



The Kaulkin Ginsberg *Bulletin* is sent each month to provide you and others in the Accounts Receivable Management (ARM) industry with valuable insight, access, and information. Each issue contains actionable content designed to assist you in making strategic business decisions.

We hope you enjoy this issue. Comments are always welcome at [hq@kaulkin.com](mailto:hq@kaulkin.com).

I can't believe that 15 years ago, we closed our first M&A transaction involving a collection agency. In August of 1991, we sold Eastern Credit to an investor that was based in New York. This transaction turned a lot of heads at the time. I remember being asked "Why was an investor interested in buying a collection agency?" And, "why did they pay cash for that company?"

A lot has transpired over the past 15 years. As a firm, we've evolved as specialists alongside the accounts receivable management industry. In this edition of The Kaulkin Ginsberg *Bulletin*, we thought we'd take a moment to look back at the evolution of our industry, and then take a look at current and future trends.

No matter what the future holds, we'll continue to advise you on ways to capitalize on developing opportunities.

Feel free to contact any member of our team confidentially if you want to discuss how changes may impact your business, and how we can help you in your efforts to [analyze, grow, or exit](#). We look forward to hearing from you.

Sincerely,

Mike Ginsberg  
President & CEO



In this Special Edition of the Bulletin...

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## Evolution of the U.S. Accounts Receivable Management Industry

By Paul Legrady  
Director, Research Group

American Capital Strategies. Asset Acceptance. Citigroup. Convergys. J.P. Morgan. NCO Group. Portfolio Recovery Associates. Sallie Mae. West. And so on.

Not exactly “mom and pop” shops.

The stereotypical company in the accounts receivable management (ARM) industry has changed. And for good reason: success in this industry can no longer be created with a spare bedroom and an extra telephone line.

In today’s ARM industry, modern call centers house technology-enabled collection operations with considerable economies of scale. As a result, this industry attracts the interest of Wall Street, large corporations, and private equity firms alike.

### **The Early History of Debt Collection in the United States**

Small collection agencies proliferated throughout the United States in the 1920s and 1930s. When creditors could not collect account balances on installment plans or retail accounts, small companies were hired to collect the debt. These companies typically serviced a few local clients, had relatively few employees, and utilized manual systems for servicing accounts. Familiar names in the modern ARM industry got their start during this period, including NCO Group in 1926 and the American Collectors Association in 1939. Generally speaking, collection agencies generated revenues only when they recovered cash for creditors.

The work of an average collector was difficult and full of pressure. Collectors reached debtors directly by phone and mail and kept record of their communications on handwritten index cards. When these efforts proved unsuccessful, many collectors went door to door. During this period, collectors were frequently referred to as “door knockers” as a result.

While this business model allowed owners and high-performing collectors to have successful careers, there were drawbacks to this way of doing business. The pressures of this revenue model and the inefficiencies of existing infrastructure led collection agencies to base their success almost entirely on the discretion of collectors. Difficulties ensued, not only for the consumers contacted by aggressive collectors, but also for the company owners that were legally responsible for their actions.

Congress cited “abundant evidence of the use of abusive, deceptive, and unfair debt collection practices by many debt collectors” when it passed the Fair Debt Collection

Practices Act (FDCPA) in 1977. Government regulation would reshape the industry for the better.

### **The Industry Evolves**

The FDCPA ushered in a new era for the ARM industry by regulating the way in which delinquent debt could be collected from consumers. Among its many provisions, the FDCPA established guidelines on how, when, and where a collector can contact a debtor. The law also required specific notice and disclosure requirements that industry professionals had to follow when collecting debt. Consumers could also sue collection agencies for illegal tactics such as threatening violence to a debtor or harassing a debtor’s friends, relatives, or employer.

The FDCPA forced many collection agencies to transform the ways in which they did business. Collectors curtailed what had been largely unmonitored collection techniques. Perhaps more importantly, collection agencies began to evaluate and improve business processes supporting these collection efforts. Advances in supervision on the collection floor, telephone systems, and early collection technologies allowed collection agency managers to improve financial and operational results by managing their companies as systems, rather than as groups of collection agents. Compliance with legal requirements became important not only to collection agencies, many of which were being sued for first time under the law, but also to the creditors whose accounts they were collecting.

At the same time, a different way of doing business was developing within the ARM industry. Debt buying traces its roots to the isolated retail stores in the 1960s and the bankruptcy courts of the late 1970s. However, debt buying in the United States began in earnest during the mid-1980s, when the Resolution Trust Corp., a division of the Federal Deposit Insurance Corp., sold large portfolios of delinquent credit card debt to fund the government’s bailout of failed savings and loans. A number of today’s most prominent debt buying companies can trace their lineage to these portfolio sales, which not only increased the supply of paper but signaled the government’s endorsement of this new business activity.

ARM companies grew rapidly during this period along with the domestic market for consumer credit. The level of outstanding consumer debt in the U.S. continued to increase to \$1.2 billion in 1996. Much of this increase in consumer debt was attributable to the rapid adoption of credit cards on the part of American consumers. The percentage of U.S. families using revolving consumer credit increased rapidly, from 16% in 1977 to 37% in 1995. Predecessor companies to today’s J.P. Morgan Chase,

*(Continued on page 3)*

Evolution of the U.S. Accounts Receivable Management Industry (Continued)

(Continued from page 2)

Citigroup, MBNA, Bank of America, and Capital One benefited greatly, establishing national footprints and increasing demand for the services of ARM companies, which served credit-granting companies in other industries such as healthcare, telecommunications, and utilities, not to mention federal, state, and local government entities trying to convert their receivables into cash.

**The Modern Accounts Receivable Management Industry**

NCO Group filed for an Initial Public Offering in September 1996, the first of today's six ARM companies to have public ownership. This public offering and the receptivity shown by Wall Street in subsequent years for ARM stocks allowed greater visibility and set greater expectations for companies competing in the ARM industry.

Larger ARM companies hardly resembled their predecessors. Collection supervisors actively monitored the collection floor. Collection software packages automated aspects of the collection process. Collection letters were based on templates developed for the company as a whole and reviewed by counsel. Other collection technologies such as skiptracing and predictive dialing grew more sophisticated and popular, allowing collectors to spend more time speaking with debtors. More recently, developments in portfolio scoring and related forecasting models brought heightened sophistication to the financial management of collection operations. With technology platforms in place, some companies have turned to acquisition as a growth strategy.

Public and private investors have consistently rewarded accomplishments such as these. Although the privatization of public companies has recently been in vogue – with NCO Group itself recently offering to take the company private in a buyout of \$1.26 billion – the market capitalization of publicly traded ARM stocks more than tripled in recent years, from \$878 million in January

2000 to \$3.1 billion in May 2006.

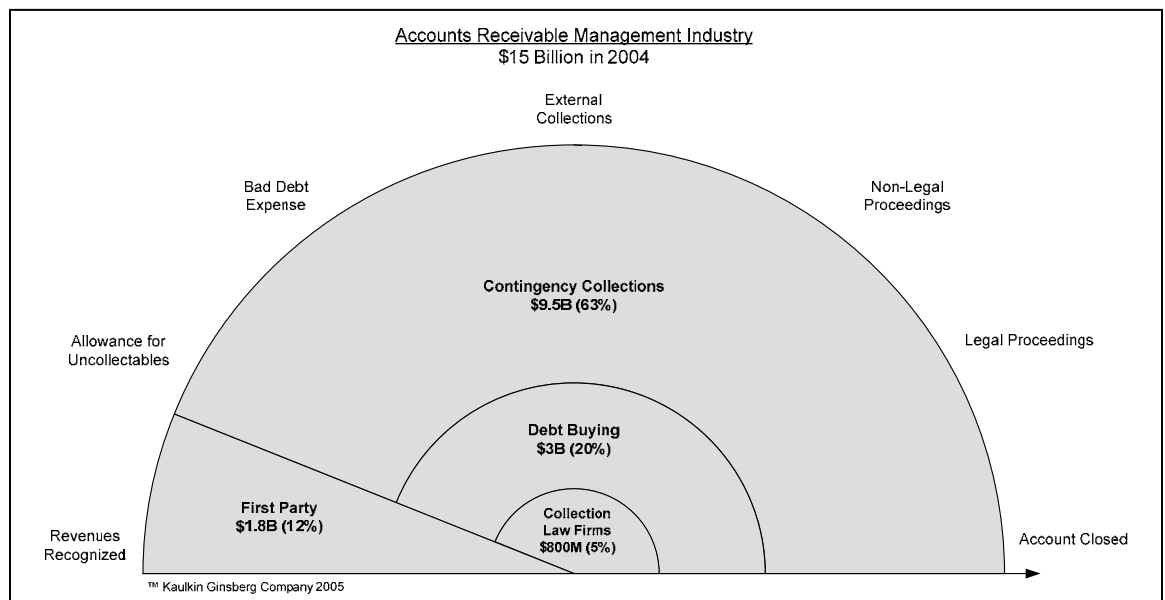
Large consolidators backed by private equity investors such as Outsourcing Solutions, IntelliRisk, and Nationwide Credit have also brought scale and scope to the ARM industry. Well-known companies with comparable resources have entered the ARM industry as well, including Sallie Mae, Convergys, and West. Blue chip private equity firms have also made regular investments in these companies, bringing significant expectations that hold industry executives accountable for growth forecasts.

**Diverse Business Models in Today's Industry**

As more companies have extended credit to consumers, the ARM industry has adapted to the demands of its clients and diversified. As a result, the industry now sees revenues generated from contingency collections, debt buying, first party collections, and legal efforts.

Frequently, competitors in the ARM industry operate under more than one of these business models in order to serve the interests of their clients.

Debt buying is one of the fastest growing and most dynamic parts of the ARM industry. Purchasing and collecting distressed debt can be more complicated than collecting on a contingency or flat fee basis, but it can also be much more profitable. The transfer of legal ownership that takes place in a debt purchase increases both the risk and the potential profitability of a collection effort. Contingency agencies can earn fees of up to 50% of each dollar on collected debt; debt buyers can collect up to three times or more of the original purchase price of collected debt. The prospect of better returns such as these will continue to lead new capital and new companies into this market.



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Evolution of the U.S. Accounts Receivable Management Industry (*Continued*)*(Continued from page 3)*

First-party collections take place under a creditor's name, either by the creditor itself or by collection agencies working with creditors on fixed price contracts. The primary difference between first party and contingency collections is the stage at which the service occurs: first party work takes place earlier in the receivable's life cycle, typically when a delinquent account is between 30 and 90 days past due but has not yet been charged off by the creditor. Contingency collections generally take place after a creditor has officially charged off the account.

Collection law firms constitute the smallest but fastest growing market in the accounts receivable management industry. Collection law firms interact with other parts of the ARM industry in a number of ways. While collection law firms and contingency agencies can compete directly for contracts with creditors, contingency agencies also forward collection of later stage debts to these firms after their regular collection efforts are exhausted. Similarly, collection law firms frequently work on contract for debt buyers as they collect debts through legal channels. Some collection law firms have also been active in recent years as debt buyers themselves. Regardless, the pursuit of delinquent debt through legal channels has led to high recovery rates in recent years, contributing to this market's heightened visibility as well as its increased growth.

Still, the mainstay of the ARM industry has been and continues to be contingency collections, a third party service provided by collection agencies to credit grantors that have delinquent or charged off receivables. The revenue model here is as it was for the small collection agencies that existed in the 1920s and 1930s – the agency is paid on a commission basis, typically defined as a percentage of the total amount collected by the agency. While rates have come down considerably over the years, operations have also become more efficient. The infrastructure of the larger ARM companies dwarfs the

small businesses that collected debt during that time. Interestingly, many ARM companies offer their clients more than one of these services. A collection law firm that represents clients in court proceedings may also purchase debt, filing suit to collect its own paper. A contingency collection agency that services a hospital may provide first party collection services to the hospital as well. In fact, larger ARM companies are likely to have diverse business models available for many clients, as well as the workforce and infrastructure needed to execute on these plans. The ARM industry grew in turn, as total revenues increased from an estimated \$5.5 billion in 1996 to an estimated \$15 billion in 2004.

**History as Prologue**

The ARM industry has grown throughout its history along with the regulatory framework, business models, client expectations, and technology platforms that have contributed to its development. While the industry's early history was marked mainly by the personal expertise of individual collectors, ARM companies came to depend more on the business systems and processes that allow these companies to function and grow as a whole. These trends will continue as the industry continues to grow, take advantage of specialized technologies, and achieve greater economies of scale.

While small companies continue to have a place in this industry serving local creditors in local areas of business, the "mom and pop shop" is an anachronism in today's ARM industry. Although the industry has already attracted some prominent competitors, more will continue to be drawn to this space as its history continues to unfold.

*As Director of the Research Group, Paul oversees custom research projects and publications focusing on the ARM industry. For more information, visit [www.kaulkin.com/research](http://www.kaulkin.com/research) or contact Paul at 301-907-0840 ext. 104.*

**Industry Leaders Look Ahead**

In celebration of our 15-year anniversary, we asked a few industry leaders to share their recollections of the early '90s. And then, because we can't resist, we asked them to look ahead and tell us what they see happening in the coming years.

**Columbia Ultimate ([www.columbiultimate.com](http://www.columbiultimate.com))**  
**R. Fred Houston, President and CEO**

**15 years ago...**

- Margins were a lot higher for contingency collections.

- PCs were not as powerful as they are today. Most systems were closed and connectivity was definitely a challenge. The big argument when upgrading computer systems was whether to go to a client-server or a centralized, hosted system.
- Telephony was a relatively new technology and pretty cost-prohibitive for most agencies.

**Looking ahead...**

- Frivolous lawsuits will intensify, forcing the industry to be very prudent, as HIPAA, FDCPA, and other

Industry Leaders Look Ahead (*Continued*)*(Continued from page 4)*

regulations continue to make it more difficult to do business.

- Identity theft will play into compliance issues. Data security will become critical. It will become more costly to protect and maintain the data, but it will end up being better for everybody.
- There will be an increased use of analytics. There's a lot of "data pollution" now; agencies don't know how to use the data available. Analytics will help agencies working accounts to work smarter, getting the right account at the right time to the right person using the right strategy. There is a lot of talk about this now, but it's not yet a day-to-day practice.
- The industry will need to take better care of its people. Turnover in the industry is huge. If data security issues cause employees to be screened more carefully, it will become critical to retain good employees, making sure they have the tools they need to do their job.
- Debt purchasing will continue to grow; however, there will be some fallout. A lot of people are getting into it because it's hot, but won't stay in the business.
- There will be a lot of change ahead, but the success of any business is still predicated on a strong management team with good vision, values, and leadership.

**West Asset Management**[www.westassetmanagement.com](http://www.westassetmanagement.com)**Jim Richards – President****Darrell T. (Tye) Hanna - Executive Vice President, Purchasing Group****Jeff Shiovitz - Executive Vice President**

All three sat down to reminisce and look ahead:

**15 years ago...**

- Rate compression was starting to happen in the contingency business.
- There was only talk of the Internet. Most PCs were detached, stand-alone systems.
- By the mid-'80s, automated collection systems were on most computers, but it was an electronic version of the old work cards. They could print out letters and

find accounts easily, but they were not nearly as sophisticated as the software available today.

- It was the beginning of dialer deployment technologies on a small scale.
- The debt buying business was just beginning.
- Agencies were highly regionalized with lots of small off-site offices. "Back then, we had 60 sites, whereas today we have about 30," noted Shiovitz. In the early '90s, the industry started figuring out economies of scale.
- Consolidation was beginning. Before this period, there were companies like FCA and Payco buying up agencies, but there was not a lot of outside money involved in the aggregation. That changed with Integratec, which was backed by a venture firm. They began buying up multi-office collection companies. Soon consolidators like OSI and Intellirisk began getting involved, too.

**Looking ahead...**

- For contingency collections, servicing debt buyers will become as important as providing service for issuers.
- Contingency rates will increase.
- For debt buyers, there will be a decrease in the cost of buying paper, but not a dramatic one.
- We will continue to see security and data privacy force our hand.
- Technologies will keep getting bigger and better, helping to lower operating costs. However, expect more inbound IVR and other technologies that will take the place of human interaction.
- Increased use of analytics and scoring. People can finally score and actually use the information. Scoring has become "validatable." It will become more prevalent in the deployment practices of mid-size agencies.
- Call centers will come back to the U.S. "The cost savings are not what they thought they would be," said Hanna.
- There will be more of a movement toward balance. Debt buyers will move more toward contingency services. In the coming years when asking the question "to sell or to place," credit issuers will seek a balanced, 50/50 approach.

## Mortgage Opportunities Knocking for ARM Companies

By Mike Ginsberg  
President & CEO

There are strong indications that mortgage delinquencies will increase significantly in the near future. As this occurs, some accounts receivable management companies – especially those servicing mortgage lenders – are well-positioned to benefit from this trend.

Traditionally, most homes were purchased using fixed rate mortgages where borrowers lock into an interest rate over a definite period of time. Over the past five years, however, an alarming number of borrowers have utilized adjustable rate mortgages known as interest-only and option mortgages to finance their home purchases.

The lure is that these loans have lower monthly payments initially compared to fixed-rate loans. In regions across the United States where housing prices are relatively high, the use of adjustable rate mortgages has enabled many buyers to purchase homes that are way beyond their means.

The risk to the borrower is that at a future point, the monthly payments will increase two-fold or more to cover the deferred interest and principal amounts that were not paid initially. When the rate adjusts and monthly payment amounts increase significantly, these homeowners find themselves stretched thin financially. Some owners are already starting to struggle to make their monthly payments.

Borrowers with these nontraditional types of mortgages are most vulnerable because they could wind up losing their homes to foreclosure if they cannot afford to make the increased payment; or, if prices start to come down, they could wind up owing more than their home is worth in the marketplace.

This is already starting to occur. From 2004 to 2005, the number of borrowers that owe more than their house is worth has nearly tripled – from approximately 10% of those who took out loans in 2004, compared to nearly 30% in 2005, according to a study completed by Christopher L. Cagan, Director of the research and analytics firm First American Real Estate Solutions. Some fear that this is only the tip of the iceberg. According to the *Washington Post*, about two thirds of all people who bought homes in the Washington DC area in 2005 used interest-only or option mortgages.

Earlier this year, John M. Reich, director of the Office of Thrift Supervision, voiced concern that if housing values fall, borrowers who have taken on risky nontraditional adjustable rate mortgages could face foreclosure, leading to financial losses for the lenders who made such loans. Some regulators, likening the real estate market to the

savings and loan fallout of the early 1990s, have been warning lenders that they will restrict the use of nontraditional loans. To date, regulators have only offered guidelines to federally chartered banks and credit unions to make certain that loan applicants truly understand the loan's mechanics. It hasn't yet reached down to state regulated mortgage brokers and independent mortgage companies.

By the time restrictions are firmly in place the damage may be too severe. With more adjustable rate mortgages in the market now than ever before, the rate at which mortgage payments are becoming delinquent is increasing. Mortgage delinquencies historically peaked around three years after the loans were made. With adjustable rate mortgages, delinquencies most likely will occur a lot sooner.

This could be the making of a “perfect storm” for collection agencies and debt buyers already servicing financial institutions that provide mortgage loans. Many of these credit grantors have experienced the benefits of outsourcing their collection needs, or selling debt, to third party professionals. As mortgage delinquencies increase, these collection agencies and debt buyers are well positioned to see more business as a result of this trend.

Many borrowers are on the verge of financial crisis – making minimal monthly payments on their credit cards and juggling other obligations just to make ends meet. Borrowers are always making choices about which delinquent accounts they should pay and which ones they should put off. When their adjustable rate mortgages come due – unexpectedly increasing their monthly debt loads – the fear of losing their home to foreclosure will be enough of a reason to convince most homeowners to put their delinquent mortgage payment on the top of their list of bills to pay, ahead of credit cards and healthcare bills. Collectors are always trying to convince debtors that their accounts should be paid first. Now the convincing will be done for them.

I realize that mortgage delinquencies are still relatively low by historical standards. However, with the housing market showing signs of cooling off, and more adjustable rate mortgages in the market than ever before, we are already beginning to see increases in delinquency rates for mortgages. For the accounts receivable management companies that service mortgage lenders, now is a good time to prepare for what's coming.

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2006 ARM M&A Deal Value on Course to Double Last Year's Record



By Mark Russell  
Director, Strategic Advisory Group

M&A activity is phenomenal for this industry, which has already been experiencing a period of record growth. Last year was the second consecutive year of record-breaking total deal value, but if all the pending and announced transactions close as expected this year, the total estimated deal value could reach \$3.5 billion – that's *double* last year's all time high!

In the 3rd quarter of 2006, activity was characterized by international deals, as nearly half of the transactions completed took place outside the U.S. Of the 22 deals that closed, 10 involved non-U.S. companies: five Australian; two U.K.; and one Indian, Canadian, and French company. ARM is a growth industry on a global scale. More businesses worldwide are outsourcing or selling their debt and consumer, commercial and government debt levels are continuing to rise. This is attracting interest in the market from strategic and financial buyers worldwide – especially private equity. In the current marketplace, private equity firms have a lot of investment capital, and well-run ARM companies represent a golden opportunity for many of them.

The estimated total deal value for completed transactions in the quarter is \$536 million; however, Kaulkin Ginsberg estimates that there is over \$1.6 billion in deal value represented in several pending transactions, which are slated to close this year. If these deals close as anticipated,

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2006 could reach \$3.5 billion – a historic high in total deal value!

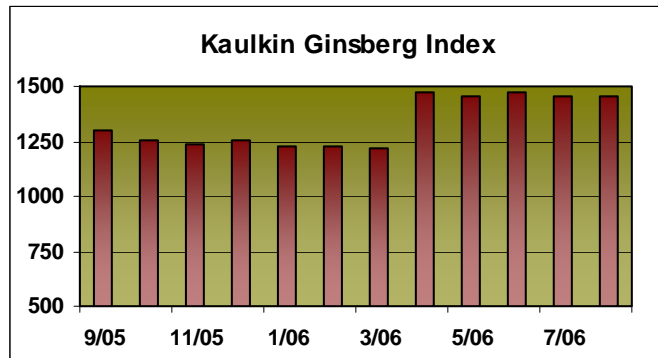
To keep you informed on the current M&A market, we produce a quarterly report on the industry. In it, we analyze what's going on and why, and what to expect moving forward. If you'd like details of third quarter M&A transactions (in PDF Format), please email your request to Nancy Fleming at [nfleming@kaulkin.com](mailto:nfleming@kaulkin.com).

*Mark Russell manages M&A transactions for Kaulkin Ginsberg as Director of the Strategic Advisory Group. Mark can be reached at 301-907-0840 ext. 120 or at [hq@kaulkin.com](mailto:hq@kaulkin.com).*

Kaulkin Ginsberg Index Continues to Increase

Overall market conditions in the ARM industry remain favorable, according to the Kaulkin Ginsberg Index (KGI), the leading indicator of economic conditions affecting the accounts receivable management (ARM) industry. The KGI has increased 0.2% since last month – largely due to slight positive movements in four of the index's seven economic indicators. Overall, the KGI remains up 13.5% year over year and slightly under its all-time high of 1472.7.

For more information about the Kaulkin Ginsberg Index, see [www.kaulkin.com/research/kgi](http://www.kaulkin.com/research/kgi).



Events Inside ARM from CollectionIndustry.com



CollectionIndustry.com sent out a free fall calendar to help you plan for upcoming industry events.

If you'd like a copy, please [send us an email](mailto:hq@kaulkin.com) with your current mailing address.

To review a complete listing of upcoming events, you can also visit [www.collectionindustry.com/events](http://www.collectionindustry.com/events).

If you know of an event that would be of interest to ARM executives, please notify Jaime Rossman at [jrossman@kaulkin.com](mailto:jrossman@kaulkin.com).

About Kaulkin Ginsberg

We've been helping collection industry executives with advice, expertise, and information to make well-informed decisions for 15 years. We offer a full array of advisory services to support you through almost every stage of your company's lifecycle, from operational assessments, to executive-level



recruiting, to custom industry research, to company valuation, to buying or selling a business. The Kaulkin Ginsberg family of companies also includes Kaulkin Media, publisher of the most popular sources of industry information such as CollectionIndustry.com™ and Credit & Collection Daily™. Kaulkin Information Systems creates secure and affordable document and business process management technology ([www.kistrack.com](http://www.kistrack.com)). Read more about Kaulkin Ginsberg at [www.kaulkin.com](http://www.kaulkin.com).

What can we do for you?

To discuss your business needs in confidence, send an email to [hq@kaulkin.com](mailto:hq@kaulkin.com) or call us at 301.907.0840.



Correction

In September, we sent out a 15-year anniversary timeline that highlighted milestones for Kaulkin Ginsberg in the industry, including the publication of *The Kaulkin Report*, the launch of CollectionIndustry.com, and many representative M&A transactions over the years. In this piece, we inadvertently indicated that we represented Arrow Financial Services in its sale to Sallie Mae. In fact, while we initiated this transaction, we did not represent Arrow. We regret this error and apologize for the confusion.