THE BATTLE FOR EUROPE STARTS HERE

In its ninth annual analysis of the credit management and debt collection market across Europe, OC&C Strategy Consultants explores the real drivers of continental expansion. A mega merger among the elite may be on the cards, claims NIGEL STIRK

OC&C Strategy Consultants

Each year since 2008, OC&C has offered an assessment of the health of the credit management and debt collection industry with its CMDC Index, which identifies not just the current leaders but the strategies likely to unlock future advantage.

The industry has changed enormously, partly reflecting seismic shifts in the global economy and partly as a result of increased scale and greater maturity.

Overall what we have observed has been a remarkable success story, with huge growth in revenue and profit, much smarter businesses, and a radically-improved level of compliance compared to the 1990s or early 2000s.

The businesses that we have ranked highly have all performed very strongly across financial, operational and strategic dimensions.

This year, we have chosen not to produce a ranking of the leading businesses in the way we have done previously. A combination of some very different accounting methods, some opaque reporting across multiple countries, and closer convergence of the strategies of the leaders, means that it would be very hard to distinguish fairly between the top few businesses.

Market context

The sector has now reached a fascinating point in its development.

The main waves of recessionary effects (funding shortages, vintages of debt that turned out to deliver super-normal profits, major interventions by regulators) have subsided, and the post-recession ripples, in particular the UK's release of warehoused debt, have also calmed down.

A simple comparison of 2015 to 2010 shows that the 30 largest businesses collectively achieved £4.2bn revenue (up 70 percent over five years) and more than £800m EBIT (more than 60 percent higher than 2010 in absolute terms). By any standards, this represents highly attractive operating margins.

Yet although the market seems calmer, better understood and more accepted than ever, two very different interpretations of the current situation are possible.

One is a bull case, in which there is plenty of debt created, from multiple industry verticals, with acceleration expected when interest rates rise, and where stockmarkets and private funders alike are now very comfortable backing debt collection businesses.

Market-related risk has reduced too: Creditors across Europe are now so committed to working with third parties to resolve debt, and in some cases totally dependent on them, that it is hard to construct a downside case as severe as when debt sale in the UK halved in a single year during the recession. The barriers to entry are extremely high, and creditors increasingly want close, multi-service long-term relationships with their partners.

Well-funded leaders can move increasingly easily into less mature countries, applying skills honed in more established markets to unlock very attractive returns.

The other is a bear case, in which tighter lending has choked debt creation to a structurally lower level than before, competition has squeezed profitability further and further down - a trend made worse by impatient investors wanting to see growth rates continue at the levels achievable in 2011 or 2012 - and governments and regulators turning the screw harder and harder on compliance. The latter has brought the industry to the point where even the largest businesses need to invest significantly to maintain the required standards.

In addition, there are fewer and fewer small players to acquire or win share from, and there is less and less scope for differentiation on the basis of scale or depth of data.

The super league

Across Europe, there is no single winner that stands out clearly as better than the rest. What can be seen is a super league of nine businesses, all achieving upwards of €100m in revenue, whose scale and performance set them apart from the rest of the field. Strictly in alphabetical order, they are:

- Arrow Global
- Arvato
- Cabot Credit Management
- GFKL Lowell
- Hoist
- Intrum Justitia
- Kruk
- Lindorff
- PRA Group / Aktiv

The majority of these already operate in multiple countries; Kruk is an interesting example of building enough scale in a single domestic market (Poland), to sustain a leadership position and, crucially for the longer term, to have the financial muscle to be able to contemplate challenging some of the others in new geographies should it choose to do that.

The quality of this group is extremely high, from Lowell, which historically has scored highest in this index more than anyone else, and which is now sharing its formidable skills with GFKL, to Arrow, which stood out for years based on the purity of its highly effective data-led model and was the first UK player to float. The super league also includes Lindorff, which led the way in BPO and has operated across geographies very effectively.

All of them continue to invest significantly in operational improvement and new proposition development.

In financial terms too, the performance of the super league has been head and shoulders above the rest of the market – their revenue growth has averaged 15 percent pa, roughly twice the level of the rest, and they achieve profit margins close to 30 percent (again, virtually double what others have managed).

Success in the super league has been achieved by following one of five main strategies:

- Internationalising and becoming a portfolio manager;
- Extending into BPO, offering services

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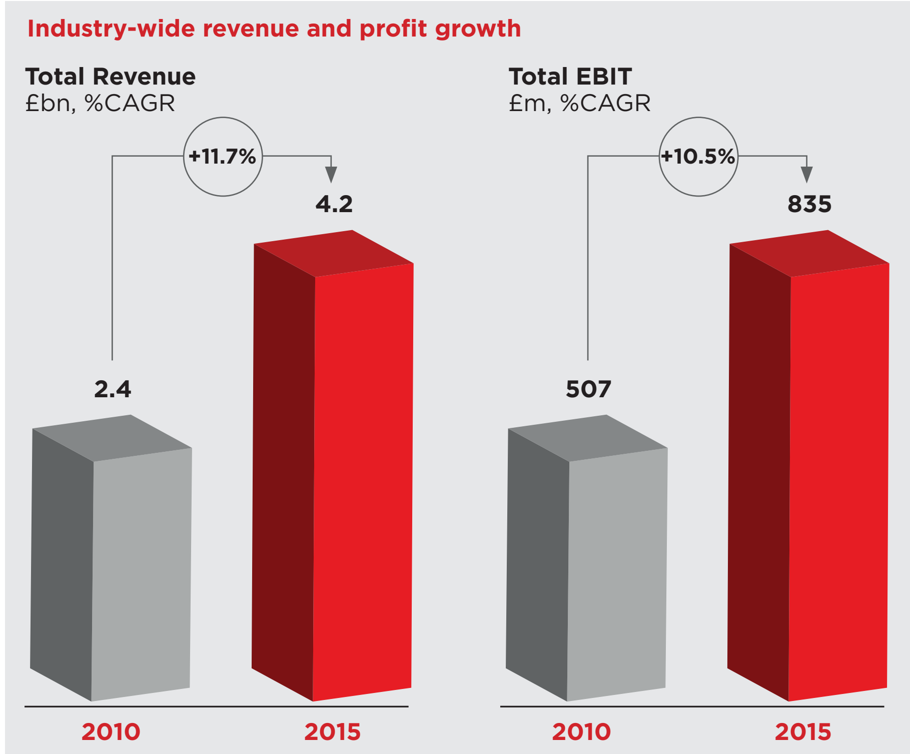

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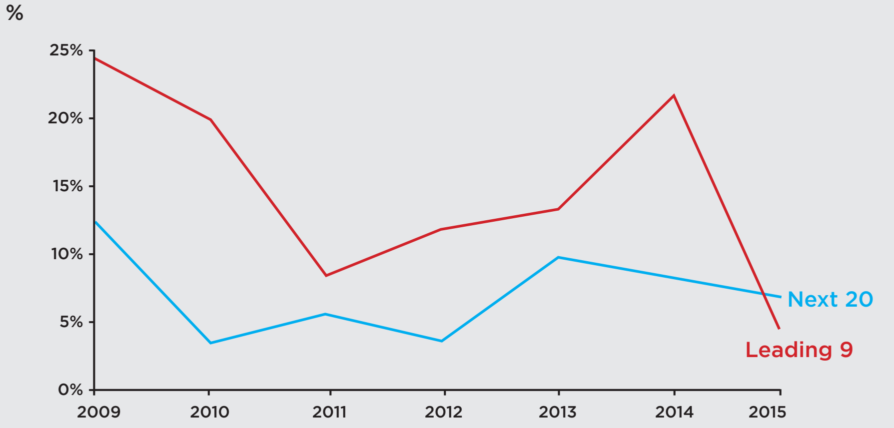
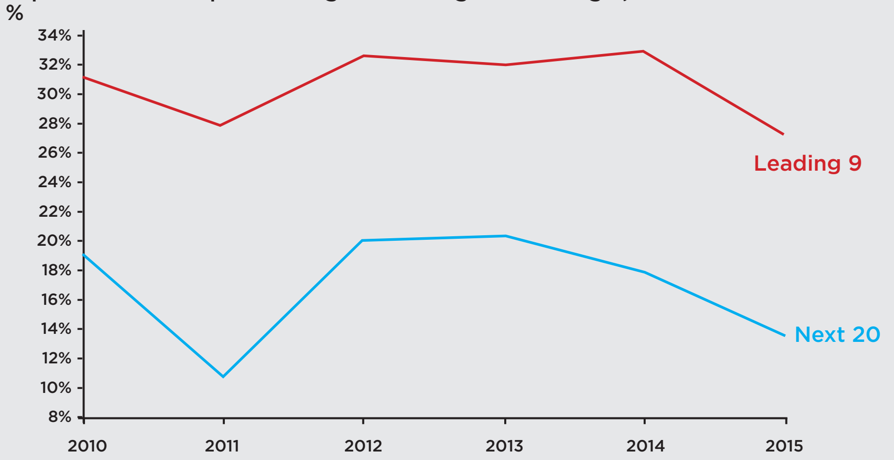
Revenue growth of leaders versus the rest

Weighted Average YOY revenue growth; Super League vs Top 30, 2009-15



Profitability of leaders versus the rest

Top 30 CMDC companies weighted average EBIT margin, 2010-15



upstream in accounts receivable management and beyond;

• Expanding across asset classes, such as secured as well as unsecured debt;

• Establishing differentiated data or analytics capabilities;

• In probably the least exploited strategy so far, rehabilitating debtors and offering business-to-consumer financial propositions.

Financial outlook

Looking closer at the headline financial evidence, we can detect a downward trend in top-line growth and the margins being extracted.

Since these are businesses that carry strong momentum from the performance of previous years' debt portfolios, to see a cohort of companies edging downwards is a worrying sign.

We can put that together with recent trading updates and reports from several geographies of less debt being available than was seen in previous years, of some fiercely competitive auctions and of money multiples closer to 1.7x being targeted where the goal used to be 2.0x and the best years offered 2.5x.

We should assume that this is temporary, since even those lower money multiples still offer attractive returns on investment, and competition continues to be fierce, with the shareholders of public and private companies alike expecting further expansion.

Even when economic conditions lead to more debt being created, prices paid and multiples achieved are unlikely to be very different given the scale of resource available to the leading players.

One reason for such intense competition is that where there used to be clear dividing lines, for example between debt purchase and debt collection agency, or focussing purely on bank debt or working more widely, at one level the leading group now looks more similar than ever before.

Each may have a different weighting between countries or debt types, and different tactics, but the overlap between them looks larger than ever, as businesses are effectively pursuing several of the five strategies listed earlier.

With these pieces of evidence in mind, we have to ask whether some geographical expansion is driven by running away from problems rather than running towards new opportunities?

There are still reasons to be very positive about the long-term potential of the market across Europe as a whole. Three factors stand out:

• The scale of non-performing debt is huge, with large quantities in countries like Italy and Spain where the propositions of the in-house teams, DCAs and DPs that have operated there have not been nearly as sophisticated as those deployed in the UK or Scandinavia. Italy with €161bn and Spain with €105bn have the largest NPL stock volumes in Europe, and together they represent almost half of the European total. Acceptance of outsourcing is growing, and changes in the tax laws and data-sharing rules have recently made the environment much more favourable to CMDC models from northern Europe;

• Creditors still have numerous challenges that they are unable to rectify on their own, and increasingly they are open to longer-term relationships, in the form of BPO contracts or forward flow deals, or simply some form of partnering that shares data more freely or aligns risk and reward;

• The firepower available to invest and innovate is remarkable, either from the super league reinvesting more of their profits, or by tapping into the debt and equity markets that continue to look very favourably on this sector. Even if there are challenges looming, there is time to reinvent and enough money to experiment.

It is possible that higher interest rates, or Brexit-related economic problems, could trigger a higher level of debt creation that allows a new wave of growth without much need to rethink current approaches or to review strategy.

But that scenario would only delay what is likely to be the next phase of evolution of the market: The move to a market led by four to five fully European CMDC businesses, integrated across borders and behaving more like long-term outsourcing businesses than

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balance-sheet traders. It now looks unlikely for any of the businesses outside the super league to bridge the gap, at least not to compete head on. No doubt some niche positions will be defensible, but to out-compete the leaders in their core markets is a big ask. One reason for this is that even an M&A strategy that combined three or four of the smaller players would struggle to deliver the operational quality of the leaders.

We can expect continued very tough competition. It is hard to think of a European market of any scale where there are fewer than three or four major players contesting any large debt sale or new contract. Partly because of that, we expect consolidation at the top, as the leaders are still hungry for growth and organic methods will not provide them with a quick enough route to an enlarged international footprint. It is highly likely, then, that any high-quality single-market business will be an acquisition target.

Also, having nine members of a super league will soon start to feel crowded, and although the obstacles to delivering value from a mega-merger are considerable, pooling the data and knowledge of two of the leaders could be a way to vie for real dominance of the European stage.

If this does happen, it will need to be handled extremely skilfully, and with recognition that scale for its own sake will not be an enduring advantage – at the heart of any deal should be a very clear thesis about benefit delivered to the creditors or debtors touched by the new business.

Members of the super league best positioned for the future are those with real leadership positions in at least one major market.

Some that are successful, but with a collection of businesses that are outside the top three in a geography, are likely to find themselves fighting defensive actions to maintain a meaningful, profitable presence.

Strategic options

These trends raise several questions. The nine businesses in the super league will need clear answers to the following challenges: In which debt types or relationships do they have genuine sustainable competitive advantage?

What new propositions, eg in BPO for creditors or in B2C interactions with rehabilitated debtors, can they develop that fundamentally reposition their business rather than just adding complexity?

Just how much synergy can they gain from working in multiple countries?

What M&A strategies can they pursue to avoid being outflanked by two of the rival businesses partnering?

The stakes grow ever higher, which means a higher level of risk, so we should not rule out the potential for one of the current leaders to suffer a severe decline in performance.

For smaller businesses, there is a harsh reality of margins being lower than the leaders and a scale deficit. Their options appear to be limited, either to preparing themselves to be absorbed by one of the leaders, or establishing very clearly what market niche they address that could be defensible against the leviathans of the sector once they set their mind on winning there.

There are some very well-run, innovative businesses in this category, but the strategic question remains about how they can best compete with the much larger businesses. In areas like BPO, for example, there may still be space for some to carve out a role, but the window of opportunity appears to be closing given the number of players now trying to expand their propositions into earlier-stage work with creditors.

For investors too, there are questions to be answered, particularly about where they will get best return on investment.

Despite the revenue and profit growth of the last five years, shares in listed CMDC businesses, on both sides of the Atlantic, have offered quite disappointing rates of return. Too often the communication to the market puts the emphasis on scale and financial engineering, at the expense of clear strategy and differentiation.

Conclusion

OC&C continues to be optimistic about the market as a whole in Europe, particularly given the strength of capabilities held by the leading players, but we expect the number in the super league to shrink rather than grow.

Long-term winners are likely to be those who can identify and build a strategy on more than efficient collections or lowest cost of funding.

The 2016 CMDC Index was authored by Nigel Stirk and Mark Jannaway at OC&C, with assistance on the underlying analysis from Lorenzo Marion and Fay Sandford. CS