

Bad Times Are Good for Debt Collectors

The debt collection industry is poised to prosper amid rising levels of bad debt and a souring economy

by Arthur Epstein

From [Standard & Poor's Equity Research](#) During these gloomy times for the U.S. economy, many businesses are suffering. But some are uniquely positioned to do well when times are tough for most others, namely debt collection agencies and related companies.

The U.S. now has more than 6,000 debt collection companies, according to [Kaulkin Ginsberg](#), a Maryland-based market research firm. Most of them are small, privately held entities. However a few debt collection agencies are publicly traded, including Portfolio Recovery Associates ([PRAA](#)) and IDT ([IDT](#)).

Although the debt collection business may get a bad rap when depicted in the movies or on television shows, it is actually a heavily regulated industry. While debt collectors may be tempted to use any tactics that will pry owed money from debtors' hands, they must comply with the federal Fair Debt Collection Practices Act, which prohibits deceptive, unfair, and abusive practices by third-party collectors; requires debtors to be treated fairly; and forbids certain methods of debt collection, including threats, abusive language, or harassment, such as repeatedly calling.

According to the Federal Reserve, the consumer credit industry increased from \$133.7 billion of consumer debt obligations in 1970 to \$2.5 trillion of consumer debt obligations in November, 2007, a compound annual growth rate of 8.2%. The Kaulkin Ginsberg report states the amount of outstanding revolving and non-revolving consumer credit increased at a compound annual growth rate of 6.4% from \$1.3 trillion in June, 1997, to \$2.5 trillion in June, 2007.

RATE INCREASES

In the early 1990s the consumer debt-buying industry began to gain steam, and in 2005 debt buyers purchased about \$110 billion of delinquent debts, about twice the amount bought in 2000. Credit-card debt consists of about 70% of the accounts sold to debt buyers, followed by automobile loans, telecommunications debt, and retail accounts. According to Kaulkin Ginsberg, the [charge-off](#) rate and the amount of outstanding consumer credit both increased in the third quarter of 2007, indicating a favorable supply environment for debt purchasers.

However the unemployment rate and the number of bankruptcy filings also rose in that quarter, indicating a more challenging collection environment as debtors had fewer resources available to pay down debts. And in February of this year U.S. consumer bankruptcy filings increased more than 15% over the prior month and 37% from a year ago, according to the American Bankruptcy Institute, using data from the National Bankruptcy Research Center.

DEBT AT A DISCOUNT

Portfolio Recovery Associates specializes in receivables that have been charged off by a credit originator. In 2007, Portfolio Recovery had net income recognized on finance receivables of \$184.7 million, an increase of \$21.3 million, or 13%, compared to \$163.4 million in 2006. Because credit originators and/or other debt servicing companies unsuccessfully attempted to collect these receivables, Portfolio Recovery was able to purchase this debt at a substantial discount to face value. From its inception in 1996 through Dec. 31, 2007, Portfolio Recovery acquired 1,030 portfolios with a face value of \$35.3 billion, for \$791.6 million, representing more than 16.7 million customer accounts.

IDT, a Newark (N.J.) company, which mainly provides telecommunications services and products worldwide to retail and wholesale customers, began buying up and collecting debt in 2005. Its IDT Carmel segment, which accounts for less than 1% of the company's revenues, acquires portfolio assets at a discount to face value, and services such portfolios in an effort to maximize ultimate cash recoveries. IDT Carmel also provides debt collection services for debt portfolios owned by third parties for a service fee.

During fiscal 2007 (ended July), IDT Carmel purchased debt portfolios with a face value of \$997.6 million for \$78.4 million, including \$57.3 million of credit-card debt.

INCREASED BUSINESS DESPITE SUBPRIME FALLOUT

One institutional shareholder that's been building up a stake in a couple of companies that can benefit from this poor economy is the Heartland Value Plus mutual fund ([HRVIX](#)).

"With a sluggish economy and a bad job market, debt collection companies are well-positioned to take advantage of rising levels of bad debt that can be purchased at falling prices," says Brad Evans, portfolio manager for the Heartland Value Plus and Heartland Value fund ([HRTVX](#)).

Heartland Value Plus recently added Navigant Consulting ([NCI](#)) and Asset Acceptance Capital ([AACC](#)) to its holdings, as they are companies it believes should see increased business as a direct result of the subprime fallout. Navigant Consulting provides dispute, investigative, financial, and

regulatory services to the legal community. Evans and portfolio co-manager Adam Peck say Navigant sells at a significant discount to its competitors on a number of valuation metrics. They also think the tsunami of lawsuits relating to the subprime crisis should float Navigant's sales growth for the next few years.

Asset Acceptance, another subprime beneficiary, buys and then collects defaulted and charged-off loans. Evans and Peck expect the company to grow nicely over the next couple of years as the number of bad loans rises and demand from competitors wanes, thereby improving pricing and driving higher returns. They especially like that insiders own more than half of the company and Asset Acceptance's managers and directors have increased their stake through open-market purchases.

Arthur Epstein is associate editor of Standard & Poor's Analytical Services .

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