WHERE NEXT?

In its annual report on the market, the Credit Management and Debt Collection (CMDC) Index, OC&C Strategy Consultants charts different paths to growth for debt purchasers. NIGEL STIRK, partner at the consultancy, reports

COVER STORY OC&C CMDC Index

Since 2008, we at OC&C have written an article each year about the state of the credit management and debt collection (CMDC) industry in Europe, and there is never a shortage of topics to debate.

The pace of change has been remarkable, reflecting not just the transition from the depths of the financial crisis to more stable conditions (and now the looming expectation of Brexit), but also the growth of some very large businesses, repeated tightening of the regulatory environment, and a mix of good and bad publicity.

Several contrasts are apparent: What we see now is a sector that is maturing, but is still not entirely stable. It has leaders, but their position is not absolutely secure. It is still labour intensive, while also being close to the cutting-edge of data and analytics. Financially, it still delivers strong growth and excellent overall profitability, but the sustainability of those returns is in question.

At the root of those contrasts is a question about whether the forces that drove such steep growth have now abated. There's another question about whether the industry as a whole is settling into the status of a financial services utility – large, predictable, but facing a future of low growth, modest margins, and a regulatory environment that deters innovation.

In this article we examine this question, with a view to identifying the options left for the businesses (large and small) that remain. Three main topics deserve attention:

- The remaining headroom for growth in the forces that have shaped the market;
- Trends in the performance of the leading players;
- The strategies being pursued.

Are we hitting a debt sale ceiling?

Across Europe, in the last two to three years, it has been evident that the growth of new delinquent debt has slowed down, reflecting tighter lending policies since the financial crisis and more regulatory constraints on lenders and borrowers.

Continued healthy growth in debt sale was supported first by the release of the backlog of debt that went uncollected in the 2008 to 2011 period, and then by creditors reducing their use of contingent collection in favour of earlier sale. The backlog has been cleared in the UK and in most of northern Europe, and while there is scope for some even earlier sale, that trend is slowing too. Ultimately, the key driver continues to be the creation of new delinquent debt.

If current economic conditions continue, and if nothing else changes in terms of regulation or banking policies, then an equilibrium between new debt creation and debt sale will be reached in the next two to three years. In that situation, debt purchasers (DPs) and others would be faced with a much tougher outlook in countries where the market has matured to that degree. To expand further, they would increasingly need to compete head to head with other major DPs, most of which will have the same growth ambitions.

However, we are not yet on the brink of a price war. Current economic conditions are highly unusual, and there is a fork in the road approaching, with the path depending on whether rising interest rates, inflation running ahead of wage growth (and possible recession) trigger a new wave of delinquent debt. Consumer indebtedness has crept back up to historically high levels, and particularly for lower-income households, their repayments represent a high enough proportion of their income that if and when interest rates increase, there is a real risk of default rates jumping much higher in a very short period of time.

The optimistic case is to say that lending has been much more prudent since 2008 than before; the Financial Conduct Authority (FCA) and other regulators have prevented aggressive lending or collections practices, and protected consumers from themselves by taking an axe to payday lending and other short-term high-cost credit. That optimism could rapidly look like wishful thinking, as the controls on lending have had more effect on mortgage lending than on unsecured credit. The level of outstanding debt that has been carried by many less well-off households since the recession has also been stubbornly high.

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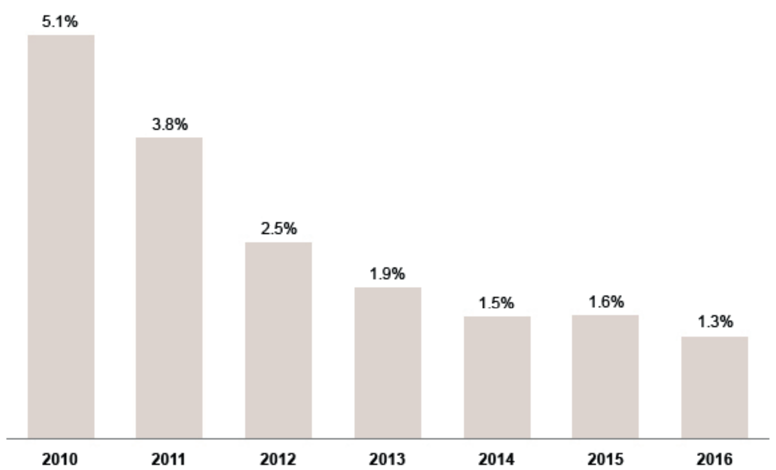
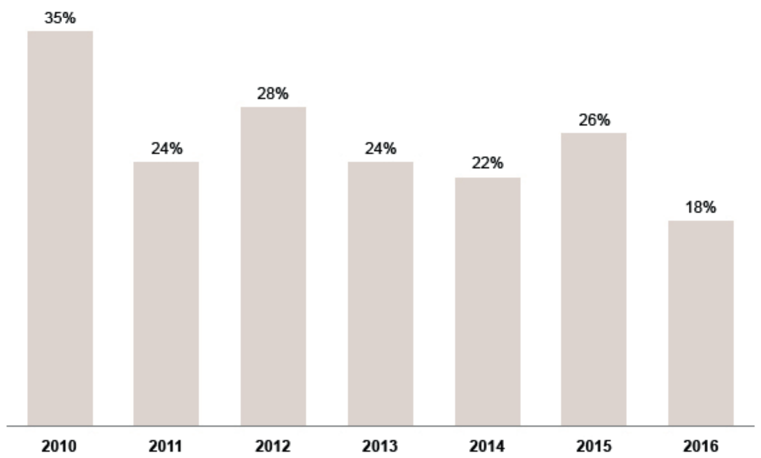
UK Consumer Credit Write-Off Rates



Top 30 European CMDC Players - Return On Capital Employed



Performance

Every year we analyse the financial performance of more than 80 DP and debt collection agency (DCA) businesses operating across Europe, and the headlines are impressive. In 2008, Lowell was a £30m revenue business less than five years old, Arrow Global was a new player and just five years away from its IPO, and the largest player in Europe was a Swedish DCA.

In 2017, the CMDC landscape is dominated by five to six impressive international businesses each worth £1bn or more, employing thousands of people, and able to tap into stockmarkets, private equity finance and debt markets. Profitability is at a level that mainstream banks could only dream of, and operationally the leaders compare well to any BPO business.

Looking closer at year-to-year trends, there are signs of maturity approaching quite quickly. Organic revenue growth is slowing down (masked in some cases by acquisitions, and particularly by buying positions in less mature markets), and although publicly available data does not show it perfectly clearly, the profitability of recent vintages of debt is likely to end up at lower levels than historically. The chart to the left shows average reported return on capital employed for the 30 largest businesses in Europe since 2010, indicating that gradual erosion is underway. Put simply, like-for-like price inflation has been faster than the improvements in collections effectiveness, and as DPs shift more of their collection curves to very long repayment plans, their

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net returns have started to erode. To be clear, the leaders still achieve returns that are highly attractive by most standards, but a downward trend is starting to become visible.

The final aspect of financial performance worth monitoring is the valuations of the businesses by external investors. The multiples that the stockmarket places on Arrow, and the prices paid by private equity investors, are still those appropriate to high-growth businesses, but they are nudging down, and one of the reasons for Cabot Credit Management deciding not to continue with its IPO plans this year is some uncertainty about the price investors are willing to pay.

Crucially, the trends we see in terms of performance are relatively slow, meaning the leaders have time to try to change course, and they certainly have the financial firepower to reinvent themselves if they can identify a clear strategy to do so.

Strategy

So who has a clear, winning strategy? A feature of market maturity and the increased scale of the leaders has been convergence in their strategies – almost all the players of any significance are multi-country businesses, DP-focussed but with some exposure to DCA, vertically integrated, participating in virtually all the major auctions and using a range of amicable and litigation-based approaches.

Where previously there were some marked differences in operational structure and preferred debt types, plus some exclusive relationships with creditors, it appears the leaders have had to become generalists to satisfy their desire for growth. As they became bigger, the more distinctive niches they had thrived in were no longer large enough to offer enough growth, and increasingly they have copied each other's techniques for collecting debt, effectively chipping away at some of their distinctive features. Operationally, the leaders continue to improve, and year-on-year they enhance their analytics capabilities, learn more from the data they process, find better ways to train and deploy their staff, and so on. Core activities are typically managed to a very high standard. Strategically, though, several of the largest businesses appear to be in an exploratory phase where they have placed a number of bets and have not yet decided which one to back. International growth, new service models, new data products and so on are all in play without any one of them yet being the defining element of the strategy.

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Outside the top five, the smaller players that remain are a mixture of sub-contractors and specialists, generally at lower levels of profitability and with limited opportunity to leap to the scale of the very biggest businesses. For the specialists, there is still a viable future if they can identify differentiated approaches to a particular debt type, or tie up a set of creditor relationships, but without one of those types of defensibility, their future is likely to feature either decline or having to sell out to one of the scale leaders.

The future

The near-term challenge is clearly to trade successfully over the next two to three years and to navigate economic uncertainty. Just as in 2008, when the effects of the financial crisis on the collectability of debt became clear, the agility of incumbent businesses is being tested. Back in 2008, some were better than others at interpreting the data on how collection curves were changing, at adjusting their collections strategies, and at managing finances through an initial period of tighter cashflow.

We expect to see variations in how well the current leaders trade, but all of them should be much better prepared than in 2008 – they have much better data, more capacity for analysing it, and typically are less dependent on any given creditor or portfolio. For those with good access to funding, an extra wave of debt available for sale will in fact be good news. However, they all have much bigger back books to manage than they did when the crisis hit, so their skill in servicing their semi-performing books will be severely tested.

The possibility of an economic downturn in the short term should not disguise the need – sooner rather than later – for Europe's leading DPs to define a genuinely differentiated position for themselves, or risk the steady glide towards utility status. There are three main strategies that could have potential:

- Pursue growth from more international expansion. As long as there are countries where debt sale is still in a growth phase, then there will be scope to top up the limited organic growth being experienced in core markets with more dynamic expansion elsewhere. A fundamental challenge is doing that without having to take unreasonable risks on the quality of the debt being bought, and of course there remains the perennial issue of what cross-border synergies can be extracted.
- Expand relationships with creditors into new types of service. 'BPO' is the obvious description, and in countries like Germany it is becoming commonplace to bolt on earlier-stage collections or something closer to accounts receivable management. The challenge here is less about the revenue potential (which is significant) but the margin dilution that typically arises from taking on a BPO role.
- Convert relationships with debtors into new forms of revenue. Once debtors have repaid debts, there should be real potential for providing them with a new form of credit and helping them to manage their money to avoid returning to debt. After years of interaction when the initial debt was being repaid, DPs should know those debtors extremely well and hold a unique data-set that should enable a valuable further relationship to be built.

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Several of the leaders could rightly claim to have started reshaping their businesses in these directions, and big bets have been placed in the form of M&A.

Yet there needs to be careful thought about the viability of trying to do several of these things at once. The capabilities needed to succeed in each of these three strategies are essentially different, and the operational complexity of executing them perfectly is potentially overwhelming.

We are approaching the time when placing chips on all the possibilities will no longer be possible, and a narrower focus on maximising returns from just one of these strategies will be a smarter move. CS

UK Household Debt as % Of Disposable Income