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A Growth Play in Financial Services?

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By [AVRAM DAVIS](#)

While "bailout" could be considered a four-letter word in the debt collection business, the struggles of companies like GMAC, GE Capital and of course the GSE's Fannie Mae and Freddie Mac underscore the opportunity in the fragmented debt collection industry. Indeed, the sector represents one of the very few bright spots in the slumping financial services sector.

The M&A activity, however, has yet to really reflect the niche's relative strength. A few notable deals were cinched earlier this year, the largest of which was Investor AB's \$558 million acquisition of a 50% stake in Norway-based Lindorff Group. Other deals include Iceland-based Intrum Justitia's acquisition of Canadian outfit Eastern Collection Services and the acquisition of British outfit Lowell Holdings by Exponent Private Equity, a UK sponsor.

If observers are correct, it stands to reason that this industry will see explosive growth regardless of economic conditions. **Addison Wiggin**, who was the executive producer the recently released documentary film "I.O.U.S.A.," describes a world in which Americans too often relied on credit as opposed to cash on the barrelhead when it came to making purchases. Whether it was through refinanced mortgages, multiple credit cards or even retail's favorite 12-month deferred payment plan, too many people spent beyond their means, which quite obviously should translate into more demand for debt collection outfits. "What we're experiencing is the rapid de-leveraging of America," Wiggin says. "This was a phony era of prosperity."

Of course it's not just individuals who relied on easy credit. The corporate world too fell into the same trap. Whether it was retail expansion into incongruous markets or leveraged buildups modeled after the high-flying private equity deals, many companies are now struggling with an onerous debt load that may leave them unable to pay their suppliers.

Because of this, the debt collection industry is poised to consolidate. **Milton Marcotte**, managing director at **RSM McGladrey**, calls the space "a growing industry," noting that he is anticipating PE firms could help spearhead rollups, drawn to the sector by its attractive growth profile.

According to **Kaulkin Ginsberg**, an advisory firm specializing on accounts receivable management, the total deal value for mergers and acquisitions in the sector amounted to \$1.8 billion at the end of the third quarter, topping last year's total of \$1.7 billion. Kaulkin Ginsberg director **Mark Russell** noted, "Interestingly enough, deal activity remains high," and he expects interest to continue in the near term.

While the profile of the sector is appealing, bear markets do not always translate into heady

times for debt collection. For instance, even if the industry experiences an uptick in contractual business, profits can't be tallied until the debt is paid off. And the consumer who opted for a 12-month deferred payment on that Tempur-Pedic mattress last December may be less inclined to swallow the \$2,000-plus outlay after watching the Fed fly in to rescue Wall Street.

Russell notes, for instance, that when portfolios are liquidated, it impacts the debt collection industry. He cites that this year alone, he is anticipating a 20% dropoff in the amount recovered by debt collection companies compared to last year. This is partly attributable to the real estate collapse, as homeowners in previous years would pay off their debts by taking on more debt when they refinanced their homes. Russell adds that it's also important to keep an eye on unemployment figures, which have climbed from 4.5% to 6% year over year in September. Naturally, this trend is stretching household resources even thinner.

Brad Bernstein, president and chief financial officer of factoring company **Anchor Funding Services, LLC**, notes that his business has experienced rapid growth recently that he attributes to the present financing conditions. The plan Bernstein hopes to execute would supplement Anchor's organic expansion with an acquisition strategy, although he notes that it's not necessarily easy. "In the past 60 days we have seen unbelievable demand, so [a target] is going to ask for much higher multiples," Bernstein says, noting that the valuations were too rich for his taste.

Russell too is seeing similar trends play out, although he anticipates that larger players could pick off the attractive smaller operators. In addition, he believes larger customer relationship management companies, business processing outsourcing and offshore players, could see the most activity in coming years. In short, horizontal or synergistic acquisition opportunities will abound.

McGladrey's Marcotte, however, does not expect to see significant cross-border activity in the space. He cites that regulatory issues make a global play difficult in the sector. "I don't know how transferable the skills are, because the legislation is very specific. It just looks like that would be a big barrier to entry," he stressed.

This of course, alludes to another risk, most notably, what will happen as Democratic President-elect Barack Obama assumes his seat in the White House. For instance, many question whether the present system that is used to collect student loans will change substantially. If it does, this is but one aspect of the business that could change drastically overnight.

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