ENCORE CAPITAL GROUP INC
Form 10-Q
August 02, 2012
Table of Contents

UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

FORM 10-Q

(Mark One)

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended June 30, 2012

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from_________ to _________.

COMMISSION FILE NUMBER: 000-26489

ENCORE CAPITAL GROUP, INC.

(Exact name of registrant as specified in its charter)

Delaware	**48-1090909**
(State or other jurisdiction of incorporation or organization)	**(IRS Employer Identification No.)**
3111 Camino Del Rio North, Suite 1300 San Diego, California	**92108**
(Address of principal executive offices)	**(Zip code)**

(877) 445-4581

(Registrant s telephone number, including area code)

(Not Applicable)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the last 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ¨ No x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date.

Class	**Outstanding at July 16, 2012**
Common Stock, $0.01 par value	24,807,861 shares

Table of Contents

ENCORE CAPITAL GROUP, INC.

INDEX TO FORM 10-Q

Table of Contents

PART I FINANCIAL INFORMATION

Item 1 Condensed Consolidated Financial Statements (Unaudited)

ENCORE CAPITAL GROUP, INC.

Condensed Consolidated Statements of Financial Condition

(In Thousands, Except Par Value Amounts)

(Unaudited)

	June 30, 2012	December 31, 2011
Assets		
Cash and cash equivalents	$ 15,014	$ 8,047
Accounts receivable, net	1,745	3,265
Investment in receivable portfolios, net	869,859	716,454
Deferred court costs, net	40,170	38,506
Property tax payment agreements receivable, net	139,421	
Interest receivable	4,115	
Property and equipment, net	20,161	17,796
Other assets	21,592	11,968
Goodwill	55,318	15,985
Identifiable intangible assets, net	550	462
Total assets	$ 1,167,945	$ 812,483
Liabilities and stockholders equity		
Liabilities:		
Accounts payable and accrued liabilities	$ 41,149	$ 29,628
Deferred tax liabilities, net	15,799	15,709
Debt	702,316	388,950
Other liabilities	5,040	6,661
Total liabilities	764,304	440,948
Commitments and contingencies		
Stockholders equity:		
Convertible preferred stock, $.01 par value, 5,000 shares authorized, no shares issued and outstanding		
Common stock, $.01 par value, 50,000 shares authorized, 24,797 shares and 24,520 shares issued and outstanding as of June 30, 2012 and December 31, 2011, respectively	248	245
Additional paid-in capital	128,615	123,406
Accumulated earnings	277,854	249,852
Accumulated other comprehensive loss	(3,076)	(1,968)
Total stockholders equity	403,641	371,535
Total liabilities and stockholders equity	$ 1,167,945	$ 812,483

See accompanying notes to condensed consolidated financial statements

1

Table of Contents

ENCORE CAPITAL GROUP, INC.

Condensed Consolidated Statements of Comprehensive Income

(In Thousands, Except Per Share Amounts)

(Unaudited)

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	**2011**	**2012**	**2011**
Revenues				
Revenue from receivable portfolios, net	$ 138,731	$ 111,093	$ 265,136	$ 216,419
Tax lien transfer				
Interest income	2,982		2,982	
Interest expense	(650)		(650)	
Net interest income	2,332		2,332	
Total revenues	141,063	111,093	267,468	216,419
Operating expenses				
Salaries and employee benefits (excluding stock-based compensation expense)	22,651	17,129	42,689	33,796
Stock-based compensation expense	2,539	1,810	4,805	3,575
Cost of legal collections	41,024	40,686	79,659	77,195
Other operating expenses	12,427	8,250	24,025	17,040
Collection agency commissions	4,166	3,596	8,125	7,510
General and administrative expenses	18,582	9,089	32,240	18,767
Depreciation and amortization	1,420	958	2,660	1,862
Total operating expenses	102,809	81,518	194,203	159,745
Income from operations	38,254	29,575	73,265	56,674
Other (expense) income				
Interest expense	(6,497)	(5,369)	(12,012)	(10,962)
Other income	77	35	349	160
Total other expense	(6,420)	(5,334)	(11,663)	(10,802)
Income from continuing operations before income taxes	31,834	24,241	61,602	45,872
Provision for income taxes	(12,846)	(9,475)	(24,506)	(17,824)
Income from continuing operations	18,988	14,766	37,096	28,048
(Loss) income from discontinued operations, net of tax	(2,392)	9	(9,094)	406
Net income	$ 16,596	$ 14,775	$ 28,002	$ 28,454
Weighted average shares outstanding:				
Basic	24,919	24,433	24,850	24,384
Diluted	25,825	25,610	25,822	25,594
Basic earnings (loss) per share from:				

Continuing operations	$ 0.76	$ 0.60	$ 1.49	$ 1.15
Discontinued operations	$ (0.10)	$ 0.00	$ (0.37)	$ 0.02
Net basic earnings per share	$ 0.67	$ 0.60	$ 1.13	$ 1.17
Diluted earnings (loss) per share from:				
Continuing operations	$ 0.74	$ 0.58	$ 1.44	$ 1.09
Discontinued operations	$ (0.10)	$ 0.00	$ (0.37)	$ 0.02
Net diluted earnings per share	$ 0.64	$ 0.58	$ 1.08	$ 1.11
Other comprehensive loss:				
Unrealized loss on derivative instruments	(2,944)	(888)	(1,822)	(52)
Income tax benefit related to unrealized gain on derivative instruments	1,154	351	714	23
Other comprehensive loss, net of tax	(1,790)	(537)	(1,108)	(29)
Comprehensive income	$ 14,806	$ 14,238	$ 26,894	$ 28,425

See accompanying notes to condensed consolidated financial statements

Table of Contents

ENCORE CAPITAL GROUP, INC.

Condensed Consolidated Statements of Stockholders Equity

(Unaudited, In Thousands)

	Common Stock		Additional Paid-In	Accumulated	Accumulated Other Comprehensive (Loss)	Total
	Shares	Par	Capital	Earnings	Income	Equity
Balance at December 31, 2011	24,520	$ 245	$ 123,406	$ 249,852	$ (1,968)	$ 371,535
Net income				28,002		28,002
Other comprehensive loss:						
Unrealized loss on derivative instruments, net of tax					(1,108)	(1,108)
Exercise of stock options and issuance of share-based awards, net of shares withheld for employee taxes	277	3	(1,180)			(1,177)
Stock-based compensation			4,805			4,805
Tax benefit related to stock-based compensation			1,584			1,584
Balance at June 30, 2012	24,797	$ 248	$ 128,615	$ 277,854	$ (3,076)	$ 403,641

See accompanying notes to condensed consolidated financial statements

Table of Contents

ENCORE CAPITAL GROUP, INC.

Condensed Consolidated Statements of Cash Flows

(Unaudited, In Thousands)

	Six Months Ended June 30, 2012	Six Months Ended June 30, 2011
Operating activities:		
Net income	$ 28,002	$ 28,454
Adjustments to reconcile net income to net cash provided by operating activities		
Depreciation and amortization	2,660	1,862
Impairment charge for goodwill and identifiable intangible assets	10,400	
Amortization of loan costs and premium on property tax payment agreements receivable	1,210	901
Stock-based compensation expense	4,805	3,575
Income tax provision in excess of (less than) income tax payments	89	(162)
Excess tax benefit from stock-based payment arrangements	(1,689)	(4,727)
Loss on sale of discontinued operations	2,416	
(Reversal) provision for allowances on receivable portfolios, net	(789)	6,504
Changes in operating assets and liabilities, net of effects of acquisition		
Other assets	298	63
Deferred court costs	(1,664)	(3,910)
Prepaid income tax and income taxes payable	(6,455)	24
Accounts payable, accrued liabilities and other liabilities	5,322	(841)
Net cash provided by operating activities	44,605	31,743
Investing activities:		
Cash paid for acquisition, net of cash acquired	(185,990)	
Purchases of receivable portfolios	(361,446)	(184,376)
Collections applied to investment in receivable portfolios, net	207,205	163,144
Proceeds from put-backs of receivable portfolios	1,625	1,698
Originations of property tax payment agreements receivable	(14,072)	
Collections applied to property tax payment agreements receivable, net	7,467	
Purchases of property and equipment	(2,595)	(1,461)
Net cash used in investing activities	(347,806)	(20,995)
Financing activities:		
Payment of loan costs	(1,619)	(814)
Proceeds from senior secured notes		25,000
Proceeds from revolving credit facilities	383,399	55,000
Repayment of revolving credit facilities	(70,500)	(87,000)
Proceeds from exercise of stock options	2,583	1,248
Taxes paid related to net share settlement of equity awards	(2,177)	(3,388)
Excess tax benefit from stock-based payment arrangements	1,689	4,727
Repayment of capital lease obligations	(3,207)	(1,766)
Net cash provided by (used in) financing activities	310,168	(6,993)
Net increase in cash and cash equivalents	6,967	3,755
Cash and cash equivalents, beginning of period	8,047	10,905

Cash and cash equivalents, end of period	$ 15,014	$ 14,660
Supplemental disclosures of cash flow information:		
Cash paid for interest	$ 11,075	$ 9,718
Cash paid for income taxes	23,108	17,814
Supplemental schedule of non-cash investing and financing activities:		
Fixed assets acquired through capital lease	2,779	1,726

See accompanying notes to condensed consolidated financial statements

Table of Contents

ENCORE CAPITAL GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1: Ownership, Description of Business and Summary of Significant Accounting Policies

Encore Capital Group, Inc. (Encore), through its subsidiaries (collectively, the Company), is a leading provider of debt management and recovery solutions for consumers and property owners across a broad range of assets. The Company purchases portfolios of defaulted consumer receivables and manages them by partnering with individuals as they repay their obligations and work toward financial recovery. Defaulted receivables are consumers unpaid financial commitments to credit originators, including banks, credit unions, consumer finance companies, commercial retailers, auto finance companies, and telecommunication companies, which the Company purchases at deep discounts. Defaulted receivables may also include receivables subject to bankruptcy proceedings, or consumer bankruptcy receivables. In addition, through its newly acquired subsidiary, Propel Financial Services, LLC (Propel), the Company assists Texas property owners who are delinquent on their property taxes by paying these taxes on behalf of the property owners in exchange for payment agreements collateralized by tax liens on the property.

Portfolio purchasing and recovery

The Company purchases receivables based on robust, account-level valuation methods and employs a suite of proprietary statistical and behavioral models across the full extent of its operations. These investments allow the Company to value portfolios accurately (and limit the risk of overpaying), avoid buying portfolios that are incompatible with its methods or goals and precisely align the accounts it purchases with its operational channels to maximize future collections. As a result, the Company has been able to realize significant returns from the receivables it acquires. The Company maintains strong relationships with many of the largest credit providers in the United States, and possesses one of the industry s best collection staff retention rates.

The Company uses insights discovered during its purchasing process to build account collection strategies. The Company s proprietary consumer-level collectability analysis is the primary determinant of whether an account will be actively serviced post-purchase. The Company continuously refines this analysis to determine the most effective collection strategy to pursue for each account it owns. After the Company s preliminary analysis, it seeks to collect on only a fraction of the accounts it purchases, through one or more of its collection channels. The channel identification process is analogous to a funneling system where the Company first differentiates those consumers who it believes are not able to pay from those who are able to pay. Consumers who the Company believes are financially incapable of making any payments, facing extenuating circumstances or hardships (such as medical issues), serving in the military, or currently receiving social security as their only source of income are excluded from the next step of its collection process and are designated as inactive. The remaining pool of accounts in the funnel then receives further evaluation. At that point, the Company analyzes and determines a consumer s perceived willingness to pay. Based on that analysis, the Company will pursue collections through letters and/or phone calls to its consumers. Despite its efforts to reach consumers and work out a settlement option, only a small number of consumers who are contacted choose to engage with the Company. Those who do are often offered deep discounts on their obligations, or are presented with payment plans that are better suited to meet their daily cash flow needs. The majority of contacted consumers, however, ignore both the Company s calls and letters, and therefore the Company must then make the difficult decision whether or not to pursue collections through legal means.

Tax lien transfer

Propel s principal activity is originating and servicing property tax lien transfers in the state of Texas by paying real estate taxes on behalf of real property owners in exchange for payment agreements collateralized by tax liens on the property. Propel purchases the property owner s delinquent tax obligation from the local tax authority at par value and works with the property owner to create an affordable payment plan. Tax lien transfers provide the local taxing authorities with much needed tax revenue and property owners with a longer period of time to satisfy their obligations at a lower interest rate and fee structure than what the local tax authority would charge. Based in San Antonio, Texas, Propel is the largest tax lien transfer company in Texas. Propel offers competitive rates, flexible payment terms and has the ability to fund the transaction with the property owner quickly, thus saving the property owner from incurring additional fees and interest levied by the local tax authority. Propel is subject to regulation by the Office of Consumer Credit Commissioner of the state of Texas.

Financial Statement Preparation

The accompanying interim condensed consolidated financial statements have been prepared by Encore, without audit, in accordance with the instructions to the Quarterly Report on Form 10-Q, and Rule 10-01 of Regulation S-X promulgated by the U.S. Securities and Exchange

Commission (the SEC) and, therefore, do not include all information and footnotes necessary for a fair presentation of its consolidated financial position, results of operations and cash flows in accordance with accounting principles generally accepted in the United States.

Table of Contents

In the opinion of management, the unaudited financial information for the interim periods presented reflects all adjustments, consisting of only normal and recurring adjustments, necessary for a fair presentation of the Company s consolidated financial position, results of operations, and cash flows. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements included in the Company s Annual Report on Form 10-K for the fiscal year ended December 31, 2011. Operating results for interim periods are not necessarily indicative of operating results for an entire fiscal year.

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts and the disclosure of contingent amounts in the Company s financial statements and the accompanying notes. Actual results could materially differ from those estimates.

Basis of Consolidation

Encore is a Delaware holding company whose principal assets are its investments in various wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

On May 8, 2012, the Company completed its acquisition of Propel Financial Services, LLC, BNC Retax, LLC, RioProp Ventures, LLC, and certain related affiliates (collectively, the Propel Entities). The condensed consolidated statements of comprehensive income for the three and six months ended June 30, 2012 includes the results of operations of the Propel Entities only since the date of acquisition. For additional acquisition related information relating to the Propel Entities, please refer to the Company s Current Report on Form 8-K filed with the SEC on July 24, 2012.

Reclassification

Certain reclassifications have been made to the condensed consolidated financial statements to conform to the current year s presentation.

Note 2: Discontinued Operations

On May 16, 2012, the Company completed the sale of the assets of its bankruptcy servicing subsidiary Ascension Capital Group, Inc. (Ascension) to a subsidiary of American InfoSource, L.P. (AIS). The Company agreed to fund certain, agreed-upon operating losses in the first year of AIS ownership of the Ascension business, not to exceed $4.0 million. If the Ascension business becomes profitable under AIS ownership, the Company will be paid an earn-out equal to 30 to 40% of Ascension s EBITDA for the first five years commencing May 16, 2012. The Company received no proceeds from the sale. Additionally, the Company recognized the entire $4.0 million loss contingency during the three months ended June 30, 2012.

The Company performed an interim goodwill impairment test for Ascension as of March 31, 2012 and concluded that the entire goodwill balance relating to Ascension of $9.9 million was impaired. Additionally, the Company wrote-off the remaining identifiable intangible assets of approximately $0.4 million relating to Ascension.

Ascension s operations are presented as discontinued operations for the three and six months ended June 30, 2012 and 2011, in the Company s consolidated statements of comprehensive income. The following table presents the revenue and components of discontinued operations, net of tax (*in thousands*):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	**2011**	**2012**	**2011**
Revenue	$ 1,892	$ 4,725	$ 5,704	$ 9,693
(Loss) Income from discontinued operations before income taxes	$ (924)	$ 20	$ (11,942)	$ 669
Income tax benefit (expense)	362	(11)	4,678	(263)

(Loss) income from discontinued operations	(562)	9	(7,264)	406
Loss on sale of discontinued operations, before income taxes	(2,416)		(2,416)	
Income tax benefit	586		586	
Loss on sale of discontinued operations	(1,830)		(1,830)	
Total (loss) income from discontinued operations	$ (2,392)	$ 9	$ (9,094)	$ 406

6

Table of Contents

Note 3: Business Combination

On May 8, 2012, the Company acquired all of the outstanding equity interests of the Propel Entities (the Propel Acquisition) for $186.8 million in cash. The Propel Acquisition is being accounted for using the acquisition method of accounting and, accordingly, the tangible and intangible assets acquired and liabilities assumed were recorded at their estimated fair values as of the date of the acquisition.

The Company has completed an independent valuation study and determined the fair value of the assets acquired and the liabilities assumed from the Propel Entities. Fair value measurements have been applied based on assumptions that market participants would use in the pricing of the respective assets and liabilities. However, the purchase price allocation is still preliminary and is subject to adjustment based on a reconciliation of the actual balance sheet accounts as of the closing date to estimates used at the time of the consummation of the Propel Acquisition. This reconciliation is expected to be completed during the third quarter of 2012. As of the filing date of this Form 10-Q, the Company s preliminary analysis indicated an additional payable to the seller amounted to approximately $0.7 million, which is reflected below.

The components of the preliminary purchase price allocation for the Propel Entities are as follows (*in thousands*):

Purchase price:	
Cash paid	$ 186,814
Estimated purchase price adjustment	725
Total estimated purchase price	$ 187,539
Allocation of purchase price:	
Cash	$ 824
Accounts receivable	1,049
Interest receivable	3,679
Property tax payment agreements receivable	132,978
Fixed assets	461
Other assets	860
Liabilities assumed	(2,153)
Identifiable intangible assets	570
Goodwill	49,271
Total net assets acquired	$ 187,539

The following summary presents unaudited pro forma consolidated results of operations for the three and six months ended June 30, 2012 and 2011 as if the Propel Acquisition had occurred on January 1, 2012 and 2011, respectively. The following unaudited pro forma financial information does not necessarily reflect the actual results that would have occurred had the Company and the Propel Entities been combined during the periods presented, nor is it necessarily indicative of the future results of operations of the combined companies (*in thousands*):

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	**2011**	**2012**	**2011**
Consolidated pro forma revenue	$ 143,109	$ 115,168	$ 273,975	$ 224,277
Consolidated pro forma income from continuing operations	21,557	15,205	40,708	29,126

Note 4: Earnings per Share

Basic earnings per share is calculated by dividing net earnings available to common stockholders by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share is calculated on the basis of the weighted average number of shares of common stock plus the effect of dilutive potential common shares outstanding during the period using the treasury stock method. Dilutive potential common shares include outstanding stock options and restricted stock units.

Table of Contents

The components of basic and diluted earnings per share are as follows *(in thousands, except earnings per share)*:

	Three Months Ended June 30,		Six Months Ended June 30,	
	2012	2011	2012	2011
Income from continuing operations	$ 18,988	$ 14,766	$ 37,096	28,048
(Loss) income from discontinued operations, net of tax	(2,392)	9	(9,094)	406
Net income available for common stockholders	$ 16,596	$ 14,775	$ 28,002	$ 28,454
Weighted average common shares outstanding basic	24,919	24,433	24,850	24,384
Dilutive effect of stock-based awards	906	1,177	972	1,210