

ENCORE CAPITAL GROUP INC

Form 10-Q

May 09, 2012

[Table of Contents](#)

**UNITED STATES**  
**SECURITIES AND EXCHANGE COMMISSION**  
**WASHINGTON, D.C. 20549**

**FORM 10-Q**

(Mark One)

**QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended March 31, 2012

OR

**TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from \_\_\_\_\_ to \_\_\_\_\_.

COMMISSION FILE NUMBER: 000-26489

**ENCORE CAPITAL GROUP, INC.**

(Exact name of registrant as specified in its charter)

Delaware  
(State or other jurisdiction of  
incorporation or organization)

**48-1090909**  
(IRS Employer  
Identification No.)

3111 Camino Del Rio North, Suite 1300

San Diego, California

92108

Edgar Filing: ENCORE CAPITAL GROUP INC - Form 10-Q

(Address of principal executive offices)

(Zip code)

(877) 445 - 4581

(Registrant's telephone number, including area code)

(Not Applicable)

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the last 90 days. Yes  No

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes  No

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act. (Check one):

Large accelerated filer  Accelerated filer  Non-accelerated filer  Smaller reporting company

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes  No

Indicate the number of shares outstanding of each of the issuer's classes of common stock, as of the latest practicable date.

Class	Outstanding at April 16, 2012
Common Stock, \$0.01 par value	24,695,920 shares

**Table of Contents**

**ENCORE CAPITAL GROUP, INC.**

**INDEX TO FORM 10-Q**

	<b>Page</b>
<b><u>PART I FINANCIAL INFORMATION</u></b>	<b>1</b>
<u>Item 1 Condensed Consolidated Financial Statements (Unaudited)</u>	1
<u>Condensed Consolidated Statements of Financial Condition</u>	1
<u>Condensed Consolidated Statements of Comprehensive Income</u>	2
<u>Condensed Consolidated Statements of Stockholders' Equity</u>	3
<u>Condensed Consolidated Statements of Cash Flows</u>	4
<u>Notes to Condensed Consolidated Financial Statements (Unaudited)</u>	5
<u>Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations</u>	17
<u>Item 3 Quantitative and Qualitative Disclosures About Market Risk</u>	31
<u>Item 4 Controls and Procedures</u>	31
<b><u>PART II OTHER INFORMATION</u></b>	<b>32</b>
<u>Item 1 Legal Proceedings</u>	32
<u>Item 1A Risk Factors</u>	32
<u>Item 2 Unregistered Sales of Equity Securities and Use of Proceeds</u>	32
<u>Item 5 Other Information</u>	32
<u>Item 6 Exhibits</u>	33
<b><u>SIGNATURES</u></b>	<b>34</b>

**Table of Contents****PART I. FINANCIAL INFORMATION****Item 1. Condensed Consolidated Financial Statements (Unaudited)****ENCORE CAPITAL GROUP, INC.****Condensed Consolidated Statements of Financial Condition**

(In Thousands, Except Par Value Amounts)

(Unaudited)

	March 31, 2012	December 31, 2011
<b>Assets</b>		
Cash and cash equivalents	\$ 15,446	\$ 8,047
Accounts receivable, net	3,615	3,265
Investment in receivable portfolios, net	741,580	716,454
Deferred court costs, net	39,839	38,506
Property and equipment, net	19,603	17,796
Other assets	11,842	11,968
Goodwill	6,047	15,985
Identifiable intangible assets, net		462
Total assets	\$ 837,972	\$ 812,483
<b>Liabilities and stockholders equity</b>		
Liabilities:		
Accounts payable and accrued liabilities	\$ 31,161	\$ 29,628
Income tax payable	2,078	
Deferred tax liabilities, net	16,333	15,709
Debt	398,246	388,950
Other liabilities	5,297	6,661
Total liabilities	453,115	440,948
Commitments and contingencies		
Stockholders equity:		
Convertible preferred stock, \$.01 par value, 5,000 shares authorized, no shares issued and outstanding		
Common stock, \$.01 par value, 50,000 shares authorized, 24,696 shares and 24,520 shares issued and outstanding as of March 31, 2012 and December 31, 2011, respectively	247	245
Additional paid-in capital	124,638	123,406
Accumulated earnings	261,258	249,852
Accumulated other comprehensive loss	(1,286)	(1,968)
Total stockholders equity	384,857	371,535
Total liabilities and stockholders equity	\$ 837,972	\$ 812,483

*See accompanying notes to condensed consolidated financial statements*



**Table of Contents****ENCORE CAPITAL GROUP, INC.****Condensed Consolidated Statements of Comprehensive Income**

(In Thousands, Except Per Share Amounts)

(Unaudited)

	<b>Three Months Ended March 31,</b>	
	<b>2012</b>	<b>2011</b>
<b>Revenues</b>		
Revenue from receivable portfolios, net	\$ 126,405	\$ 105,326
Servicing fees and other related revenue	3,817	4,977
<b>Total revenues</b>	<b>130,222</b>	<b>110,303</b>
<b>Operating expenses</b>		
Salaries and employee benefits (excluding stock-based compensation expense)	23,109	19,040
Stock-based compensation expense	2,266	1,765
Cost of legal collections	38,635	36,509
Other operating expenses	12,411	10,096
Collection agency commissions	3,959	3,914
General and administrative expenses	14,132	10,169
Depreciation and amortization	1,363	1,053
Impairment charge for goodwill and identifiable intangible assets	10,349	
<b>Total operating expenses</b>	<b>106,224</b>	<b>82,546</b>
<b>Income from operations</b>	<b>23,998</b>	<b>27,757</b>
<b>Other (expense) income</b>		
Interest expense	(5,515)	(5,593)
Other income	267	116
<b>Total other expenses</b>	<b>(5,248)</b>	<b>(5,477)</b>
<b>Income before income taxes</b>	<b>18,750</b>	<b>22,280</b>
<b>Provision for income taxes</b>	<b>(7,344)</b>	<b>(8,601)</b>
<b>Net income</b>	<b>\$ 11,406</b>	<b>\$ 13,679</b>
<b>Weighted average shares outstanding:</b>		
Basic	24,779	24,260
Diluted	25,740	25,451
<b>Earnings per share:</b>		
Basic	\$ 0.46	\$ 0.56
Diluted	\$ 0.44	\$ 0.54
<b>Other comprehensive income:</b>		
Unrealized gain on derivative instruments	\$ 1,122	\$ 836
Income tax provision related to unrealized gain on derivative instruments	(440)	(329)
<b>Other comprehensive income, net of tax</b>	<b>682</b>	<b>507</b>

Comprehensive income	\$ 12,088	\$ 14,186
----------------------	-----------	-----------

*See accompanying notes to condensed consolidated financial statements*

**Table of Contents****ENCORE CAPITAL GROUP, INC.****Condensed Consolidated Statements of Stockholders Equity**

(Unaudited, In Thousands)

	Common Stock		Additional Paid-In	Accumulated	Accumulated Other Comprehensive (Loss) Income	Total
	Shares	Par	Capital	Earnings		Equity
<b>Balance at December 31, 2011</b>	24,520	\$ 245	\$ 123,406	\$ 249,852	\$ (1,968)	\$ 371,535
Net income				11,406		11,406
Other comprehensive income:						
Unrealized gain on derivative instruments, net of tax					682	682
Exercise of stock options and issuance of share-based awards, net of shares withheld for employee taxes	176	2	(2,018)			(2,016)
Stock-based compensation			2,266			2,266
Tax benefit related to stock-based compensation			984			984
<b>Balance at March 31, 2012</b>	24,696	\$ 247	\$ 124,638	\$ 261,258	\$ (1,286)	\$ 384,857

*See accompanying notes to condensed consolidated financial statements*



**Table of Contents****ENCORE CAPITAL GROUP, INC.****Condensed Consolidated Statements of Cash Flows**

(Unaudited, In Thousands)

	<b>Three Months Ended March 31,</b>	
	<b>2012</b>	<b>2011</b>
<b>Operating activities:</b>		
Net income	\$ 11,406	\$ 13,679
Adjustments to reconcile net income to net cash provided by operating activities:		
Depreciation and amortization	1,363	1,053
Impairment charge for goodwill and identifiable intangible assets	10,349	
Amortization of loan costs	466	440
Stock-based compensation expense	2,266	1,765
Deferred income tax expense (benefit)	623	(58)
Excess tax benefit from stock-based payment arrangements	(1,067)	(1,343)
Provision for allowances on receivable portfolios, net	373	5,498
Changes in operating assets and liabilities		
Other assets	(326)	(1,819)
Deferred court costs	(1,333)	(2,128)
Prepaid income tax and income taxes payable	2,130	8,437
Accounts payable, accrued liabilities and other liabilities	853	(450)
Net cash provided by operating activities	27,103	25,074
<b>Investing activities:</b>		
Purchases of receivable portfolios	(130,463)	(90,675)
Collections applied to investment in receivable portfolios, net	104,230	80,211
Proceeds from put-backs of receivable portfolios	734	900
Purchases of property and equipment	(1,555)	(630)
Net cash used in investing activities	(27,054)	(10,194)
<b>Financing activities:</b>		
Payment of loan costs		(734)
Proceeds from senior secured notes		25,000
Proceeds from revolving credit facility	43,500	19,000
Repayment of revolving credit facility	(34,500)	(46,000)
Proceeds from exercise of stock options	1,061	297
Taxes paid related to net share settlement of equity awards	(2,093)	(1,439)
Excess tax benefit from stock-based payment arrangements	1,067	1,343
Repayment of capital lease obligations	(1,685)	(877)
Net cash provided by (used in) financing activities	7,350	(3,410)
Net increase in cash and cash equivalents	7,399	11,470
Cash and cash equivalents, beginning of period	8,047	10,905
Cash and cash equivalents, end of period	\$ 15,446	\$ 22,375

Supplemental disclosures of cash flow information:

## Edgar Filing: ENCORE CAPITAL GROUP INC - Form 10-Q

Cash paid for interest	\$	5,119	\$	5,002
Cash paid for income taxes		4,075		166
Supplemental schedule of non-cash investing and financing activities:				
Fixed assets acquired through capital lease		1,564		371
		<i>See accompanying notes to condensed consolidated financial statements</i>		

---

**Table of Contents**

**ENCORE CAPITAL GROUP, INC.**

**NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS**

(Unaudited)

**Note 1: Ownership, Description of Business and Summary of Significant Accounting Policies**

Encore Capital Group, Inc. (Encore), through its subsidiaries (collectively, the Company), is a leader in consumer debt buying and recovery. The Company purchases portfolios of defaulted consumer receivables and manages them by partnering with individuals as they repay their obligations and work toward financial recovery. Defaulted receivables are consumers' unpaid financial commitments to credit originators, including banks, credit unions, consumer finance companies, commercial retailers, auto finance companies, and telecommunication companies, which the Company purchases at deep discounts. Defaulted receivables also include receivables subject to bankruptcy proceedings, or consumer bankruptcy receivables.

The Company purchases receivables based on robust, account-level valuation methods and employs a suite of proprietary statistical and behavioral models across the full extent of its operations. These investments allow the Company to value portfolios accurately (and limit the risk of overpaying), avoid buying portfolios that are incompatible with its methods or goals and precisely align the accounts it purchases with its operational channels to maximize future collections. As a result, the Company has been able to realize significant returns from the receivables it acquires. The Company maintains strong relationships with many of the largest credit providers in the United States, and possesses one of the industry's best collection staff retention rates.

The Company expands upon the insights created during its purchasing process when building account collection strategies. The Company's proprietary consumer-level collectability analysis is the primary determinant of whether an account is actively serviced post-purchase. Throughout the Company's ownership period, it continuously refines this analysis to determine the most effective collection strategy to pursue for each account. After the Company's preliminary analysis, it seeks to collect on only a fraction of the accounts it purchases, through one or more of its collection channels. The channel identification process is analogous to a funneling system where the Company first differentiates those consumers who are not able to pay, from those who are able to pay. Consumers who the Company believes are financially incapable of making any payments, are facing extenuating circumstances or hardships (such as medical issues), are serving in the military, or are currently receiving social security as their only means of financial sustenance are excluded from the next step of its collection process and are designated as inactive. The remaining pool of accounts in the funnel then receives further evaluation. At that point, the Company analyzes and determines a consumer's willingness to pay. Based on that analysis, the Company will pursue collections through letters and/or phone calls to its consumers. Despite its efforts to reach consumers and work out a settlement option, only a small number of consumers who are contacted choose to engage with the Company. Those who do are often offered deep discounts on their obligations, or are presented with payment plans that are better suited to meet their daily cash flow needs. The majority of contacted consumers, however, ignore both the Company's calls and letters, and therefore the Company must then make the difficult decision to pursue collections through legal means.

In addition, the Company provides bankruptcy support services to some of the largest companies in the financial services industry through its wholly owned subsidiary, Ascension Capital Group, Inc. (Ascension). Leveraging a proprietary software platform dedicated to bankruptcy servicing, Ascension's operational platform integrates lenders, trustees, and consumers across the bankruptcy lifecycle. As discussed in Note 13 Goodwill and Identifiable Intangible Assets, on May 7, 2012, the Company's Board of Directors (the Board) approved a plan to sell Ascension. At this time, the Company has reached an agreement in principle to sell Ascension to a third party.

***Financial Statement Preparation***

The accompanying interim condensed consolidated financial statements have been prepared by Encore, without audit, in accordance with the instructions to the Quarterly Report on Form 10-Q, and Rule 10-01 of Regulation S-X promulgated by the Securities and Exchange Commission and, therefore, do not include all information and footnotes necessary for a fair presentation of its consolidated financial position, results of operations and cash flows in accordance with accounting principles generally accepted in the United States.

In the opinion of management, the unaudited financial information for the interim periods presented reflects all adjustments, consisting of only normal and recurring adjustments, necessary for a fair presentation of the Company's consolidated financial position, results of operations, and cash flows. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2011. Operating results for interim periods are not necessarily indicative of operating results for an entire fiscal year.



**Table of Contents**

The preparation of financial statements in conformity with accounting principles generally accepted in the United States requires management to make estimates and assumptions that affect the reported amounts and the disclosure of contingent amounts in the Company's financial statements and the accompanying notes. Actual results could materially differ from those estimates.

**Basis of Consolidation**

Encore is a Delaware holding company whose principal assets are its investments in various wholly owned subsidiaries. All significant intercompany accounts and transactions have been eliminated in consolidation.

**Reclassification**

Certain reclassifications have been made to the condensed consolidated financial statements to conform to the current year's presentation.

**Note 2: Earnings per Share**

Basic earnings per share is calculated by dividing net earnings available to common stockholders by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share is calculated on the basis of the weighted average number of shares of common stock plus the effect of dilutive potential common shares outstanding during the period using the treasury stock method. Dilutive potential common shares include outstanding stock options and restricted stock units.

The components of basic and diluted earnings per share are as follows (*in thousands, except earnings per share*):

	<b>Three Months Ended March 31,</b>	
	<b>2012</b>	<b>2011</b>
Net income available for common shareholders (A)	\$ 11,406	\$ 13,679
Weighted average outstanding shares of common stock (B)	24,779	24,260
Dilutive effect of stock-based awards	961	1,191
Common stock and common stock equivalents (C)	25,740	25,451
<b>Earnings per share:</b>		
Basic (A/B)	\$ 0.46	\$ 0.56
Diluted (A/C)	\$ 0.44	\$ 0.54

Employee stock options to purchase approximately 209,000 and 39,000 shares of common stock were outstanding during the three months ended March 31, 2012 and 2011, respectively, but not included in the computation of diluted earnings per common share because the effect on diluted earnings per share would be anti-dilutive.

**Note 3: Fair Value Measurements**

The Company accounts for certain assets and liabilities at fair value. The authoritative guidance for fair value measurements defines fair value as the price that would be received upon sale of an asset or the price paid to transfer a liability, in an orderly transaction between market participants at the measurement date (*i.e.* the exit price). The guidance utilizes a fair value hierarchy that prioritizes the inputs used in valuation techniques to measure fair value into three broad levels. The following is a brief description of each level:

Level 1: Observable inputs such as quoted prices (unadjusted) in active markets for identical assets or liabilities.

## Edgar Filing: ENCORE CAPITAL GROUP INC - Form 10-Q

Level 2: Inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active.

Level 3: Unobservable inputs that reflect the reporting entity's own assumptions.

**Table of Contents**

Financial assets and liabilities measured at fair value on a recurring basis are summarized below (*in thousands*):

	,0000000	,0000000	,0000000	,0000000
	Fair Value Measurements as of March 31, 2012			
	Level 1	Level 2	Level 3	Total
<b>Assets</b>				
Foreign currency exchange contracts	\$	\$ 85	\$	\$ 85
<b>Liabilities</b>				
Interest rate swap agreements		(1,225)		(1,225)
Foreign currency exchange contracts		(956)		(956)

	000000000	000000000	000000000	000000000
	Fair Value Measurements as of December 31, 2011			
	Level 1	Level 2	Level 3	Total
<b>Assets</b>				
Foreign currency exchange contracts	\$	\$ 168	\$	\$ 168
<b>Liabilities</b>				
Interest rate swap agreements		(1,014)		(1,014)
Foreign currency exchange contracts		(2,371)		(2,371)

Fair values of derivative instruments included in Level 2 are estimated using industry standard valuation models. These models project future cash flows and discount the future amounts to a present value using market-based observable inputs including interest rate curves, foreign currency exchange rates, and forward and spot prices for currencies. As of March 31, 2012, the Company did not have any financial instruments carried at fair value that required Level 3 measurement.

**Financial instruments not required to be carried at fair value**

Borrowings under the Company's revolving credit facility are carried at historical cost, adjusted for additional borrowings less principal repayments, which approximates fair value. For investment in receivable portfolios, there is no active market or observable inputs for the fair value estimation. The Company does not consider it practical to attempt to estimate the fair value of such financial instruments due to the excessive costs that would be incurred in doing so.

**Note 4: Derivatives and Hedging Instruments**

The Company uses derivative instruments to manage risks related to interest rates and foreign currency. The Company's outstanding interest rate swap contracts and foreign currency exchange contracts qualify for hedge accounting treatment under the authoritative guidance for derivatives and hedging.

**Interest Rate Swaps**

The Company may periodically enter into derivative financial instruments, typically interest rate swap agreements, to reduce its exposure to fluctuations in interest rates on variable interest rate debt and their impact on earnings and cash flows. As of March 31, 2012, the Company had six interest rate swap agreements outstanding with a total notional amount of \$150.0 million. Under the swap agreements, the Company receives floating interest rate payments based on one-month reserve-adjusted LIBOR and makes interest payments based on fixed interest rates. The Company intends to continue electing the one-month reserve-adjusted LIBOR as the benchmark interest rate on the debt being hedged through its term. No credit spread was hedged. The Company designates its interest rate swap instruments as cash flow hedges.

The authoritative accounting guidance requires companies to recognize derivative instruments as either an asset or liability measured at fair value in the statement of financial position. The effective portion of the change in fair value of the derivative instrument is recorded in other comprehensive income (OCI). The ineffective portion of the change in fair value of the derivative instrument, if any, is recognized in interest expense in the period of change. From the inception of the hedging program, the Company has determined that the hedging instruments are highly effective.

**Foreign Currency Exchange Contracts**

## Edgar Filing: ENCORE CAPITAL GROUP INC - Form 10-Q

The Company has operations in India, which exposes the Company to foreign currency exchange rate fluctuations due to transactions denominated in Indian rupees, such as employee salaries and rent expenditures. To mitigate this risk, the Company enters into derivative financial instruments, principally forward contracts, which are designated as cash flow hedges, to mitigate fluctuations in the cash payments of future forecasted transactions in Indian rupees for up to 36 months. The Company adjusts the level and use of derivatives as soon as practicable after learning that an exposure has changed, and the Company reviews all exposures and derivative positions on an ongoing basis.



**Table of Contents**

Gains and losses on cash flow hedges are recorded in accumulated other comprehensive income (loss) until the hedged transaction is recorded in the consolidated financial statements. Once the underlying transaction is recorded in the consolidated financial statements, the Company reclassifies the accumulated other comprehensive income or loss on the derivative into earnings. If all or a portion of the forecasted transaction was cancelled, this would render all or a portion of the cash flow hedge ineffective and the Company would reclassify the ineffective portion of the hedge into earnings. The Company generally does not experience ineffectiveness of the hedge relationship and the accompanying consolidated financial statements do not include any such gains or losses.

As of March 31, 2012, the total notional amount of the forward contracts to buy Indian rupees in exchange for U.S. dollars was \$32.0 million. All outstanding contracts qualified for hedge accounting treatment as of March 31, 2012. The Company estimates that approximately \$0.7 million of net derivative loss included in OCI will be reclassified into earnings within the next 12 months. No gains or losses were reclassified from OCI into earnings as a result of forecasted transactions that failed to occur during the three months ended March 31, 2012 and 2011.

The Company does not enter into derivative instruments for trading or speculative purposes.

The following table summarizes the fair value of derivative instruments as recorded in the Company's consolidated statements of financial position (*in thousands*):

	March 31, 2012		December 31, 2011	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Derivatives designated as hedging instruments:				
Interest rate swaps	Other liabilities	\$ (1,225)	Other liabilities	\$ (1,014)
Foreign currency exchange contracts	Other assets	85	Other assets	168
Foreign currency exchange contracts	Other liabilities	(956)	Other liabilities	(2,371)

The following tables summarize the effects of derivatives in cash flow hedging relationships on the Company's statements of comprehensive income during the three months ended March 31, 2012 and 2011 (*in thousands*):

	Gain or (Loss) Recognized in OCI-Effective Portion Three Months Ended March 31,		Location of Gain or (Loss) Reclassified from OCI into Income - Effective Portion	Gain or (Loss) Reclassified from OCI into Income -Effective Portion Three Months Ended March 31,		Location of Gain or (Loss) Recognized - Ineffective Portion and Amount Excluded from Effectiveness Testing	Amount of Gain or (Loss) Recognized - Ineffective Portion and Amount Excluded from Effectiveness Testing Three Months Ended March 31,	
	2012	2011		2012	2011		2012	2011
Interest rate swaps	\$ (211)	\$506	Interest expense	\$	\$	Other (expense) income	\$	\$
Foreign currency exchange contracts	903	355	Salaries and employee benefits	(116)	73	Other (expense) income		
Foreign currency exchange contracts	297	65	General and administrative expenses	(16)	18	Other (expense) income		

**Note 5: Stock-Based Compensation**

On March 9, 2009, the Board approved an amendment and restatement of the 2005 Stock Incentive Plan ( 2005 Plan ), which was originally adopted on March 30, 2005, for Board members, employees, officers, and executives of, and consultants and advisors to, the Company. The amendment and restatement of the 2005 Plan increased by 2,000,000 shares the maximum number of shares of the Company's common stock that may be issued or be subject to awards under the plan, established a new 10-year term for the plan and made certain other amendments. The

## Edgar Filing: ENCORE CAPITAL GROUP INC - Form 10-Q

2005 Plan amendment was approved by the Company's stockholders on June 9, 2009. The 2005 Plan provides for the granting of incentive stock options, nonqualified stock options, stock appreciation rights, restricted stock, restricted stock units, and performance-based awards to eligible individuals. As amended, the 2005 Plan allows the granting of an aggregate of 3,500,000 shares of the Company's common stock for awards, plus the number of shares of stock that were available for future awards under the prior 1999 Equity Participation Plan ( 1999 Plan ). In addition, shares subject to options granted under either the 1999 Plan or the 2005 Plan that terminate or expire without being exercised will become available for grant under the 2005 Plan. The benefit provided under these plans is compensation subject to authoritative guidance for stock-based compensation.

**Table of Contents**

In accordance with authoritative guidance for stock-based compensation, compensation expense is recognized only for those shares expected to vest, based on the Company's historical experience and future expectations. Total compensation expense during the three months ended March 31, 2012 and 2011 was \$2.3 million and \$1.8 million, respectively.

The Company's stock-based compensation arrangements are described below:

**Stock Options**

The 2005 Plan permits the granting of stock options to certain employees and directors of the Company. Option awards are generally granted with an exercise price equal to the market price of the Company's stock at the date of issuance. They generally vest over three to five years of continuous service, and have ten-year contractual terms.

The Company uses the Black-Scholes option-pricing model to determine the fair-value of stock-based awards. All options are amortized ratably over the requisite service periods of the awards, which are generally the vesting periods.

The fair value for options granted was estimated at the date of grant using a Black-Scholes option-pricing model with the following weighted-average assumptions (there were no options granted for the three months ended March 31, 2012):

	Three Months Ended March 31,	
	2012	2011
Weighted average fair value of options granted	\$	\$ 13.26
Risk free interest rate		2.0%
Dividend yield		0.0%
Volatility factor of the expected market price of the Company's common stock		61%
Weighted-average expected life of options		5 Years

Unrecognized compensation cost related to stock options as of March 31, 2012, was \$2.1 million. The weighted-average remaining expense period, based on the unamortized value of these outstanding stock options, was approximately 1.6 years.

A summary of the Company's stock option activity as of March 31, 2012, and changes during the three months ended, is presented below:

	Number of Shares	Option Price Per Share		Weighted Average Exercise Price	Aggregate Intrinsic Value (in thousands)
Outstanding at December 31, 2011	2,182,940	\$ 0.51	\$24.65	\$ 13.00	
Granted					
Cancelled/forfeited					
Exercised	(55,867)	0.51	16.19	3.79	
Outstanding at March 31, 2012	2,127,073	\$ 0.51	\$24.65	\$ 13.24	\$ 20,238
Exercisable at March 31, 2012	1,432,745	\$ 0.51	\$24.65	\$ 12.21	\$ 14,959

The total intrinsic value of options exercised during the three months ended March 31, 2012 and 2011 was \$1.1 million and \$1.2 million, respectively. As of March 31, 2012, the weighted-average remaining contractual life of options outstanding and options exercisable was 5.6 years and 4.5 years, respectively.

**Non-Vested Shares**

Under the Company's 2005 Plan, Board members, employees, officers and executives of, and consultants and advisors to, the Company are eligible to receive restricted stock units and restricted stock awards. In accordance with the authoritative guidance, the fair value of these

## Edgar Filing: ENCORE CAPITAL GROUP INC - Form 10-Q

non-vested shares is equal to the closing sale price of the Company's common stock on the date of issuance. The total number of these awards expected to vest is adjusted by estimated forfeiture rates. As of March 31, 2012, 18,830 of the non-vested shares are expected to vest over approximately one to two years based on certain performance goals ( Performance-Based Awards ). The fair value of the Performance-Based Awards is expensed over the expected vesting period, net of estimated forfeitures. If performance goals are not expected to be met, the compensation expense previously recognized would be reversed. No reversals of compensation expense related to the Performance-Based Awards have been made as of March 31, 2012. The remaining 350,611 non-vested shares are not performance-based, and will vest over approximately one to three years of continuous service.

**Table of Contents**

A summary of the status of the Company's restricted stock units and restricted stock awards as of March 31, 2012, and changes during the three months ended, is presented below:

	Non-Vested Shares	Weighted Average Grant Date Fair Value
Non-vested at December 31, 2011	589,117	\$19.22
Awarded	17,681	\$23.38
Vested	(231,918)	\$16.92
Cancelled/forfeited	(5,439)	\$22.85
Non-vested at March 31, 2012	369,441	\$20.81

Unrecognized compensation expense related to non-vested shares as of March 31, 2012, was \$4.8 million. The weighted-average remaining expense period, based on the unamortized value of these outstanding non-vested shares, was approximately 1.7 years. The fair value of restricted stock units and restricted stock awards vested during the three months ended March 31, 2012 and 2011 was \$5.3 million and \$4.7 million, respectively.

**Note 6: Investment in Receivable Portfolios, Net**

In accordance with the authoritative guidance for loans and debt securities acquired with deteriorated credit quality, discrete receivable portfolio purchases during a quarter are aggregated into pools based on common risk characteristics. Once a static pool is established, the portfolios are permanently assigned to the pool. The discount (*i.e.*, the difference between the cost of each static pool and the related aggregate contractual receivable balance) is not recorded because the Company expects to collect a relatively small percentage of each static pool's contractual receivable balance. As a result, receivable portfolios are recorded at cost at the time of acquisition. The purchase cost of the portfolios includes certain fees paid to third parties incurred in connection with the direct acquisition of the receivable portfolios.

In compliance with the authoritative guidance, the Company accounts for its investments in consumer receivable portfolios using either the interest method or the cost recovery method. The interest method applies an internal rate of return ( IRR ) to the cost basis of the pool, which remains unchanged throughout the life of the pool, unless there is an increase in subsequent expected cash flows. Subsequent increases in expected cash flows are generally recognized prospectively through an upward adjustment of the pool's IRR over its remaining life. Subsequent decreases in expected cash flows do not change the IRR, but are recognized as an allowance to the cost basis of the pool, and are reflected in the consolidated statements of comprehensive income as a reduction in revenue, with a corresponding valuation allowance, offsetting the investment in receivable portfolios in the consolidated statements of financial condition.

The Company utilizes its proprietary forecasting models to continuously evaluate the economic life of each pool. The collection forecast of each pool is generally estimated to be between 84 to 96 months based on the expected collection period of each pool. The Company often experiences collections beyond the 84 to 96 month collection forecast. As of March 31, 2012, the total estimated remaining collections beyond the 84 to 96 month collection forecast was \$104.2 million.

The Company accounts for each static pool as a unit for the economic life of the pool (similar to one loan) for recognition of revenue from receivable portfolios, for collections applied to the cost basis of receivable portfolios and for provision for loss or allowance. Revenue from receivable portfolios is accrued based on each pool's IRR applied to each pool's adjusted cost basis. The cost basis of each pool is increased by revenue earned and decreased by gross collections and portfolio allowances.

If the amount and timing of future cash collections on a pool of receivables are not reasonably estimable, the Company accounts for such portfolios on the cost recovery method as Cost Recovery Portfolios. The accounts in these portfolios have different risk characteristics than those included in other portfolios acquired during the same quarter, or the necessary information was not available to estimate future cash flows and, accordingly, they were not aggregated with other portfolios. Under the cost recovery method of accounting, no income is recognized until the purchase price of a Cost Recovery Portfolio has been fully recovered.

Accrutable yield represents the amount of revenue the Company expects to generate over the remaining life of its existing investment in receivable portfolios based on estimated future cash flows. Total accrutable yield is the difference between future estimated collections and the current carrying value of a portfolio. All estimated cash flows on portfolios where the cost basis has been fully recovered are classified as zero

basis cash flows.

**Table of Contents**

The following table summarizes the Company's accretable yield and an estimate of zero basis future cash flows at the beginning and end of the period presented (*in thousands*):

	Accretable Yield	Estimate of Zero Basis Cash Flows	Total
Balance at December 31, 2011	\$ 821,527	\$ 32,676	\$ 854,203
Revenue recognized, net	(119,340)	(7,065)	(126,405)
Net additions to existing portfolios <sup>(1)</sup>	131,039	3,608	134,647
Additions for current purchases <sup>(1)</sup>	119,533		119,533
<b>Balance at March 31, 2012</b>	<b>\$ 952,759</b>	<b>\$ 29,219</b>	<b>\$ 981,978</b>

<sup>(1)</sup> Estimated remaining collections include anticipated collections beyond the 84 to 96 month collection forecast.

	Accretable Yield	Estimate of Zero Basis Cash Flows	Total
Balance at December 31, 2010	\$ 739,785	\$ 4,274	\$ 744,059
Revenue recognized, net	(101,709)	(3,617)	(105,326)
Net additions to existing portfolios	18,715	2,948	21,663
Additions for current purchases	93,098		93,098
<b>Balance at March 31, 2011</b>	<b>\$ 749,889</b>	<b>\$ 3,605</b>	<b>\$ 753,494</b>

During the three months ended March 31, 2012, the Company purchased receivable portfolios with a face value of \$2.9 billion for \$130.5 million, or a purchase cost of 4.5% of face value. The estimated future collections at acquisition for these portfolios amounted to \$235.9 million. During the three months ended March 31, 2011, the Company purchased receivable portfolios with a face value of \$2.9 billion for \$90.7 million, or a purchase cost of 3.1% of face value. The estimated future collections at acquisition for these portfolios amounted to \$178.4 million.

All collections realized after the net book value of a portfolio has been fully recovered ( Zero Basis Portfolios ) are recorded as revenue ( Zero Basis Revenue ). During the three months ended March 31, 2012 and 2011, approximately \$6.0 million and \$3.0 million, respectively, were recognized as revenue on portfolios for which the related cost basis has been fully recovered.

The following tables summarize the changes in the balance of the investment in receivable portfolios during the following periods (*in thousands, except percentages*):

	Accrual Basis Portfolios	Three Months Ended March 31, 2012		Total
		Cost Recovery Portfolios	Zero Basis Portfolios	
Balance, beginning of period	\$ 716,454	\$	\$	\$ 716,454
Purchases of receivable portfolios	130,463			130,463
Gross collections <sup>(1)</sup>	(223,943)		(7,065)	(231,008)
Put-backs and recalls <sup>(2)</sup>	(734)			(734)
Revenue recognized	120,746		6,032	126,778
(Portfolio allowances) portfolio allowance reversals, net	(1,406)		1,033	(373)
<b>Balance, end of period</b>	<b>\$ 741,580</b>	<b>\$</b>	<b>\$</b>	<b>\$ 741,580</b>

Edgar Filing: ENCORE CAPITAL GROUP INC - Form 10-Q

Revenue as a percentage of collections <sup>(3)</sup>	53.9%	0.0%	85.4%	54.9%
---	-------	------	-------	-------



**Table of Contents**

	Three Months Ended March 31, 2011			Total
	Accrual Basis Portfolios	Cost Recovery Portfolios	Zero Basis Portfolios	
Balance, beginning of period	\$ 644,753	\$	\$	\$ 644,753
Purchases of receivable portfolios	90,675			90,675
Gross collections <sup>(1)</sup>	(187,417)		(3,617)	(191,034)
Put-backs and recalls <sup>(2)</sup>	(900)			(900)
Revenue recognized	107,804		3,020	110,824
(Portfolio allowances) portfolio allowance reversals, net	(6,095)		597	(5,498)
Balance, end of period	\$ 648,820	\$	\$	\$ 648,820
Revenue as a percentage of collections <sup>(3)</sup>	57.5%	0.0%	83.5%	58.0%

(1) Does not include amounts collected on behalf of others.

(2) Put-backs represent accounts that are returned to the seller in accordance with the respective purchase agreement ( Put-Backs ). Recalls represent accounts that are recalled by the seller in accordance with the respective purchase agreement ( Recalls ).

(3) Revenue as a percentage of collections excludes the effects of net portfolio allowances or net portfolio allowance reversals.

The following table summarizes the change in the valuation allowance for investment in receivable portfolios during the periods presented (*in thousands*):

	Valuation Allowance	
	Three Months Ended March 31, 2012	Three Months Ended March 31, 2011
Balance at beginning of period	\$ 109,494	\$ 98,671
Provision for portfolio allowances	1,759	6,095
Reversal of prior allowance	(1,386)	(597)
Balance at end of period	\$ 109,867	\$ 104,169

The Company currently utilizes various business channels for the collection of its receivables. The following table summarizes the total collections by collection channel (*in thousands*):

	Three Months Ended March 31,	
	2012	2011
Collection sites	\$ 109,870	\$ 88,541
Legal collections	109,572	88,488
Collection agencies	11,586	13,990
Other		54
	\$ 231,028	\$ 191,073

**Note 7: Deferred Court Costs, Net**

The Company contracts with a nationwide network of attorneys that specialize in collection matters. The Company generally refers charged-off accounts to its contracted attorneys when it believes the related debtor has sufficient assets to repay the indebtedness and has, to date, been unwilling to pay. In connection with the Company's agreement with the contracted attorneys, it advances certain out-of-pocket court costs ( Deferred Court Costs ). The Company capitalizes Deferred Court Costs in its consolidated financial statements and provides a reserve for those costs that it believes will ultimately be uncollectible. The Company determines the reserve based on its analysis of court costs that have been advanced and those that have been recovered. Deferred Court Costs not recovered within three years of placement are fully written-off.

## Edgar Filing: ENCORE CAPITAL GROUP INC - Form 10-Q

Collections received from these debtors are first applied against related court costs with the balance applied to the debtors' account.

Deferred Court Costs for the three-year deferral period consist of the following as of the dates presented (*in thousands*):

	<b>March 31, 2012</b>	<b>December 31, 2011</b>
Court costs advanced	\$ 231,055	\$ 228,977
Court costs recovered	(61,929)	(60,017)
Court costs reserve	(129,287)	(130,454)
	\$ 39,839	\$ 38,506

**Table of Contents****Note 8: Other Assets**

Other assets consist of the following (*in thousands*):

	March 31, 2012	December 31, 2011
Debt issuance costs, net of amortization	\$ 3,827	\$ 4,293
Prepaid expenses	5,500	5,232
Security deposit India building lease	1,630	1,482
Deferred compensation assets	748	722
Prepaid income tax		53
Other	137	186
	\$ 11,842	\$ 11,968

Deferred compensation assets represent monies held in a trust associated with the Company's deferred compensation plan.

**Note 9: Debt**

The Company is obligated under borrowings as follows (*in thousands*):

	March 31, 2012	December 31, 2011
Revolving credit facility	\$314,000	\$305,000
Senior secured notes	75,000	75,000
Capital lease obligations and other	9,246	8,950
	\$398,246	\$388,950

**Revolving Credit Facility**

On April 10 and May 8, 2012, Encore entered into amendments to its revolving credit facility. The amendments added new lenders, appointed a new administrative agent, changed the borrowing base advance rate, increased the aggregate revolving loan commitment by \$145.0 million, from \$410.5 million to \$555.5 million, and reset the accordion feature by an additional \$100.0 million, resulting in a maximum of \$655.5 million that can be borrowed under the facility. Additionally, the May 8, 2012 amendment approved the acquisition discussed in Note 14 - Subsequent Event.

Loan fees and other loan costs associated with the above amendments amounted to approximately \$0.7 million. These costs will be included in other assets in the Company's consolidated statements of financial condition and amortized over the remaining term of the facility.

Provisions of the amended revolving credit facility include:

Interest at a floating rate equal to, at the Company's option, either: (1) reserve adjusted LIBOR, plus a spread that ranges from 350 to 400 basis points, depending on the Company's leverage; or (2) Alternate Base Rate ( ABR ), plus a spread that ranges from 250 to 300 basis points, depending on the Company's leverage. ABR, as defined in the agreement, means the highest of (i) the rate of interest publicly announced by JPMorgan Chase Bank as its prime rate in effect at its principal office in New York City, (ii) the federal funds effective rate from time to time, plus 0.5% and (iii) reserved adjusted LIBOR for a one month interest period on the applicable date, plus 1.0%;

## Edgar Filing: ENCORE CAPITAL GROUP INC - Form 10-Q

\$10.0 million sub-limits for swingline loans and letters of credit;

A borrowing base equal to (1) the lesser of (i) 30% - 35% (depending, as defined in the amendment, on the Company's trailing 12-month cost per dollar collected) of eligible estimated remaining collections, initially set at 33%, and (ii) the product of the net book value of all receivable portfolios acquired on or after January 1, 2005 multiplied by 95%, minus (2) the aggregate principal amount outstanding of the senior secured notes;

Restrictions and covenants, which limit, among other things, the payment of dividends and the incurrence of additional indebtedness and liens;

Repurchases of up to \$50.0 million of Encore's common stock, subject to compliance with certain covenants and available borrowing capacity;

A change of control definition, which excludes acquisitions of stock by Red Mountain Capital Partners LLC, JCF FPK I LP and their respective affiliates of up to 50% of the outstanding shares of Encore's voting stock;

Events of default which, upon occurrence, may permit the lenders to terminate the revolving credit facility and declare all amounts outstanding to be immediately due and payable;

---

**Table of Contents**

An annual capital expenditure maximum of \$12.5 million;

An annual rental expense maximum of \$12.5 million;

An outstanding capital lease maximum of \$12.5 million;

An acquisition limit of \$100.0 million; and

Collateralization by all assets of the Company, other than the assets of Propel (as defined in Note 14 Subsequent Event ). At March 31, 2012, the outstanding balance on the revolving credit facility was \$314.0 million, which bore a weighted average interest rate of 4.15% for the three months ended March 31, 2012. As discussed above, on April 10 and May 8, 2012, Encore entered into amendments to its revolving credit facility thereby increasing the aggregate revolving loan commitment by \$145.0 million.

Subject to compliance with the revolving credit facility, Encore is authorized by its Board to repurchase up to \$50.0 million of its common stock.

***Senior Secured Notes***

As of March 31, 2012, Encore had \$75.0 million in senior secured notes with certain affiliates of Prudential Capital Group. Twenty five million dollars of the senior secured notes bear an annual interest rate of 7.375% and mature in 2018. These notes require quarterly interest only payments through May 2013. Beginning in May 2013, the notes require a quarterly payment of interest plus \$1.25 million of principal. The remaining fifty million dollars of the senior secured notes bear an annual interest rate of 7.75% and mature in 2017 with principal amortization beginning in December 2012. These notes require quarterly interest only payments through December 2012. Beginning in December 2012, the notes require a quarterly payment of interest plus \$2.5 million of principal.

The senior secured notes are guaranteed in full by certain of Encore's subsidiaries and are collateralized by all assets of the Company. The senior secured notes may be accelerated and become automatically and immediately due and payable upon certain events of default, including certain events related to insolvency, bankruptcy or liquidation. Additionally, the senior secured notes may be accelerated at the election of the holder or holders of a majority in principal amount of the senior secured notes upon certain events of default by the Company, including the breach of affirmative covenants regarding guarantors, collateral, most favored lender treatment or minimum revolving credit facility commitment or the breach of any negative covenant. If the Company prepays the senior secured notes at any time for any reason, payment will be at the higher of par or the present value of the remaining scheduled payments of principal and interest on the portion being prepaid. The discount rate used to determine the present value is 50 basis points over the then current Treasury Rate corresponding to the remaining average life. The covenants are substantially similar to those in the revolving credit facility. Prudential Capital Group and the administrative agent for the lenders of the revolving credit facility have an intercreditor agreement related to collateral, actionable default, powers and duties and remedies, among other topics.

***Capital Lease Obligations***

The Company has capital lease obligations primarily for certain computer equipment. As of March 31, 2012, the Company's combined obligations for these computer equipment leases were approximately \$8.3 million. These lease obligations require monthly or quarterly payments through July 2016 and have implicit interest rates that range from zero to approximately 7.7%.

**Note 10: Income Taxes**

The Company recorded an income tax provision of \$7.3 million, reflecting an effective rate of 39.2% of pretax income during the three months ended March 31, 2012. The effective tax rate for the three months ended March 31, 2012 primarily consisted of a provision for federal income taxes of 32.7% (which is net of a benefit for state taxes of 2.3%) and a blended provision for state taxes of 6.5%.

The Company recorded an income tax provision of \$8.6 million, reflecting an effective rate of 38.6% of pretax income during the three months ended March 31, 2011. The effective tax rate for the three months ended March 31, 2011 primarily consisted of a provision for federal income taxes of 32.7% (which is net of a benefit for state taxes of 2.3%), a blended provision for state taxes of 6.7%, and a net benefit for the permanent

## Edgar Filing: ENCORE CAPITAL GROUP INC - Form 10-Q

book versus tax differences of 0.8%.

The Company's subsidiary in India was operating under a tax holiday through March 31, 2011, at which time the tax holiday expired. If there had been no tax holiday for the quarter ended March 31, 2011, the Company would have expensed an additional \$0.6 million in income taxes. The Company's subsidiary in Costa Rica is operating under a 100% tax holiday for the next eight years and a 50% tax holiday for the following four years. The impact of the tax holiday in Costa Rica for the three months ended March 31, 2012 was immaterial.

**Table of Contents**

As of March 31, 2012, the Company had a gross unrecognized tax benefit of \$1.9 million that, if recognized, would result in a net tax benefit of approximately \$1.2 million and would have a positive effect on the Company's effective tax rate. During the three months ended March 31, 2012, there were no material changes to the unrecognized tax benefit.

During the three months ended March 31, 2012, the Company did not provide for the United States income taxes or foreign withholding taxes on the quarterly undistributed earnings from continuing operations of its subsidiary operating outside of the United States. Undistributed earnings of the subsidiary during the three months ended March 31, 2012 and 2011, were approximately \$2.4 million and \$1.9 million, respectively. Such undistributed earnings are considered permanently reinvested.

**Note 11: Purchase Concentrations**

The following table summarizes purchases by seller sorted by total aggregate cost (*in thousands, except percentages*):

	<b>Three Months Ended</b>	
	<b>March 31, 2012</b>	
	<b>Cost</b>	<b>%</b>
Seller 1	\$ 39,789	30.5%
Seller 2	27,792	21.3%
Seller 3	15,335	11.8%
Seller 4	13,642	10.5%
Seller 5	7,864	6.0%
Other sellers	26,041	19.9%
	<b>\$ 130,463</b>	<b>100.0%</b>
Adjustments <sup>(1)</sup>	(60)	
Purchases, net	<b>\$ 130,403</b>	

<sup>(1)</sup> Adjusted for Put-backs and Recalls.

**Note 12: Commitments and Contingencies****Litigation**

The Company is involved in disputes and legal actions from time to time in the ordinary course of business. The Company, along with others in its industry, is routinely subject to legal actions based on the Fair Debt Collection Practices Act ( FDCPA ), comparable state statutes, the Telephone Consumer Protection Act ( TCPA ), state and federal unfair competition statutes and common law causes of action. The violations of law alleged in these actions often include claims that the Company lacks specified licenses to conduct its business, attempts to collect debts on which the statute of limitations has run, has made inaccurate assertions of fact in support of its collection actions and /or has acted improperly in connection with its efforts to contact consumers. These cases are frequently styled as supposed class actions. In addition, from time to time, the Company is subject to litigation and other actions by governmental bodies, including formal and informal investigations relating to its collection activities by the Federal Trade Commission, state attorneys general and other governmental bodies, with which the Company cooperates.

There has been no material development in any of the legal proceedings disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2011.

In certain legal proceedings, the Company may have recourse to insurance or third party contractual indemnities to cover all or portions of its litigation expenses, judgments or settlements. In accordance with authoritative guidance, the Company records loss contingencies in its financial statements only for matters in which losses are probable and can be reasonably estimated. Where a range of loss can be reasonably estimated with no best estimate in the range, the Company records the minimum estimated liability. The Company continuously assesses the potential liability related to the Company's pending litigation and revises its estimates when additional information becomes available. The Company's legal costs are recorded to expense as incurred.

*Purchase Commitments*

In the normal course of business, the Company enters into forward flow purchase agreements and other purchase commitment agreements. As of March 31, 2012, the Company has entered into agreements to purchase receivable portfolios with a face value of approximately \$3.3 billion for a purchase price of approximately \$142.2 million. The Company has no purchase commitments extending past one year.



**Table of Contents****Note 13: Goodwill and Identifiable Intangible Assets**

In accordance with authoritative guidance, goodwill is tested at the reporting unit level annually for impairment and in interim periods if certain events occur indicating the fair value of a reporting unit may be below its carrying value.

The Company has two reporting units that carry goodwill: portfolio purchasing and recovery and bankruptcy servicing. Annual testing is performed on October 1<sup>st</sup> for the portfolio purchasing and recovery reporting unit and on August 31<sup>st</sup> for the bankruptcy servicing reporting unit.

During the first quarter of 2012, the Company's subsidiary, Ascension (which is determined to be the bankruptcy servicing reporting unit for the purpose of goodwill impairment testing), experienced uncertainty surrounding a material client's contract renewal. The client agreed to renew the contract, provided that Ascension enters into an agreement with a specified third party to make or facilitate the technology improvements required by the client. On May 7, 2012, the Board approved a plan to sell Ascension. At this time, the Company has reached an agreement in principle to sell Ascension to the third party. As part of the sale, Ascension's new owner will invest in new technology and apply the bankruptcy servicing expertise necessary for Ascension to compete more effectively, and the Company has agreed to cover normal operating losses in the first year of ownership. If the business grows and becomes profitable, the Company will be paid an earn-out equal to 30 to 40% of Ascension's EBITDA for the first five years after closing. In connection with the preparation of its financial statements and based, in part, on these developments, the Company performed an interim goodwill impairment test for Ascension as of March 31, 2012. The goodwill impairment test is a two-step process. First, the Company estimated the fair value of Ascension by considering the proposed selling price to the potential buyer. The result of this analysis indicated that Ascension's carrying value exceeded its fair value. Therefore, the Company measured the amount of impairment charge by comparing the implied fair value of the goodwill with the carrying value of that goodwill. Based on the proposed selling price, the Company concluded that the entire goodwill balance of \$9.9 million for Ascension was impaired as of March 31, 2012. Additionally, the Company wrote-off the remaining identifiable intangible assets of approximately \$0.4 million at Ascension. Beginning in the second quarter of 2012, and regardless of whether the sale discussed above is completed, Ascension will be treated as a discontinued operation.

As a result, the Company recognized a pre-tax impairment charge for goodwill and identifiable intangible assets of \$10.3 million, or \$0.25 per diluted share, after the effect of income taxes during the three months ended March 31, 2012.

The Company's acquired intangible assets are summarized as follows (*in thousands*):

	As of March 31, 2012			As of December 31, 2011		
	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount	Gross Carrying Amount	Accumulated Amortization	Net Carrying Amount
Intangible assets subject to amortization:						
Customer relationships and other	\$	\$	\$	\$ 6,000	\$ (5,538)	\$ 462
Intangible assets not subject to amortization:						
Goodwill - portfolio purchasing and recovery			\$ 6,047			\$ 6,047
Goodwill - bankruptcy servicing						9,938
Total goodwill			\$ 6,047			\$ 15,985

**Note 14: Subsequent Event**

On May 8, 2012, the Company acquired all of the outstanding equity of Propel Financial Services, LLC, and certain of its affiliates (Propel) for \$186.8 million in cash. Propel provides property tax solutions to customers in the state of Texas by paying real estate taxes on behalf of owners of real property in Texas in exchange for notes collateralized by tax liens on the property. The Company financed the acquisition through a new \$160.0 million syndicated loan facility (the Propel Facility), the Company's existing revolving credit facility and cash on hand. The Propel Facility will be used to fund a portion of the purchase price and to fund future growth at Propel. The Propel Facility has a three year term and includes the following key provisions:

Interest at Propel's option, at either: (1) LIBOR, plus a spread that ranges from 300 to 375 basis points, depending on Propel's leverage; or (2) Prime, plus a spread that ranges from 0 to 75 basis points, depending on Propel's leverage;

A borrowing base of 90% of the face value of the tax lien collateralized notes;

Interest payable monthly; principal and interest due at maturity; and

A \$40.0 million accordion feature.

The Propel Facility is collateralized by the tax lien collateralized notes and requires Propel to maintain various financial covenants, including a minimum interest coverage ratio and a maximum cash flow leverage ratio.

---

**Table of Contents****Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations**

*This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the securities laws. The words believe, expect, anticipate, estimate, project, intend, plan, will, may and similar expressions often characterize forward-looking statements. These statements may include, but are not limited to, projections of collections, revenues, income or loss, estimates of capital expenditures, plans for future operations, products or services and financing needs or plans, as well as assumptions relating to these matters. Although we believe that the expectations reflected in these forward-looking statements are reasonable, we caution that these expectations or predictions may not prove to be correct or we may not achieve the financial results, savings or other benefits anticipated in the forward-looking statements. These forward-looking statements are necessarily estimates reflecting the best judgment of our senior management and involve a number of risks and uncertainties, some of which may be beyond our control or cannot be predicted or quantified, that could cause actual results to differ materially from those suggested by the forward-looking statements. Many factors, including but not limited to those set forth in this Quarterly Report on Form 10-Q under Part II, Item 1A. Risk Factors and in our Annual Report on Form 10-K under Part I, Item 1A. Risk Factors, could cause our actual results, performance, achievements or industry results to be very different from the results, performance, achievements or industry results expressed or implied by these forward-looking statements. Our business, financial condition or results of operations could also be materially and adversely affected by other factors besides those listed. Forward-looking statements speak only as of the date the statements were made. We do not undertake any obligation to update or revise any forward-looking statements to reflect new information or future events, or for any other reason, even if experience or future events make it clear that any expected results expressed or implied by these forward-looking statements will not be realized. In addition, it is generally our policy not to make any specific projections as to future earnings, and we do not endorse projections regarding future performance that may be made by third parties.*

**Introduction**

We are a leader in consumer debt buying and recovery. We purchase portfolios of defaulted consumer receivables at deep discounts to face value based on robust, account-level valuation methods, and employ a suite of proprietary statistical and behavioral models when building account collection strategies. We use a variety of operational channels to maximize our collections from the portfolios that we purchase, including seeking to partner with individuals as they repay their obligations and work toward financial recovery. In addition, we provide bankruptcy support services to some of the largest companies in the financial services industry through our wholly owned subsidiary, Ascension. On May 7, 2012, our Board of Directors (the Board) approved a plan to sell Ascension. At this time, we have reached an agreement in principle to sell Ascension to a third party. See Note 13 Goodwill and Identifiable Intangible Assets to our unaudited condensed consolidated financial statements for a further discussion.

While seasonality does not have a material impact on our business, collections are generally strongest in our first calendar quarter, slower in the second and third calendar quarters, and slowest in the fourth calendar quarter. Relatively higher collections in the first quarter could result in a lower cost-to-collect ratio compared to the other quarters, as our fixed costs would be constant and applied against a larger collection base. The seasonal impact on our business may be influenced by our purchasing levels, the types of portfolios we purchase, and our operating strategies.

Collection seasonality can also impact our revenue recognition rate. Generally, revenue for each pool group declines steadily over time, whereas collections can fluctuate from quarter to quarter based on seasonality, as described above. In quarters with lower collections (like the fourth calendar quarter), revenue as a percentage of collections can be higher than in quarters with higher collections (like the first calendar quarter).

In addition, seasonality could have an impact on the relative level of quarterly earnings. In quarters with stronger collections, total costs are higher, as a result of the additional efforts required to generate those collections. Since revenue for each pool group declines steadily over time, in quarters with stronger collections and higher costs (like the first calendar quarter), all else being equal, earnings could be lower than in quarters with slower collections and lower costs (like the fourth calendar quarter). Additionally, in quarters where a greater percentage of collections come from our legal and agency outsourcing channels, cost to collect will be higher than if there were more collections from our internal collection sites.

**Market Overview**

While there has been improvement in macroeconomic indicators during the last three months, a broad economic recovery has yet to fully materialize for the U.S. consumer. Slow job growth, uncertainty over state and federal taxes and limited credit availability continue to challenge U.S. consumers, as demonstrated by weak consumer spending and volatile but rising consumer confidence levels. Within the credit card space, delinquency levels have improved at a rate that may indicate a fundamental improvement in consumer financial strength. However, related measures, like personal bankruptcies and home foreclosures, remain elevated and indicate continued near-term pressure on the average consumer.



## Table of Contents

Despite this macroeconomic uncertainty through the first quarter of 2012, most of our internal collection metrics were consistent with, or better than, what we observed during the same periods in 2010 and 2011. To illustrate, payer rates and average payment size, adjusted for changes in the mix of settlements-in-full versus payment plans, remained consistent. As compared to prior years, more of our consumers continue to opt to settle their debt obligations through payment plans as opposed to one-time settlements. Settlements made through payment plans impact our recoveries in two ways. First, the delay in cash flows from payments received over extended time periods may result in a provision for portfolio allowance. When a long-term payment stream (as compared to a one-time payment of the same amount) is discounted using a pool group's internal rate of return, or IRR, the net present value is lower. In other words, despite the absolute value of total cash received being identical in both scenarios, accounting for the timing of cash flows in a payment plan yields a lower net present value, which, in turn, can result in a provision for portfolio allowance. Second, payment plans inherently contain the possibility of consumers failing to complete all scheduled payments, which we term a broken payer.

The rate at which consumers are honoring their obligations and completing their payment plans has continued to increase over the last 12 months. We believe this is the result of two factors: our commitment to partner effectively with consumers during their recovery process and the strength of our analytic platform, which allows us to make accurate and timely decisions about how best to maximize our portfolio returns. Nevertheless, payment plans may still produce broken payers that fail to fulfill all scheduled payments. When this happens, we are often successful in getting the consumer back on plan, but this is not always the case, and in those instances where we are unable to do so, we may experience a shortfall in recoveries as compared to our initial forecasts. Please refer to Management's Discussion and Analysis Revenue below for a more detailed explanation of the provision for portfolio allowances.

### **Purchases and Collections**

#### *Purchases by Type*

The following table summarizes the types of charged-off consumer receivables portfolios we purchased for the periods presented (*in thousands*):

	<b>Three Months Ended March 31,</b>	
	<b>2012</b>	<b>2011</b>
Credit card	\$ 107,935	\$ 87,991
Telecom	22,528	1,236
Consumer bankruptcy receivables <sup>(1)</sup>		1,448
	<b>\$ 130,463</b>	<b>\$ 90,675</b>

<sup>(1)</sup> Represents portfolio receivables subject to Chapter 13 and Chapter 7 bankruptcy proceedings acquired from issuers.

During the three months ended March 31, 2012, we invested \$130.5 million to acquire charged-off credit card and telecom portfolios, with face values aggregating \$2.9 billion, for an average purchase price of 4.5% of face value. This is a \$39.8 million increase, or 43.9%, in the amount invested, compared with the \$90.7 million invested during the three months ended March 31, 2011, to acquire charged-off credit card portfolios with a face value aggregating \$2.9 billion, for an average purchase price of 3.1% of face value.

Average purchase price, as a percentage of face value, varies from period to period depending on, among other things, the quality of the accounts purchased and the length of time from charge off to the time we purchase the portfolios.

#### *Collections by Channel*

During the three months ended March 31, 2012 and 2011, we utilized numerous business channels for the collection of charged-off credit card receivables and other charged-off receivables. The following table summarizes gross collections by collection channel (*in thousands*):

**Three Months Ended March 31,**  
**2012**                      **2011**

Edgar Filing: ENCORE CAPITAL GROUP INC - Form 10-Q

Collection sites	\$ 109,870	\$ 88,541
Legal collections	109,572	88,488
Collection agencies	11,586	13,990
Other		54
	\$ 231,028	\$ 191,073

Gross collections increased \$39.9 million, or 20.9%, to \$231.0 million during the three months ended March 31, 2012, from \$191.1 million during the three months ended March 31, 2011.

**Table of Contents****Results of Operations**

Results of operations in dollars and as a percentage of total revenue were as follows (*in thousands, except per share amounts and percentages*):

	Three Months Ended March 31,			
	2012		2011	
<b>Revenues</b>				
Revenue from receivable portfolios, net	\$ 126,405	97.1%	\$ 105,326	95.5%
Servicing fees and related revenue	3,817	2.9%	4,977	4.5%
<b>Total revenues</b>	<b>130,222</b>	<b>100.0%</b>	<b>110,303</b>	<b>100.0%</b>
<b>Operating expenses</b>				
Salaries and employee benefits (excluding stock-based compensation expense)	23,109	17.8%	19,040	17.3%
Stock-based compensation expense	2,266	1.7%	1,765	1.6%
Cost of legal collections	38,635	29.7%	36,509	33.1%
Other operating expenses	12,411	9.5%	10,096	9.1%
Collection agency commissions	3,959	3.0%	3,914	3.5%
General and administrative expenses	14,132	10.9%	10,169	9.2%
Depreciation and amortization	1,363	1.0%	1,053	1.0%
Impairment charge for goodwill and identifiable intangible assets	10,349	8.0%		0.0%
<b>Total operating expenses</b>	<b>106,224</b>	<b>81.6%</b>	<b>82,546</b>	<b>74.8%</b>
<b>Income from operations</b>	<b>23,998</b>	<b>18.4%</b>	<b>27,757</b>	<b>25.2%</b>
<b>Other (expense) income</b>				
Interest expense	(5,515)	(4.2)%	(5,593)	(5.1)%
Other income	267	0.2%	116	0.1%
<b>Total other expense</b>	<b>(5,248)</b>	<b>(4.0)%</b>	<b>(5,477)</b>	<b>(5.0)%</b>
<b>Income before income taxes</b>	<b>18,750</b>	<b>14.4%</b>	<b>22,280</b>	<b>20.2%</b>
<b>Provision for income taxes</b>	<b>(7,344)</b>	<b>(5.6)%</b>	<b>(8,601)</b>	<b>(7.8)%</b>
<b>Net income</b>	<b>\$ 11,406</b>	<b>8.8%</b>	<b>\$ 13,679</b>	<b>12.4%</b>
<b>Earnings per diluted share</b>	<b>\$ 0.44<sup>(1)</sup></b>		<b>\$ 0.54</b>	

<sup>(1)</sup> Includes a \$0.25 effect related to a one-time, non-cash charge of \$10.3 million (\$6.3 million after the effects of income taxes) associated with the impairment of Ascension's goodwill and identifiable intangible assets.

**Comparison of Results of Operations****Revenue**

Our revenue consists primarily of portfolio revenue and bankruptcy servicing revenue. Portfolio revenue consists of accretion revenue and zero basis revenue. Accretion revenue represents revenue derived from pools (quarterly groupings of purchased receivable portfolios) with a cost basis that has not been fully amortized. Revenue from pools with a remaining unamortized cost basis is accrued based on each pool's effective interest rate applied to each pool's remaining unamortized cost basis. The cost basis of each pool is increased by revenue earned and decreased by gross collections and portfolio allowances. The effective interest rate is the internal rate of return derived from the timing and amounts of actual cash received and anticipated future cash flow projections for each pool. All collections realized after the net book value of a portfolio has been fully recovered, or Zero Basis Portfolios, are recorded as revenue, or Zero Basis Revenue. We account for our investment in receivable

## Edgar Filing: ENCORE CAPITAL GROUP INC - Form 10-Q

portfolios utilizing the interest method in accordance with the authoritative guidance for loans and debt securities acquired with deteriorated credit quality. Servicing fee revenue is revenue primarily associated with bankruptcy servicing fees earned from Ascension, a provider of bankruptcy services to the finance industry.



**Table of Contents**

The following tables summarize collections, revenue, end of period receivable balance and other related supplemental data, by year of purchase (in thousands, except percentages):

	Three Months Ended March 31, 2012					As of March 31, 2012	
	Collections <sup>(1)</sup>	Gross Revenue <sup>(2)</sup>	Revenue Recognition Rate <sup>(3)</sup>	Net (Portfolio Allowance) Reversal	Revenue % of Total Revenue	Unamortized Balances	Monthly IRR
ZBA <sup>(4)</sup>	\$ 7,065	\$ 6,032	85.4%	\$ 1,033	4.8%	\$	
2005	3,431	1,319	38.4%	(78)	1.0%	6,114	5.7%
2006	3,769	2,505	66.5%	(1,119)	2.0%	15,010	5.1%
2007	5,050	2,737	54.2%	(209)	2.2%	15,960	5.1%
2008	17,313	9,045	52.2%		7.1%	49,979	5.4%
2009	32,578	20,738	63.7%		16.3%	76,589	8.0%
2010	63,996	37,098	58.0%		29.3%	164,036	6.7%
2011	85,220	41,924	49.2%		33.1%	291,099	4.9%
2012	12,586	5,380	42.7%		4.2%	122,793	3.5%
Total	\$ 231,008	\$ 126,778	54.9%	\$ (373)	100.0%	\$ 741,580	5.4%

	Three Months Ended March 31, 2011					As of March 31, 2011	
	Collections <sup>(1)</sup>	Gross Revenue <sup>(2)</sup>	Revenue Recognition Rate <sup>(3)</sup>	Net (Portfolio Allowance) Reversal	Revenue % of Total Revenue	Unamortized Balances	Monthly IRR
ZBA <sup>(4)</sup>	\$ 3,617	\$ 3,020	83.5%	\$ 597	2.7%	\$	
2004	1,103	180	16.3%		0.2%	242	6.6%
2005	5,471	2,741	50.1%	(603)	2.5%	13,983	5.6%