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Cracking the Continent: How to Succeed in European Debt Purchase

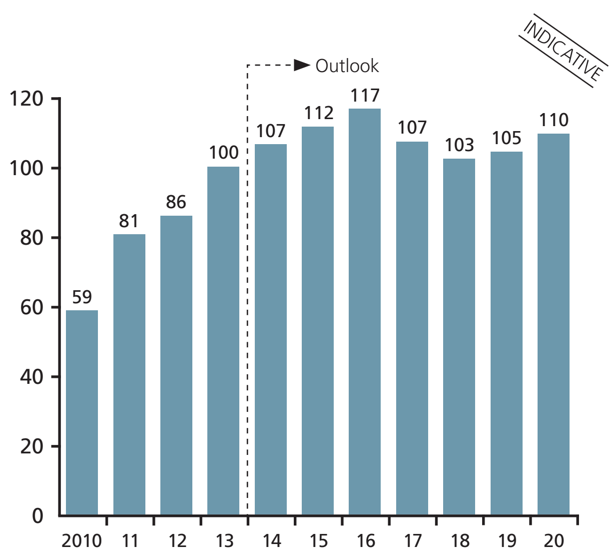
Debt purchasers (DPs) looking for growth have increasingly limited options. With many debt markets either saturated or too immature to present an acceptable level of risk, DPs are turning their attention to continental Europe. The combination of mature financial markets, access to consumer information and high levels of personal debt mean that this region is a potentially rich opportunity. Yet those considering their first move into Europe need to tread carefully; the complexity of operating across multiple diverse markets means that the promised gains can be elusive.

Figure 1

Growth Prospects of the UK Debt Purchase Market

Acquisition value of debt purchase market (Financial Services only)

Indexed to 2013



Note:*Financial Services only
Source: L.E.K. analysis

The Party at Home Will Soon be Over for UK Debt Purchasers

U.K. DPs have had a very nice ride for the past few years, but it is clear they are running out of road in their traditional markets. Growth in new portfolios is about to slow and is likely to turn negative over the next three to five years (see Figure 1). Vendors are selling the last of the backlog built up during the financial crisis. Growth in recent years has come from vendors selling debt earlier in the cycle; this growth will be exhausted in the medium term as banks will soon be selling debt as early as operationally possible. Meanwhile, on the purchaser side of the market, the field has become increasingly competitive and segmented.

With their core business maturing, U.K. DPs who want to keep growing have two options. One is developing new businesses in the U.K., such as credit checking, lending, government or utility debt, or making secondary purchases. None of these, however, is big enough to generate growth at anything like the rates they have enjoyed in the last few years. The second and more promising opportunity is continental Europe. Some operators have already proven that it is possible to build successful cross-border DP businesses there.

U.K. and other international players considering doing the same, however, need to do their homework carefully. While the total continental European market is large, it is also very fragmented. Each country and segment has its own challenges. Some DPs who have expanded across borders have found the effort in some countries more difficult and time consuming than expected.

Cracking the Continent: How to Succeed in European Debt Purchase was written by **Eilert Hinrichs** and **Peter Ward**, partners in L.E.K.'s London office. For more information, please contact financialservices@lek.com.

Cabot Financial, for instance, ended a joint venture in Spain after one year, Aktiv Kapital has withdrawn operations from a number of countries and EoS has struggled to establish a leading operation in Austria. DPs have found it hard to deploy significant capital at attractive rates of return for a number of reasons, including lack of deal flow, high prices and an inability to price competitively.

The future winners among DPs going to Europe will be those who do the most exhaustive and focused due diligence first. Previous success at home will be of little value. The most important factors in cracking the continent will be knowing which market (or markets) to enter, how to establish a cost-efficient operation, how to gain access to investment opportunities and how to choose the right time horizon.

The Complexity of the European Market Is the Main Challenge for Newcomers

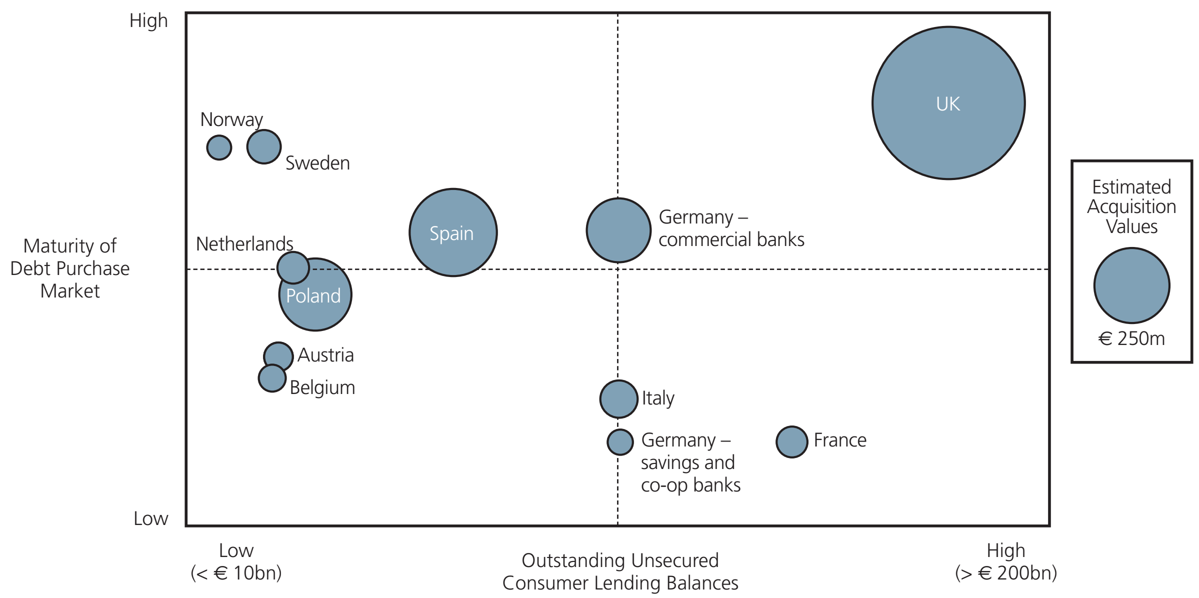
Expanding into continental Europe is a complex undertaking for any operator. The continent is a collection of several individual markets (see Figure 2), many of them small, and each with its own dynamics, requirements and regulations. The sales volumes of most of these markets are volatile and only very few single markets generate enough deals to justify a DP's necessary cost base. Any player looking for a significant return on investment and flow of opportunities will need to plant its flag in more than one country.

To do so successfully, DPs will have to adopt multiple new operating strategies. Local differences between the U.K. and the various continental markets make it impossible for U.K. DPs to simply transplant domestic operations overseas. Pricing models and collection strategies don't travel well internationally and a U.K. operator's domestic customer database or vendor network will be of little use in Austria or Spain. Similar problems face players from other geographies, notably the United States.

Meanwhile, incumbent continental European DPs have very large competitive advantages over newcomers. They have well-established collection processes based on large data sets and long experience. They know the local debt sellers well and are accustomed to their processes and preferences.

Figure 2

Maturity of European Debt Management Markets



Source: L.E.K. analysis

Mistakes Often Made by New Entrants to European DP Markets

The mistakes DPs can make trying to get started in a new European market fall into three general categories.

1. Investing too much upfront. Some DPs have taken on very large initial costs (mainly in infrastructure and people) but have then been unable to buy anything. This is usually due to lacking relationships with debt sellers, underestimating the cultural differences of a new market or being unprepared for its volatility.

2. Inaccurate pricing. Pricing in a new market is risky. A lack of good local data can lead to mispricing. Big losses on purchases are possible if bids are priced too aggressively. Lack of data can also lead to pricing so far below the market that the DP loses credibility. Depending on market entry strategy, however, pricing aggressively on a limited basis can be a useful way to get access to market and customer behavior data.

3. Entering the wrong market. Well-established markets are easier to play in but lack growth potential. Meanwhile, markets that appear to offer attractive growth prospects may, upon closer inspection, turn out to be limited by local structural or economic forces (see Market Snapshot: Debt Collection in Germany). Routes to market are different in each country. Capability isn't enough; relationships and cultural aspects are equally important.

Market Snapshot: Debt Collection in Germany

In Germany, banks of all types have their own debt collection operations. Savings and co-operative banks account for about 50% of the unsecured consumer lending market (110 billion outstanding balances). These typically small, local institutions prefer to collect debts from their owner/debtors themselves quietly, rather than sell these liabilities to third party DPs, due to their sensitivity to the reputational risks of selling defaulted debt. Their ownership structures and some cultural issues therefore present high barriers to third party DPs. By contrast, German commercial banks have embraced debt management and DPs have established successful businesses by concentrating on this segment of the market.

Figure 3

Variations in Debt Purchase Markets

Category	Examples	Key Features
Legal Markets	Sweden, Norway, Finland, Austria	Most delinquent debt collected via a legal process through the courts Often supported by well-established public bailiff system Substantial consumer data available to DPs Tracing of individuals typically not necessary
Mixed Markets	Germany, France, Netherlands, Poland, Belgium	Some aspects of both "legal" and "voluntary" markets Deploying the right mix of approaches is vital for success
Voluntary Markets	U.K., Spain	Lenders have relatively few rights Most delinquent debt is collected when DPs are able to contact debtors and get them to agree to repay Essential for DPs to be able to trace individuals Devise and employ sophisticated collection strategies vital for success

Lessons from Successful European Expansion and Strategies for Success

Despite the obstacles, expansion into Europe can be done successfully. The purchase of unsecured consumer debt is widely accepted across the continent (see Figure 2) and several leading European DPs (Aktiv Kapital, Lindorff, Hoist, EoS and Intrum) have developed successful country-by-country teams. UK players can learn from them, but should remember that they had a 20-year head start, beginning their expansion during boom times, growing organically and also making acquisitions.

The first lesson that can be learned from European DPs is that it is important to choose the right markets. That might, for instance, mean identifying markets with structural similarities. While conditions vary dramatically between countries, some are similar enough to allow leveraging operations between them (see Figure 3).

A second lesson is that newcomers need to enter new markets with appropriate business models as well as sourcing and collection strategies. For instance, the sources of debt portfolios will vary from country to country (see Market Snapshot: Debt Collection in Germany on page 3). Similarly, access to credit data is different in different countries and requires varying degrees of effort and expense. In Sweden, for example, where citizens' tax returns are a matter of public record, obtaining debtor data is comparatively easy. Each market requires its own individual debtor scorecards as well as appropriate key performance indicators.

Conclusion

While expanding in continental Europe can be challenging, the rewards of success can be high. DPs that have targeted the right the markets and have adapted their operations appropriately have then prospered. For example, Hoist has used its German operation (established in the late 1990s) to develop a pan-European operation: it now operates in nine countries and deployed more than € 200 million annually in 2012 and 2013, making it one of the largest debt management companies in Europe. Other notable successes include Arrow Global's leading position in Portugal and Cabot Financial's similar leadership in Ireland.

U.K. or other international DPs who want continued growth can find it on the continent if they know where to look. The first step is gaining access to detailed intelligence on all the potential markets. The firms with the deepest understanding of the opportunities will be best positioned to take full advantage of them.

For further information contact:

London
40 Grosvenor Place
London SW1X 7JL
United Kingdom
Tel: +44 (0) 20.7389.7200
Fax: + 44 (0) 20.7389.7440

Milan
Piazzale Biancamano 8
20121 Milano
Italy
Tel: +39 (02) 8646.2761
Fax : +39 (02) 8646.2791

Munich
Neuturmstrasse 5
80331 Munich
Germany
Tel: +49 (89) 922.0050
Fax : +49 (89) 922.0520

Paris
3 rue Paul Cézanne
75008 Paris
France
Tel: +33 (0) 1.4703.1950
Fax : +33 (0) 1.4296.1138

Wroclaw
ul. Pilsudskiego 13
50-048 Wroclaw
Poland
Tel: +48 (71) 790.16.30
Fax : +48 (71) 790.16.35

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