The KG Index

Q3 2018

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Our Services

- **Mergers & Acquisition Advisory** – Develop an effective growth or exit strategy for your company. Our dedicated team will confidentially address your firm's financial performance and current market conditions, expertly guiding you through your M&A process.

- **Strategic Consulting** – Find solutions to challenges facing your business. Our experienced staff and external advisory network will work with you to create your long-term growth and eventual exit strategy.

- **Valuation & Financial Solutions** – Determine the fair market value of your business. Our sister company Topline Valuation Group provides technical, financial, operational, and benchmarking services to help you develop effective business strategies.

- **Market Intelligence & Analysis** – Shape and support your business decisions. Through our proprietary information service KG Prime, we arm you with the most relevant and timely data, enabling you to make informed decisions about the direction of your business.

- **Litigation Support & Expert Witness** – Build your case using the appropriate experts. Our findings have never been invalidated in any court or formal proceedings.

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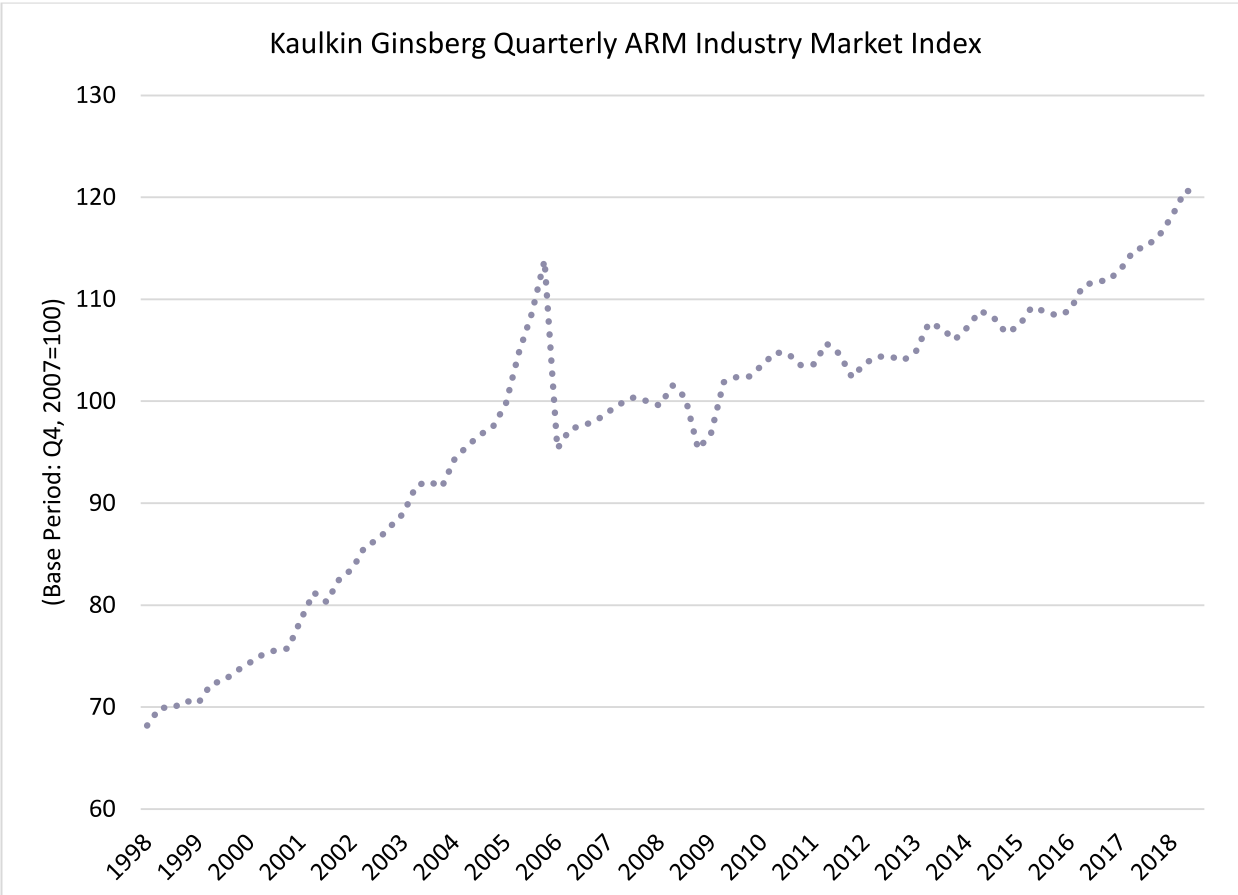
The Economy’s Effect on the ARM Industry: The KG Index



Q3 2018 data releases are complete, and that means it’s now time to start analyzing third quarter market conditions for the U.S. accounts receivable management (ARM) industry and discussing what you should look for in Q4 2018. Following a few historical revisions to prior quarter’s data points, we saw a marginal uptick in performance over the last few quarters. However, we saw a slight decline in the quarterly index for the first time since Q4 2016. Overall, the ARM industry is still up year-to-date for 2018 with relatively strong market conditions, which means that most agencies are likely still seeing an increase in placement volume and recovery rate.

More importantly, Q3 2018 came in at an index value of 120.46. This indicates that the ARM index showed negative growth in the amount of (0.2%) on a quarter-over-quarter basis with an annualized growth rate of (0.7%), which is down from the Q3 2017 annualize growth rate of 1.3%. While this may sound bad, it’s important to keep in mind that the third and fourth quarters aren’t historically strong periods, so while a negative growth rate isn’t something to celebrate, it isn’t unexpected either.

On the one hand, the ARM industry’s market conditions were nothing short of ideal since 2016, so a potential correction could be underway. On the other hand, this may be nothing more than general market volatility due to seasonality that was less apparent in the most recent quarters. Eventually, the ARM industry will begin leveling for a period like most mature industries. Additionally, changes in monetary policy, coupled with a less-than-stellar trade relationship with other major countries, could be having an effect on market conditions as well. More specifically, trade with China continues to be an issue that isn't likely to be resolved in the short-term, and Jerome Powell, Chairman of the Federal Reserve System, is maintaining the course for an increase in interest rates in order to prevent an overheating of the economy – a potentially prudent move given the extended period of artificially low interest rates for the U.S. and the limitations of monetary policy if rates remain artificially low.

Overall, the four key indicators contributing to our index – consumer bankruptcy filings, retail sales, official civilian unemployment rate (U3), and home price index – are mostly trending positively. Here are a few of our notes on the current trends within each variable:

Consumer Bankruptcy Filings

In any given year, the first and second quarters tend to be the highest points, while the third and fourth quarters trend downward through the remainder of the year. However, this trend appeared to change for the first time in a while, with Q3 2018 being greater than Q1 2018, and the number increasing 17.1% over Q3 2017. This marks the first time in over a decade that the quarterly consumer bankruptcy filings for a given quarter increased and may be an indication that the declining trend from 2010 may be coming to an end in the near term. On the one hand, a decline in bankruptcy filings means that the ARM industry should be able to collect a greater degree of consumer debt since individuals are seeking resolutions as opposed to filing bankruptcy. On the other hand, bankruptcy filings correlate with an increase in delinquent debt placements (and revenue) for the ARM industry since they are inherently related. As such, some volatility and growth in bankruptcy filings is good for the ARM industry, even if it seems counter intuitive. It will be important to monitor this trend throughout the remainder of 2018 and into 2019 since a few one-off increases in consumer bankruptcy filings is an indication of normalizing economic conditions, while systemic increases are an indication of an overheated economy that is trending towards a recession.

Retail Sales

While retail sales tend to maintain a long-term steady growth rate, the greatest period of growth is, unsurprisingly, concentrated in the third and fourth quarters of the year, while the first and second quarters are more flat. In Q3 2018, the total quarterly value of retail sales increased by roughly $16.5 billion compared to the same period in 2017, but fell short of the nearly $24 billion growth experienced a year earlier. Several factors are at play in this variable when taking the increase in bankruptcy filings into account since the majority of consumers tend to leverage these purchases through revolving credit lines that lead to a potential increase in delinquent account filings. It may not be coincidental that a year after exceptional growth in retail sales that bankruptcy filings saw an uptick, but it is too early to draw any definitive conclusions from the data.

Official Unemployment Rate (U3)

The unemployment rate appears to defy most economic projections and is now down to just 3.7% on the quarter – a level not seen even in the late 1990s and early 2000s. However, the quality of employment, as well as the labor force participation rate, dampens the significance of these measures slightly. As it relates to the ARM industry, a prolonged period of low unemployment rate tends to lead to negative market conditions unless it is offset by a relatively greater increase in consumer spending activity, which appears to be the case. While the Tax Cuts & Jobs Act (TCJA), trade wars, and free trade agreement negotiations haven't negatively impacted the labor market, they haven't improved it much either when you consider the unemployment rate doesn't have much room for improvement while the labor force participation rate appears stuck at roughly 63%. Overall, the unemployment trend is positive for the economy, but not for the ARM industry, and potential trade issues appear more likely to negatively affect the U.S. labor market in the coming months as major manufacturers, such as GM, have started cutting jobs and revisiting their business strategy.

Home Price Index

The home price index is positively correlated with the ARM industry and continues to trend upwards, which facilitates consumer confidence – especially in their ability to leverage debt – since homes account for the majority of most individual's wealth. As of Q3 2018, the index is at a record high of 205.82, and nearly 22 points greater than its Q3 2006 level right before the Great Recession. Given current housing trends and monetary policy, it appears likely that the value will continue to rise over the next few quarters, but may begin leveling off by the end of 2019. Driving this trend is the ever increasing demand for housing coupled with many consumers fear of increasing interest rates. In the short-term, the increase in interest rates appears to have driven an increase in housing demand, but the long-term effect will likely lead to a leveling off in demand as consumers begin to realign their value expectations. Additionally, the U.S. is coming out of its two biggest housing demand quarters so home builder strategy for 2019 and beyond will significantly impact home prices. If builders fear that a recession is coming, then they could scale back on construction to reduce the potential for excess inventory, which would likely lead to further increases in the index as demand outpaces supply. Alternatively, if they don't foresee any reason for concern, then housing development will likely continue and further support a leveling off of the home price index.

What to Look for Throughout 2018

2018 performed well the first half of the year and many of the key economic variables are pointing in the direction of strong growth for the ARM industry. However, fiscal policy on tax and trade agreements from the federal government and monetary policy from the Federal Reserve continue to be an area of potential concern. Additionally, trends within retail sales and consumer bankruptcy filings could indicate changing market conditions for 2019 and beyond.

Contact us at hq@kaulkin.com if you have any questions.