Executive Insights

Volume XVIII, Issue 47

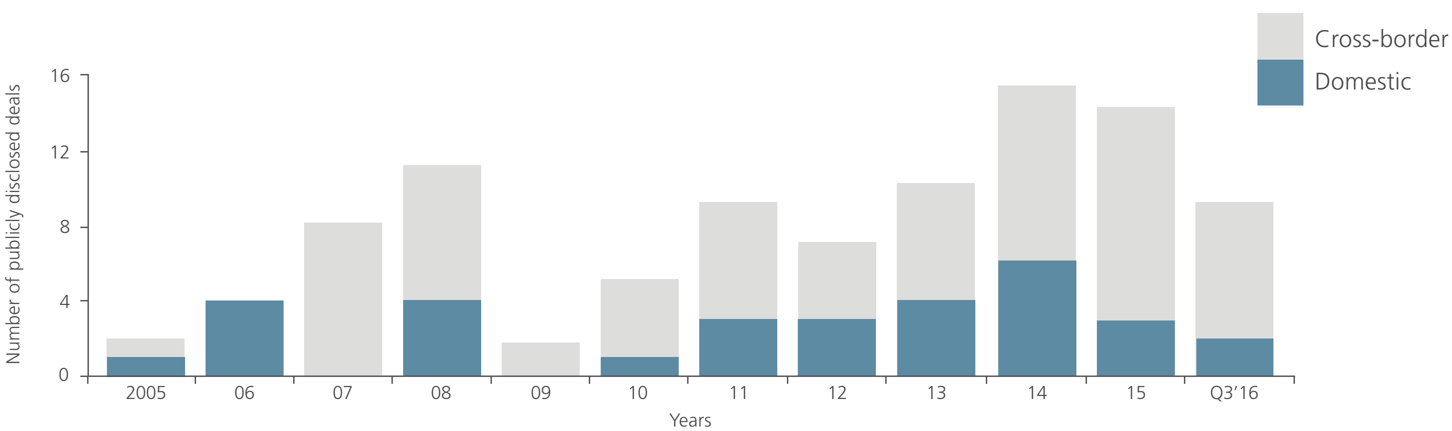
Preparing for the Endgame: Creating a Winning Position in European Debt Management M&A

The European unsecured debt management (DM) market has seen considerable M&A activity (see Figure 1) and realignment as a result of other operational and competitive developments over the past decade, and there are now around 10 players that have established multicountry European operations.

However, there is no European single market in DM,[1] and these consolidating players, as well as many other smaller and midsize ones, have pursued very different M&A strategies, each relevant to its own specific strategic position. These different strategies notwithstanding, the international majors are increasingly stepping on each other's toes and competing more directly in this continental consolidation game, even if they are not competing directly within individual DM markets. Market participants and commentators are thinking more seriously about what the endgame in European DM might be and how quickly it might come. In this context, it is essential for all management teams and investors to develop a

Figure 1

European debt management transactions (2005-Q3 2016)



Source: Publicly available deal disclosures

[1] See, for example, our prior paper on the complexities of U.K. players moving to the continent

Preparing for the Endgame: Creating a Winning Position in European Debt Management M&A was written by **Eilert Hinrichs** and **Peter Ward**, partners in L.E.K. Consulting's Financial Services practice. Eilert and Peter are based in London.

For more information, please contact financialservices@lek.com.

L.E.K.
INSIGHTS@WORK

Figure 2
Strategic approaches to European debt management

Strategy	Commentary
Strong position in a portfolio of all large markets	Establish a strong position (top 3) in all or at least a number of the largest European markets: U.K., Germany, Spain, Italy (and arguably, Poland) A combination with the below is possible
Leading position in a number of smaller markets	Become or acquire the clear leader in debt management provision in a number of smaller European markets, e.g., Ireland, Portugal, Belgium, Sweden or Austria A combination with the above is possible
Functional / niche specialization across Europe	Establish the leading position in a specific asset class (e.g., small balances) or a specific sector (e.g., telecoms or home shopping) across Europe Operational aspects may provide a sustainable advantage
Follow client relationships across Europe	Develop a multicountry or pan-European debt management business by leveraging established client relationships across multiple countries

Source: L.E.K. experience

clear strategic vision and a robust response to the M&A trend that is relevant to their specific circumstances. In doing so, they must recognize that the appropriate approach for a given European DM company will vary widely with the nature of the individual national markets within the broader continental landscape, and the specific competitive position of each player within these markets.

This paper examines the range of possible approaches to M&A strategy through the lens of the overarching corporate strategies, which can lead to sustainable success in the endgame of European DM.

The strategic context for M&A in European debt management: why do deals anyway?

There are four principal strategic options that are currently being pursued by European DM players, either alone or in combination (see Figure 2).

The key choices are, first, geographical, i.e., to focus on competitive positions in large national markets and / or clear No.1 positions in smaller ones; or, second, operational, i.e., to focus on functional specialisms, possibly leveraging multicountry relationships with individual major clients and / or leveraging operational expertise, e.g., use of data and developing data warehouses and scoring systems.

For each player, being clear on its own strategic position within its national markets and the broader European landscape, and which overall strategy is being pursued, is an essential prerequisite to successful participation in the European M&A game: Each circumstance requires different choices from the range of potential rationales for doing deals (see Figure 3).

For those European players of insufficient scale to pursue these strategies, e.g., mid-tier players in single national markets (for example in Germany), the question is more whether continuing independently is sustainable in the longer term and, if not, how best to position to be an attractive “piece of the puzzle” for larger acquiring players in due course.

Consolidation to date: What have market participants done and why?

In response to different domestic market trends and dynamics as well as market pressures, DP players have pursued a range of M&A strategies in Europe (see Figure 4).

For example, in Scandinavia, with its collection of relatively small DM markets that emerged and matured early, local players such as Intrum, Lindorff, Aktiv Kapital and Hoist “ran out of road” in their domestic markets and were forced to look for growth internationally more than a decade ago. As a consequence, Scandinavian DMs have been very active internationally, with approximately 70% of M&A transactions outside Scandinavia over the past decade. Likewise, in Germany, another mature DM market in some respects, a clear majority of transactions have been international, although the fragmented nature of the German market also offers continuing opportunities for domestic consolidation.

By contrast, the U.K. is the largest single market in Europe with historically attractive growth. Consequently there has been intense competition, including an “arms race” in analytical and operational sophistication, and this market has required strong

Figure 3
Potential rationales for doing deals in European debt management

Rationale	Commentary
Within market consolidation	• Create market power and / or achieve further growth within current markets of participation • Broaden capability set within current market of participation, e.g., broaden from debt purchase only to debt management offering
New growth storys	• Have "run out of road" domestically, need somewhere to go to demonstrate growth to investors and/or market • Enter into new geographical markets that have characteristics of immaturity in a number of ways — adoption of DM, fragmentation, operational sophistication, consumer lending. This provides growth as they develop and could also include the opportunity to enter new market segments, e.g., secured loans
Strategic synergies	• Create value by merging companies' skill sets, making more than the sum of the parts • Examples include following clients internationally, applying country best operational practices in other country markets
'Vanilla' financial returns (e.g., PE)	• Classic "invest, run it harder and more efficiently" approach • Can apply other rationales within this framework

Source: L.E.K. experience

funding and serious focus to survive and thrive. As a result, the drive to internationalize has been relatively recent, precipitated by a leveling off of domestic growth,[2] and less than half of M&A deals undertaken by U.K. players have been international.

However, as markets have evolved and individual players have grown, there is an increasing degree of similarity between European players in M&A strategy as they are now all focused principally on international transactions: competition for assets is high and acquisitions are driven by an element of "land grab," and / or major players aiming to keep other majors out of specific markets in which they have established positions. Both rationales can be solid strategic imperatives to participate in M&A, but can also lead to overpaying for specific assets, and the high prices now being paid may well be unsustainable in the medium to long term.

Prospects for European DM M&A: selling like hotcakes

We believe that further consolidation in European DM is inevitable and is likely to accelerate.

First, single-country operators in Europe are increasingly strategically vulnerable as (i) they are more at the mercy of individual market volatility than the set of increasingly diversified international players; and (ii) such players also tend to have less competitive cost of capital structures because, with the exception of U.K. and Polish players, they are relatively small and struggle to gain access to capital markets: this higher cost of capital can leave them at a disadvantage particularly in DP bidding processes and also more generally. Both of these factors increasingly call into question the longer-term viability of these players, and increase the likelihood and urgency of transactions involving them.

Second, and as noted above, though there is no single European DP market, the geographical universe in which the major European players operate, or would like to operate, has become more overlapping. Combined with their continued focus on unsecured consumer debt and having access to the European capital markets, although their culture and approaches are somewhat different, major European DM players are increasingly playing a similar game on overlapping playing fields. Consequently, competition for the assets that form part of their ultimate winning strategies is increasingly intense and urgent.

We also expect valuations to remain high, driven by this increasing competitive intensity and urgency, together with increasing scarcity value as the endgame approaches.

Positioning for success: visions of the endgame

Successful, value-creating M&A strategy in European DM for the international majors will depend upon clear positioning within a well-defined endgame strategy, i.e., developing a sustainable "seat

[2] See also http://www.lek.com/sites/default/files/EuropeanDebtPurchase_ExecutiveInsights2015_2.pdf.

Figure 4
International acquisitions in European debt management

Location of target country \ Location of acquirer country	Scand.	Germany	U.K.	U.S.	Other	Total
Germany	3	13	1	1	-	18
Iberia	5	3	5	2	3	18
Scan.	10	1	-	1	-	12
U.K.	3	-	9	4	-	16
Benelux	2	1	1	-	3	7
CEE	4	4	-	1	1	10
France	1	2	1	-	-	4
Italy	1	-	1	1	-	3
Switz.	2	2	-	-	-	4
Other	-	4	-	-	-	4
Total	31	30	18	10	7	96

Source: Publicly available deal disclosures

at the table" as the continental picture shakes out. However, there are competing visions of this endgame.

One vision is that the endgame is already here. In this vision, all large or potentially large markets are now as mature as they'll ever be: Differences in market practices and the penetration of debt management are fundamentally cultural and / or structural, and any further change is likely to be generational rather than commercially driven. As a result, the existing 10 or so major international European players have sustainable strategic positions and can remain independent. M&A activity is therefore focused on in-fill and/or consolidation of smaller national players into larger international ones, with some "national champions" also surviving. This vision seems unlikely to us, as the collective ambition of the international majors requires a level of growth from each of them that is incompatible with such a gradualist picture: We expect they will continue to compete hard until some have won and some have lost, and the field consolidates to around four to six major players, somewhat similar to the U.S.

A second vision of the endgame is that the European DP market is only just really getting started. In this vision, the example of the U.K. shows what can be achieved in terms of debt management sophistication, in terms of both penetration of debt management in national markets and operational sophistication, and acts as a template to be followed by other countries, supported by further growth as the majors also increasingly participate in secured debt. M&A activity therefore takes a long time to play out, as domestic development within individual country markets is the dominant strategic theme: international market expansion is pursued principally as individual country markets "top out" at maturity. This scenario also seems unlikely to us: It is a mistake to assume that other European countries will end up looking like the U.K. and adopting their processes and policies. Cultural and structural differences have a significant impact on national approaches to debt management and it is wrong to assume that all will eventually migrate toward the U.K. approach — not all less penetrated markets are immature, they're just different.

A third vision is that it's a waiting game. In this vision, most markets are fundamentally stable, but (i) trigger points can cause cultural change, e.g., the Spanish debt crisis following the credit crunch or the Italian bank crisis, resulting in waves of M&A activity as such events occur; and (ii) more evolutionary change, e.g., growth in the use of consumer debt in Eastern Europe results in new markets joining the international "big league," and again waves of M&A activity as such events occur. In both instances, the European international majors will optimize their current positions and address opportunities as they arise. As this occurs, some major players will accumulate more dominant positions across the continent and others will lose out: as a result, the current situation of around 10 international majors also becomes unsustainable and the field again consolidates to around four to six major players.

In our view, this third vision is the most likely and compelling. The big strategic and commercial questions that must be answered as the endgame plays out are:

- Strategic rationale: How complementary are the leading players to each other either geographically or operationally? (E.g., (i) Kruk is geographically complementary to most other European international majors, whereas the benefits of combining two of the leading U.K. players are less clear; (ii) U.K. players may have operating capabilities that can be leveraged in international markets to achieve superior collections.) Which combinations create shareholder value, and how?
- Feasibility of major combinations: Which sets of current owners will be prepared to do business with each other? Who has access to sufficient funding to achieve this scale of transaction?

For management teams and investors alike, having a clear vision of the endgame and its timing, and a realistic assessment of their strategic position is critical, and increasingly urgent. Within this vision, individual players can aspire to be one of the ultimate winners themselves or, alternatively, build a critical piece of the jigsaw puzzle for an "endgame player" and position themselves to be consolidated, thus still realizing significant value for their shareholders.

About the Authors

Eilert Hinrichs is a partner in L.E.K.'s London office. He has almost 20 years of consulting experience and has completed a large number of pan-European financial services projects, advising on strategy reviews, market entry strategy development and transaction support on both the buy side and sell side.

Peter Ward is a partner in L.E.K.'s London office. Having joined L.E.K. in 2000, his primary focus has been corporate strategy development, complemented by substantial experience in buy and sell side commercial due diligence, commercial bid support and litigation support. He also has significant expertise in performance measurement and incentive structures, both within organizations and across contractual boundaries.

About L.E.K. Consulting

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and rigorous analysis to help business leaders achieve practical results with real impact. We are uncompromising in our approach to helping clients consistently make better decisions, deliver improved business performance and create greater shareholder returns. The firm advises and supports global companies that are leaders in their industries — including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. Founded more than 30 years ago, L.E.K. employs more than 1,200 professionals across the Americas, Asia-Pacific and Europe. For more information, go to www.lek.com.

L.E.K.
INSIGHTS@WORK®