entered a recession which will inevitably place serious pressures on recoveries for credit grantors, debt buyers, service providers, and even vendors in 2008. This should not be viewed as a time for panic. We are confident that companies who accept the challenges and learn how to adjust their strategy will be even stronger when the business cycle inevitably turns up again.

Opportunity often hides in adversity. As you read through our recap of the significant events of 2007 and the emerging trends we see in 2008 and beyond, I hope it will spark ideas on how your company can maintain or increase its competitive advantage.

- Economic conditions will impact recoveries going into 2008
- Mergers and acquisitions are still active, but some buyers are changing strategy
- Trends are shifting on the pricing of delinquent debt portfolios
- Other important areas to watch closely in 2008

Economic conditions will impact recoveries in 2008

The sub-prime mortgage crisis, decreasing home prices, and the credit crunch are already impacting credit and collection professionals at every level. Adding fuel to the fire, the unemployment rate has crept up to a 2 year high of 5% as the problems in the housing market, coupled with a disappointing holiday shopping season, forced some sectors of the economy to add far fewer jobs than originally forecasted. (It is interesting to note that the services sector, which includes ARM companies, actually fared better than most, adding nearly 100,000 jobs last year.)

Even though most economists would argue that we're not yet in a recession, many consumers are already behaving as if we are. Those who are providing ARM services to credit grantors, including collection agencies, collection law firms, debt buyers, and other vendors, will undoubtedly feel the effect of these tumultuous economic conditions on collection results if they haven't already. In our debt-based monetary system, consumers and businesses alike are finding it increasingly more challenging to repay their past due accounts. As a result, charge-off rates are increasing and credit grantors are reacting by scrutinizing recovery strategies, causing abrupt and sometimes unexpected changes in debt sales and placement activities. The choices made at the credit grantor level will

impact all of us in the ARM business, both in the short term and for many years to come as we adapt to market conditions forced upon us.

Mergers and Acquisitions are still active, but some buyers are changing strategy

We calculate that the total deal value in 2007 was \$1.65 billion from 48 completed transactions. 2007 was characterized by fewer total transactions compared to 2006 but at comparatively higher values. If you pull out the 2006 management-led buyout of NCO Group and the recapitalizations of West Corp and Cabot Financial, which accounted for roughly two-thirds of the total deal value for the year, the total for 2007 is consistent with 2004, 2005, and 2006 levels.

Looking to the year ahead, financial and strategic buyers will continue to actively seek deals in the ARM industry and favorable transactions will get done with top performing companies that are well positioned in their respective market segments. However, some buyers may become more conservative with their valuations for a couple of reasons. In some collection market segments, liquidation results are tracking down, causing some buyers to become uncertain about where these markets are heading in the short term. The credit crunch is also starting to impact financing of some larger size transactions as lenders are raising concerns about economic conditions overall. In general, smaller and mid-size M&A transactions, which comprise most of the transaction activity in the ARM industry, are faring better because the debt-to-EBITDA ratios remain relatively conservative.

One point to note that may have a positive impact on M&A transactions in the U.S. is that the dollar has fallen to a record low against the Euro and now stands at its lowest value in a decade when compared to over 20 other currencies. This may spark more investing into U.S. companies and into the ARM industry in particular. Exchange rates are volatile, and although this has not had an impact on M&A in the ARM industry in previous years, it might be too attractive an opportunity for foreign buyers and investors to pass up.

All told, we are confident that M&A transactions will still get done at competitive price levels with top performing companies. Even less attractive companies will sell so long as buyers and sellers are willing to share the risk. To bridge gaps, transactions may include more structure – such as earn-outs, equity retention, and seller financing – instead of the all-cash transactions that have been more prevalent in recent years.

Strategic buyers continue their acquisitive ways

Business Process Outsourcing (BPO) and CRM companies continued to aggressively acquire U.S. ARM companies. We expect this trend will continue well into 2008 and beyond as these strategic buyers seek to expand their service offering to include ARM. Consider that in 2007 alone:

- Indian business conglomerate Essar Global acquired Global Vantedge, an India-based ARM and business process outsourcing provider
- Ocwen Financial acquired Nationwide Credit
- West Corporation purchased Omnium Worldwide
- France-based global BPO firm Teleperformance acquired AllianceOne
- Firstsource Solutions, Inc., based in Mumbai, India, acquired MedAssist Holding, Inc. of Kentucky

Collection Law Firms are fast becoming attractive M&A targets

Collection law firms are the smallest but fastest growing segment in the ARM industry. Historically,

law firms had very limited options when it came time for senior partners to retire or otherwise exit their firm. They either transitioned their practice to junior partners or they merged into another practice, resulting in transactions with insignificant amounts of liquidity at closing. This appears to be changing; some financial and strategic buyers are realizing that collection law firms are competitively well positioned to service major credit card issuers and other grantors amidst tougher economic conditions.

In 2007, we assisted in the sale of the non-legal assets of Wolpoff & Abramson, one of the country's largest law firms focused on debt collections, to Axiant LLC, joining Eskanos & Adler and Mann Bracken to provide legal collection services to clients in the majority of the U.S. Many in the industry took note of this transaction and we are confident similar transactions will occur in 2008.

Bank mergers will continue

Early in 2007, we watched as Bank of America acquired LaSalle Bank for \$21 billion, State Street Corporation acquired Investors Financial Services Corporation for \$4.2 billion, and Bank of New York Company acquired Mellon Financial Corporation for \$18.3 billion. Consolidation among larger banks translates to greater revenue concentration among the top-performing collection agencies and debt buyers that are focused in the financial sector.

On the international front, TD Bank Financial Group acquired Commerce Bank for \$8.5 billion, Royal Bank of Canada acquired Alabama National Bancorp for \$1.6 billion, and China Minsheng Banking Corp purchased a 9.9% stake in San Francisco-based UCBH, the first such deal by a Chinese bank. If a weak U.S. dollar persists through 2008, foreign banks may continue to acquire their way into the U.S. market. We believe that foreign banks seeking to employ best accounts receivable management practices may look to U.S. collection agencies to handle their own collection needs, creating a growth opportunity worth watching.

As the housing market and the economy continue to slow down, larger banks will continue to pull back from extending credit, thus opening up opportunities for local and regional banks to step in and fill the void created in the market. However, smaller banks are not immune to the economic conditions affecting larger players and some will be forced into mergers in order to cut costs and boost their branch networks. As the dust settles, we expect increased M&A activity among small to mid-sized regional banks in 2008 and beyond. This trend should be watched carefully by ARM service providers and debt buyers. Some collection agencies dependent upon bank clients may find themselves in an environment where they will need to consolidate in order to keep up, or risk losing these now larger clients to larger agencies that can offer a broader array of service offerings at lower fee rates. Debt buyers should see attractive buy opportunities as banks seek to clean up their balance sheets to position themselves as more attractive merger candidates.

Healthcare ARM firms continue to attract M&A interest

Regarding healthcare M&A, two trends are noteworthy as we look into 2008. On the offshore front, Firstsource Solution's acquisition of MedAssist for \$330 million marks the first time that an Indian BPO company acquired a healthcare collection and receivables management company. In the past, healthcare providers shied away from enabling their service providers to off-shore collection efforts. Is this changing? It is important to note that MedAssist was the largest company of its kind in the ARM industry and therefore, we are not likely to see other healthcare M&A transactions of this magnitude. But we will watch to see if smaller healthcare agencies become targets of offshore companies.

Also in 2007, at least six M&A transactions were completed involving small and mid-sized healthcare collection agencies selling to private equity-backed, healthcare-focused buyers. We are

confident that M&A in general will continue to remain active within this market sector as the players try to reposition themselves as larger, multi-state participants in a market that historically has been reserved for local businesses.

Another catalyst for increased mergers and acquisitions among healthcare collection agencies could come from reform at the state level. Four states—Illinois, California, North Dakota, and Nevada — each passed healthcare collections reform legislation in 2007. These reforms could provide the tools for other states to regulate the way healthcare providers and their ARM services providers recover bad debt. If they do, this could impact collection strategy from state to state and may encourage some local agencies to merge or sell to larger regionally focused players.

Trends are shifting on the pricing of delinquent debt portfolios

In the debt purchasing marketplace, we began seeing the effects of declining prices within the secondary market during the second half of 2007, with prices dropping as much as 50% as compared to a year ago. This trend has also made its way up the chain to the issuers themselves but with less significant price decreases.

We expect that pricing on a national level will continue to wane in 2008, but pricing on a regional, state, and local level will not be as heavily impacted and may even improve, enticing sellers to segment their portfolios to maximize yield. Issuers will continue to feel the pressures from buyer demands around contract language, terms and provisions and will strive to be more creative with their offerings as it relates to vintage, portfolio make-up, documentation, and contract language to keep prices elevated.

Other areas to watch closely in 2008

Changes in the FTC are expected.

In October 2007, the FTC held a workshop to examine the current state of the collection industry including the Fair Debt Collection Practices Act (FDCPA), the most significant review of its kind since its enactment some 30 years ago. The collection industry has evolved considerably since then; most noteworthy is the involvement of debt purchase and sale. The industry remains in a wait-and-see mode to learn what the FTC will recommend.

Evolving regulatory compliance will remain a hot topic for debt buyers.

Some state regulators and their attorneys general are watching debt buyers within their regions. States like Wisconsin and Michigan have already placed strict limits on the statute-of-limitations for collecting debts, and some municipalities are increasing regulations within their own jurisdictions. This will continue to impact purchases of portfolios of aged debt.

In addition, those interested in purchasing healthcare receivables will watch to see if other states follow Nevada's lead in passing legislation barring county and district hospitals from selling or transferring the interest of the hospital in a lien created against a debtor.

What impact will the '08 presidential election have on the ARM industry?

Going into the end of last year, the IRS showed signs that it would continue to utilize private collection agencies amidst intense pressure from consumer groups that strongly oppose the plan. Will the \$350 billion plus tax gap be enough incentive for the program to continue? Every move will be closely watched by those ARM service providers who believe they are well positioned for this windfall if it ever materializes.

The State of the Industry: What's Next for ARM?

Also worth noting for those contemplating sale of their businesses in the near future: many believe that a Democratic administration will try to increase the capital gains rate from its current level of 15% to as much as 25%, materially reducing the after-tax proceeds resulting from a business sale.

Finally, the three Democratic frontrunners all have established plans for some type of national universal healthcare coverage. Any implementation of those plans is still years away, but some federal legislative action is likely to occur during the next administration. A December Kaiser Family Foundation poll found that Americans rank healthcare the second most important topic that they would like presidential candidates to address (after the economy and before the Iraq war). Estimates indicate that more than 45 million U.S. citizens lack health insurance. We do not envision a government single payer model in the United States; however, pressure is too great for material changes not to occur.

Municipalities will continue to outsource collections.

Municipalities have emerged in recent years as a significant source of business for many collection agencies. There are some 35,000 towns and municipalities in the U.S. generating roughly \$1.25 trillion in revenues each year, with a staggering \$40 billion of delinquent debt owed to them. In the past, few municipalities outsourced their collection matters to third party agencies and those that did predominately placed their accounts with local agencies based in their region. Municipalities today, burdened with declining federal and state support, are forced to decide whether to cut spending, increase taxes, or improve collections. More and more municipalities are placing accounts with collection agencies; however one trend we are watching closely is the movement among some municipalities from local collection agencies and collection law firms to larger, regional players.

In good times and in bad, our mission at Kaulkin Ginsberg has never changed. We are constantly striving to deliver successful solutions to our clients' business challenges. I hope this information provides some useful context for you as you develop and implement your own strategy for growth or exit. If you ever have any questions about the changes that are occurring in the industry, how these changes might affect your business, or how we may assist you, do not hesitate to confidentially and confidently call me or a member of our advisory team.

We look forward to speaking with you.



Mike Ginsberg
President & CEO

About Kaulkin Ginsberg

Kaulkin Ginsberg is the leading strategic advisor for the accounts receivable management (ARM) industry. For ARM service providers, our value-add services focus on analysis, growth, and exit strategies. For credit grantors, our focus is on optimizing receivables management strategies. Kaulkin Ginsberg's media division is the worldwide leader in providing timely news and insight on the recovery of debt in all industries. Kaulkin Information Systems creates secure and affordable workflow, document, and business process management technologies. Read more about Kaulkin Ginsberg at www.kaulkin.com. For the latest news and information, register for free at www.INSIDEARM.com