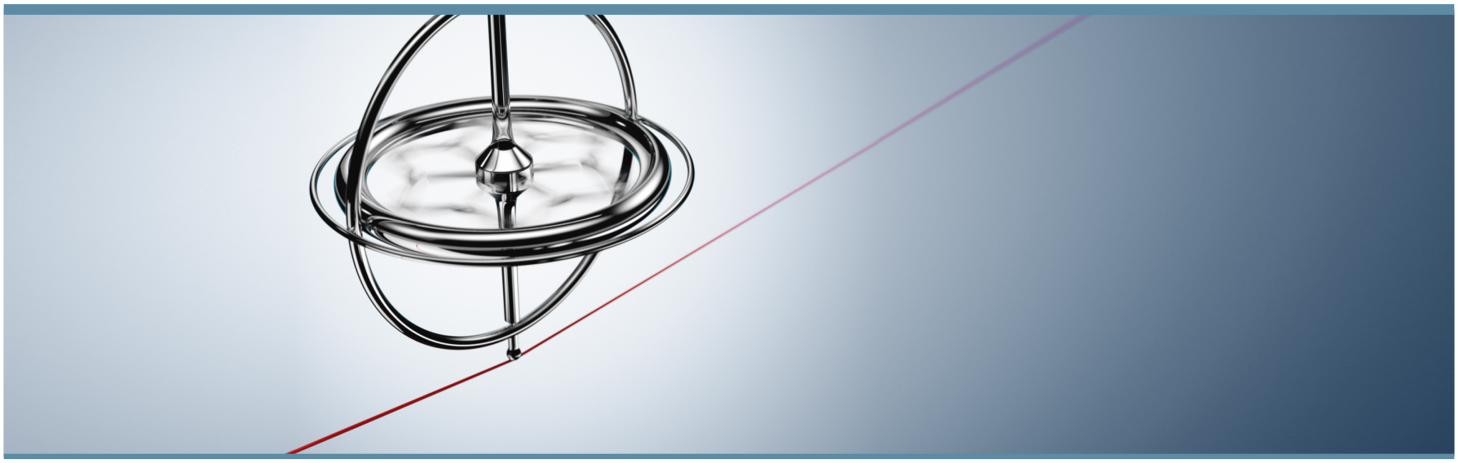

Executive Insights

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We Can't Go On Like This – or Can We? Why the UK Debt Purchase Market is Sustainable

On the face of it, the buoyant economics of the U.K.-based debt purchase market do not look sustainable. In the aftermath of the financial crisis, the market grew impressively fast as banks and other financial institutions sought to offload distressed consumer loans.

But with demand starting to outstrip supply, the prices of loan portfolios have risen, and debt purchasers' profitability, as measured by the internal rate of return (IRR), has fallen.

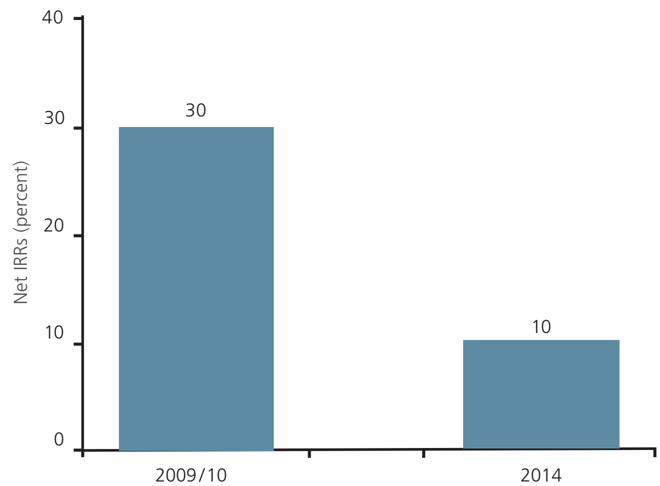
Traditionally, debt purchasers have targeted net IRR hurdle rates of 15-20%, which is consistent with a net cash collection multiple of about two times the amount paid for the loan portfolio (over 84 months). In some years – notably 2009 and 2010 – these multiples have been significantly higher due to both a favorable pricing environment and improving collections, boosting profitability and attracting more capital from investors.

But by 2014, net collection multiples had fallen to below two times, primarily due to increased prices, which negatively impacted net IRRs. Arrow Global and Cabot Financial – two of the big three U.K. debt purchasers, along with Lowell Group – have seen their collection multiples decline significantly. In 2010, Arrow's gross cash multiple (84 months) was three times. By 2014, it was just 1.7 times. Likewise, Cabot's fell from 3.67 in 2009 to 1.49 in 2014.

These numbers suggest a drop in net IRRs from c.30% to c.10% (see Figure 1).

Figure1

Declining cash multiples and IRRs over the past 5 years



Cash multiples

Arrow	3.0	1.7
Cabot	3.7	1.5

Source: L.E.K. analysis

Groundhog day?

The situation is reminiscent of the dark days of the financial crisis. In 2007, demand also outstripped supply, as a large number of debt buyers – around 40 companies – with a surfeit of capital chased a fixed pool of assets. Back then, the consequences were

We Can't Go On Like This – or Can We? Why the UK Debt Purchase Market is Sustainable was written by **Peter Ward** and **Eilert Hinrichs**, partners in L.E.K. Consulting's Financial Services practice. Peter and Eilert are based in London.

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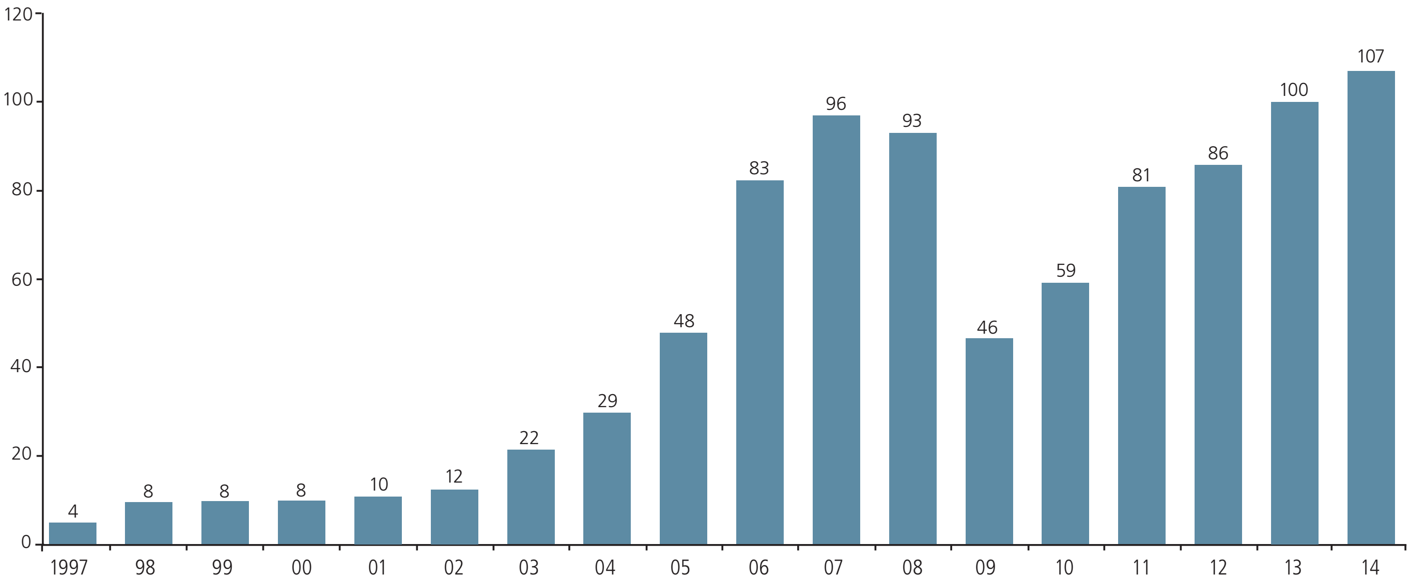
Figure 2
Size of the U.K. debt purchase market
Acquisition value of debt purchase market (financial services only)



Note: Index – 2013=100
Source: L.E.K. analysis

severe. The market collapsed from £900m of sales in 2007 to just £425m of sales in 2009 (see Figure 2).

Today, the question is this: given the headline similarities, could the market suffer the same kind of collapse again? Or are things different this time?

In essence, how sustainable is the U.K. debt purchase market?

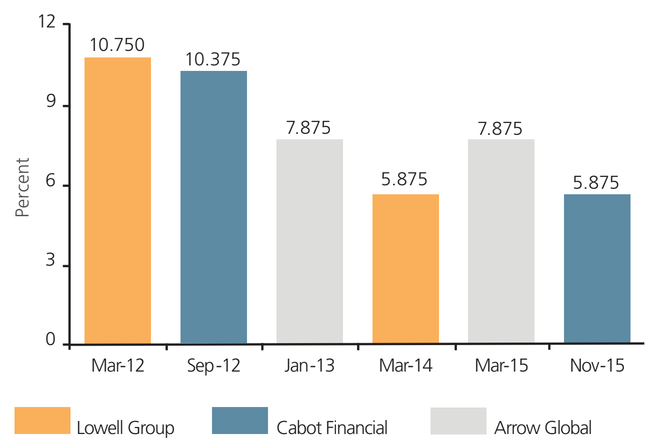
This time it really is different

In our view, the market is sustainable and will continue to offer profitable opportunities, even though the IRRs are falling. This is because the leading debt purchasers have changed in two fundamental ways over the past eight years.

First, their capital structures are very different. Back in 2007, funding for loan acquisitions was usually sourced from private equity and senior debt – which was extremely expensive, not aligned to the investment horizon and with availability dependent on collections performance of past portfolios. Typically, private equity expected returns in excess of 20% per annum, while senior debt rates were around 15%. Now, capital for portfolio acquisitions is commonly sourced from bonds, which are better aligned to the investment horizon and have become steadily cheaper in recent years. Interest rates can be as low as 6% (see Figure 3). Some leading European purchasers are using even cheaper deposit funding, albeit that this can come with regulatory and other restrictions. Taking into account equity mix, the right capital structure can bring a competitive cost of capital differential of 2-3%.

Second, the debt purchasers' collection strategies have become much more sophisticated. Overall, the process of debt collection has been helped by the economic recovery in the U.K., with more customers able to repay loans. But, at the same time and more

Figure 3
Public bond coupon rates
Cost of capital



importantly, the major companies have ramped up their investment in I.T. and built vast libraries of data. Arrow for example, has a Proprietary Collections Bureau with 21.6 million records. The sheer volume of this data, combined with access to external information sources (in particular credit bureau data) as well as investment and reinvestment in the analytical techniques to mine it, has allowed them to develop significantly more targeted and efficient collections strategies and consequently get much more out of existing loan portfolios.

The new data also shows that there is much more value in the "tail" of portfolios as collections continue well beyond historical expectations of around 60 months to around 120 months today. As a result, debt purchasers expect to, and in fact do, collect significantly more from the same debt than previously expected and priced. Therefore the leading buyers can price up accordingly without losing their shirts.

These two factors – mature capital structures and superior collections strategies – are huge advantages to the leading companies vs. new entrants. Also, with the passage of time, they have been able to establish strong relationships with the major financial institutions. This has become increasingly important as the banks have become choosier about selling to a select group of debt purchasers, not least as regulatory scrutiny has increased. Taken together, these barriers to entry are now higher than ever, and still rising. Future success will depend on continuing to invest in all of these aspects: focusing only on collections strategies and operational matters will not be enough to sustain competitive advantage.

Return to returns (on equity): A better way to measure success and a new basis for competition

Given the changing nature of debt purchasers' business models and funding structures, IRRs no longer present the full picture. Some, such as Arrow, prefer to refer publicly to their return on equity (RoE), and more do so in private where the real decisions are made.

When capital structures were all the same between different companies, publishing this metric was just expressing IRRs in a different currency. However, now it is important to make this distinction to show true returns to debt purchasers' owners. On this basis, it is clear that the leading players' performance is healthy and sustainable. For example, in the six months to June 2015, Arrow Global reported underlying return on equity figures for the last twelve months of 25.5%. This compared to 23.9% for the same period in 2014, despite a rising pricing environment in the market as a whole.

This change of mindset also appears to have coincided with developments in the basis of competition: if debt purchasers price on the basis of RoE, then it follows that those with advantaged capital structures can win portfolios by pricing these in to bids in a way that others cannot (rationally) follow. It appears that this feature of the market, long supported by commercial logic but rarely easily observable in reality, is starting to become a more prominent feature of how portfolios are won and lost.

Looking further ahead, those debt purchasers backed by public equity with its lower return requirements may further leverage their capital structures in pricing to compete against those who are more expensively backed by private equity. This could push the market further towards a U.S.-like model of lower but stable returns.

No room for complacency: What debt purchasers need to do to stay ahead

Although IRRs have fallen sharply in the last two years, this does not appear to have dented the interest of investors. Capital is continuing to flow into the debt purchase market, both in terms of bond funding to finance portfolio purchases (as discussed above) and equity funding to buy debt purchase companies themselves as both private equity investors look to buy individual companies and public equity markets continue to support the existing listed players. For example, in October 2015, Permira, the U.K.-based buyout group, completed its acquisition of Lowell, following its also recently completed acquisition of GFKL, and further afield in Europe Nordic's acquisition of Lindorff in 2014 and B2's acquisition of Ultimo, also in 2014, illustrate broader demand across the continent.

Yet, as we reported in the first *Executive Insights* in this series, "Cracking the Continent: How to Succeed in European Debt Purchase", growth in new loan portfolios in the U.K. is poised to slow significantly and it is likely to turn negative over the next three to five years. This is because banks and other vendors are in the process of selling the last of the backlog built up during the financial crisis.

The implications are clear: with a large amount of capital chasing an increasingly static pool of opportunities, prices could continue to rise. So debt purchasers cannot afford to be complacent and should focus on three principal aspects of their business to stay ahead:

1. Pro-actively continue to optimize capital structures.
For now, the cost of capital is low. If interest rates rise by 0.5%, this should pose few problems for the major companies. But what if the cost of capital is, say, 8% instead of 6%? It would be advisable to conduct a stress test for this kind of interest rate rise.

2. Continue to invest actively in collection strategies.
Given the rising costs of acquiring loan portfolios, companies should be unstinting in their efforts to squeeze more value from those they already possess. The key to success here is allocating resources for upgrades to the I.T. and data systems.

3. Actively scan the horizon for new opportunities. Europe offers some great prospects for companies wishing to expand – so long as they do their due diligence. Other opportunities to differentiate or diversify, for example by providing outsourcing services further up the supply chain, are also feasible and potentially attractive. Either way, it is essential to avoid being beholden to a single market which could potentially overheat, especially with bondholders or public equity holders to satisfy.

Out-performance in one of these dimensions will not be sufficient to survive and thrive in the U.K. debt purchase market; only by excelling in all three will sustained profitable business be assured.

About the Authors

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