An Industry in Transition: Trends and Events Shaping ARM
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About the Speakers

Rozanne M. Andersen J.D., currently serves as Ontario Systems’ Chief Compliance Officer and Vice President of Business Development. Her expertise keeps Ontario Systems on top of the constantly changing legal and regulatory environment, ensuring products and services help clients comply with the broad spectrum of state and federal requirements. She has successfully led the company’s efforts to bring Ontario Systems CFPB Consulting Services, Consumer Complaint Resolution Program and its comprehensive Compliance Management Systems to the market place.

Mike Ginsberg is president and CEO of Kaulkin Ginsberg, providing industry-leading M&A and strategic advice to the ARM industry for more than 20 years. Clients served include domestic US and international collection agencies and ARM companies, financial investors as well as Fortune 500 companies. He maintains a blog at kaulkin.com (click to see Mike’s latest posts).

Mike is a member of ACA International, DBA, and the Association for Corporate Growth. He sits on the advisory boards of several industry associations and publications.
Client Changes and Opportunities

Student Loans

U.S. student loan debt has reached $1 trillion (13Q3), with $100 billion in delinquencies. From 12Q1-13Q1, there was a drastic increase in student loans and the amount in +90 days delinquent increased at a much faster rate than the total amount issued. Private lenders have been leaving the student loan market since the Obama administration started originating loans in 2010. Currently, about 85% of loans come from the government, and this is anticipated peak at 90%. Many lenders have been leaving this particular market segment, including JP Morgan Chase, as Wells Fargo expands its student loan concentration.

Healthcare

The healthcare market revenues have been on a steady increase from 2004-2012 for both non-profit and for profit hospitals. By 2016, the hospital market will generate $1 trillion in revenue. Historically, healthcare providers were reluctant to refer debt to collections in fear of scaring away the consumer, because half of the bad debt was eligible to be paid off by charity institutions. However, the contribution from charity institutions is slowly decreasing. This will lead to a need for hospitals to outsource their collection efforts in order to recover delinquent receivables.
**STATE COLLECTIONS**

More and more states are turning to collection agencies: California leads the pack with non-tax bad debt of 24%, followed by Ohio at 16% and NJ at 14%. The delinquency rate mirrors the unemployment rate and the real estate market. During the 2007 mortgage crisis, delinquency rates were much higher than the previous years. We see this as a growth market because state governments are struggling to meet their budgets and they must either cut spending or increase taxes. Outsourcing collections is an enticing alternate solution for this budget crisis.

**TELECOMMUNICATIONS**

Telecom is a growth market for ARM companies. The overall market growth has increased from 5.9% in 2011 to 6.2% in 2012 and collections have increased 15% in that period. Consumers spent nearly $100 billion on data in 2012. The difference in telecom is that there is significant client concentration, which is only going to get worse as consolidation in the telecom industry continues.

**FINANCIAL SERVICES**

The financial services sector totals to $10.25 trillion, this is down 15% from the levels in 2008. There was a drop across all market segments, except the student loan market, as consumers started to deleverage.

Major lenders are cutting their vendor networks when it comes to collections. This may even mean that they only keep 1 recovery manager to handle all their debts. The silver lining: regional banks are returning to the credit market which will create growth in this particular segment.
Vendor Management

Vendor Management

Historically, regulators recognized and appreciated the bright line between the unique responsibilities of creditors and the unique responsibilities of debt collectors in the consumer debt collection process. With the advent of the Consumer Financial Protection Bureau (CFPB) and its expectation that creditors oversee, manage and in some instances mandate the collection practices engaged in by their third party debt collector service providers; the bright line is at best dim. This means accountability for compliant behavior no longer falls to the debt collection agency; rather it becomes the responsibility of the large market participant (LMP) to manage and oversee. Vendor management is a key area of focus during the CFPB examination process. LMPs that cannot show evidence of a robust process to select, monitor and manage their vendors’ compliance with financial services laws will receive a lower performance score than those LMPs that can. LMPs are well advised to include compliance expectations in their RFPs and service provider contracts; establish controls over their service providers, routinely perform compliance audits and in all cases examine consumer complaints filed against their service providers to identify noncompliance with the law.

Technology Advancements

Technology Advancements

The collection industry as whole spends less than 2% of gross revenue on technology. Yet technology is now, and will continue to be, the number one means by which members of the ARM industry can implement and scale an effective Compliance Management System. Managing complaints, monitoring changes in state and federal law, updating policies and procedures, delivering and recording role based training and managing compensation plans based on compliant debt collection behavior are just a few of the ways technology can support a robust, comprehensive Compliance Management System.
Major Macroeconomic Trends

There was a growth period from the mid-90s until 2008, which came predominately from the credit card boom. Collectors focused in this market grew extensively.

The financial crisis hit and banks nearly stopped issuing credit. In 2009-2012 consumers started to pay their debt down as debt as the debt level increased in this period.

The increasing debt trend is expected to return as consumers are getting back into their old spending habits.
Unemployment is the leading indicator of liquidation results/improvement in collections. As job creation increases, people will have a higher repayment capacity which means a higher recovery rate for delinquent debts.

The U6 unemployment rate had a sudden decrease in March 2013 as more and more people found full-time positions rather than part-time jobs in that particular month. This bodes well for recoveries but has not shown evidence of being a sustainable trend.

The goal is to create more full time job opportunities, which gives more leeway in repaying debts. Although it seems that the unemployment rate (U3) is slowly improving, there is no evidence that the employment trend is increasing. Rather, the number of people looking for a full time job has decreased.
The CFPB opened its doors on July 21, 2011. Since that date, the CFPB has slowly, but steadily, become a juggernaut when it comes to U.S. Federal agency rulemaking. In fact, if you are not reading the CFPB’s website at least weekly, it is safe to say you have fallen behind. In the past year, the CFPB has released a variety of advisory bulletins on topics ranging from consumer complaints on the CFPB’s Consumer Complaint Web Portal to its outright warning to anyone who even mentions the topic of credit reporting to a consumer. Each of these CFPB advisory bulletins evidence the CFPB’s willingness to engage in informal rulemaking as the need arises.

If you engage in the collection of consumer debt, either as a first party creditor, hospital, third party debt collector, debt buyer or collection law firm, staying abreast of the CFPB’s requirements is a vital component of your compliance program. Be aware the CFPB began the process to issue new rules surrounding debt collection on November 12, 2013. For additional information visit www.cfpb.gov.
Compliance Update

Litigation against the collection industry, consumer complaints and administrative actions, all have one thing in common, they are trendy. In 2013, the leading compliance issues for the collection industry in all three categories include:

• Telephone Consumer Protection Act Compliance
• Electronic Funds Transfers and the related authorization requirements
• Call recording requirements in all party consent states requirements
• Dispute management under the Fair Credit Reporting Act
• Collection notice deficiencies
• Convenience fees and the requisite disclosure requirements
• Time barred debt

“A supervised entity must develop and maintain a sound compliance management system that is integrated into the overall framework for product design, delivery, and administration – that is, the entire product and service lifecycle.”

CFPB CMR 1 Manual
**Changing M&A Landscape**

**ARM Industry Market Share**

The U.S. ARM industry remains highly fragmented, with approximately 70% of market share belonging to the mid-size and smaller size firms. When we first started focusing on ARM industry over 20 years ago, the largest player in the space was Payco American. At the time, Payco had $150 million a year in revenues and they were the largest. Today, NCO has 10x that amount. With the increased regulation, we see the landscape of the ARM industry becoming increasingly concentrated in the next 3-5 years.

**ARM Deal Volume**

2012 was a year of uncertainty in the ARM industry, as increasing regulatory scrutiny at the state and federal level combined with business volume declines in several consumer markets made it difficult for owners, executives and acquirers to forecast financial performance. Buyers either, took a back seat to see how the industry would evolve without making any acquisitions, or they took their time in working through due diligence. Some buyers had to revise their deal value or transaction structures to account for the ambiguity.
2013 has been a year of increased confidence for acquisitions, with due diligence still taking a bit longer than usual in the pre-recession days. Underperforming companies are seeing creative deal structures to account for the buyer’s concerns and the seller’s desire to close a deal. There has also been significant newfound interest in purchasing ARM companies in the healthcare, government and student loan sectors from non-industry (financial and strategic) and industry participants which will add to the overall number of transactions completed in the ARM sector.

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<th>Mid-Sized** ($5-$10M)</th>
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<th>Platform** ($20M+)</th>
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<td>Multiples</td>
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<td>3-6x Adj. EBITDA</td>
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*SDE = Seller’s Discretionary Earnings (Seller compensation + expenses combined with EBITDA)
**Adj. EBITDA (Earnings Before Interest, Taxes, Depreciation + Amortization adjusted for non-recurring expenses that would not exist post-transaction)

This is a current snapshot of valuation multiples for ARM companies. There are always outliers, but these ranges should give you some guidance on current approaches to pricing and structure based on size.

Most transactions include some cash at closing. Those deals that include little or no cash at closing are typically mergers among industry players and do not typically apply to outright sales or purchases. Higher amounts of cash tend to drive lower multiples for smaller size transactions or underperforming companies but not typically for the larger size transactions or performing companies.

In those instances when severe client concentration exists, less cash is typically paid at time of closing and more is paid out over time based on retention of key client(s). In any market condition, a rock-solid company will always sell for full market value.
**Predictions**

**Increased regulation will accelerate consolidation within ARM industry.** Looking forward over the next 12-24 months, we expect a flurry of vertical transactions as owners of small and mid-size ARM companies seek to sell out or combine forces with larger firms to combat increased operating costs running as stand-alone businesses.

**On the debt buying front, we will see an outbreak of portfolio sales** from some large and many mid-size debt buyers to a handful of LMP debt buyers. However, sellers will have to produce nearly complete data in order for industry buyers to satisfy the needs of the CFPB when purchasing debt portfolios in the secondary market or they will not get full market value for the sale.

**The intense regulatory environment is creating, for the very first time in the ARM industry, a true barrier-to-entry in the U.S. ARM industry.** Fewer ARM companies will be equipped to service needs of the larger grantor due to increased data security and compliance costs.

From the dozens of agencies focused on financial services, **there will be less than 15 ARM companies left servicing the needs of the largest financial institutions.** This includes collection agencies, law firms and debt buyers. Large financial institutions will seek to consolidate their ARM vendor networks even further as they collapse various business lines that were previously managed separately into one focused center. As a result some specialty ARM companies will be forced to consider rapidly expanding or merging with other specialists to successfully maintain existing client engagements.
**Consolidators will become a part of industry history.** The private equity backed roll-ups that took place from 1996 to 2002 were fixated on amassing market share as quickly as possible, regardless of the industry focus, even if the clients serviced by the selling company overlapped significantly. Today’s focus is toward acquisitions with a clear purpose that add select clients or services in a particular market segment.

**Government will become the single largest source of new business for ARM service providers for the next decade.** When you factor in the U.S. Department of Education, other segments of the Federal Government that I am confident will be outsourced to 3rd party professionals, and what has been developing at the state and city level, government will easily replace financial services which was king of the hill in placement volumes for 15 years leading up to the great recession.

**There has been an exodus of private lenders leaving the student loan space since the Obama administration began originating loans in 2010.** As a result, about 85% of outstanding loans are now coming from the Federal Government, a trend we think will continue into the foreseeable future until direct lenders re-enter the market.

**In addition to student loans, the U.S. Federal Government marked $56.2 billion individual tax debts and $53.7 billion business tax debts as uncollectable in 2012, a market that has the potential to be outsourced to third-party collection agencies.**

**Collectors need to be accountable for the service your employees are providing.** Consumer satisfaction will be the #1 KPI.

**In the short run, the CFPB will continue to regulate the industry through informal rulemaking.** They have released the *Advance Notice of Proposed Rulemaking (ANPR)* and are requesting feedback from the public on potential rules. To stay current on new regulation, follow the CFPB’s bulletins.