COMMENTARY

November 14, 2014

Dear clients and colleagues,

Credit card debt is the third largest source of household indebtedness in the US behind mortgages and student loans. At its peak in July 2008, US consumer credit card debt was equal to Mexico's annual GDP - about $1 trillion. However, as of August 2014, American credit card debt has been reduced to $880B. Therefore, one could conclude that consumers are paying off their debt; however, the rising number of defaults is a major contributor to this trend. Banks and credit card companies have been forced to write off seriously delinquent debts, which are then sold to debt collectors.

History of Debt Buying

During the savings and loan crisis of the late 1980s, $500B in unpaid loans were auctioned off. The success of these transactions persuaded others to sell delinquent debt. Bank of America sold the first credit card receivables in 1989. Since then, the amount of debt sold in the US has increased from $700M in 1993 to $51B in 2011, according to the Nilson Report.

Regulatory Environment

Currently the amount of debt sold is low due to new regulations requiring a higher level of compliance from both buyers and sellers. However, as these new regulations come into effect, we anticipate only best-in-class buyers will survive, resulting in less competition. There is no added value for banks to hold on to their non-performing loans.

This week we shall introduce you to one of our holding which is ideally positioned to benefit from this trend. The company is PRA Group.

PRA Group (PRAA US – $61.71)
http://www.pragroup.com

Business Overview

PRA Group is based in Norfolk, Virginia and was formed in 1996. It is the largest, publicly traded distressed consumer debt buyer in the US. They buy written-off credit card receivables and other debts and then collect them. Basically, PRA buys debt for $0.05-$0.10 on the dollar and recovers approximately $0.12- $0.14 on the dollar. Historically, PRA has collected 2.5x - 3x its purchase price.

Ten percent of PRA’s revenue is derived from activities outside of distressed consumer debt such as:

1) Asset location service for auto insurance companies, where they help to locate a missing asset.

2) Helping local towns and governments in collecting unpaid taxes and fees.

3) Assisting with class action claims.

What sets PRA apart from other debt collectors is its focus on data analytics. The company scores each debtor on an array of metrics, such as if they have purchased a new cell phone or the zip code in which they live. They then contact only the top quartile of the debtors who are able to pay, but have chosen not to, rather than pursuing consumers who cannot afford to make the payment.

PRA does not use outsourced call centers. Every call is monitored to ensure agents follow an approved script. This also ensures quality and helps build trust with clients - after all, one could argue that the agent is acting more as an advisor in helping the client get back on track with debt payments. In fact, PRA uses Nice Systems (another one of our holdings) for data analytics and to monitor call quality.

Target Market

- $2.8T in US consumer debt and $1.6T in European non-performing consumer loans
- Market for credit card charge-offs has grown at CAGR of 20% from 1996 to 2003
- Other assets, such as telecom, utility, healthcare and auto, can be emerging opportunities

PRA's Competitive advantages

- Deep data set allows accurate underwriting and better collection (focus on who can pay)
- $4.3B existing book of business in 15 markets globally gives scale
- Buying debt directly from issuer rather than re-trade market reduces risk
- Purchases and collects traditional charged-off and Chapter 13 bankruptcy receivables

Growth strategy

- Gain market share
- International markets (South America, Australia)

Supply Demand dynamics

- Shrinking as regulators tighten rules. Five largest debt buyers account for about 81% of purchases, up from only 35% in 2000.
- Debt sellers want stronger compliance and no re-selling or outsourcing from debt buyers. A positive for PRA.

Management

The CEO and CFO are founders of PRA and together own about 2% of the company. Coming from humble beginnings, the four original founders gave up 98% of ownership in order to raise $5M to make PRA a reality. The company finally raised $20M and is today worth $3.1B. As a result, the founders have a small piece but of a much bigger pie.

Risks

- Regulations
- Banks hold on to non-performing loans
- Pricing of non-performing loans gets irrational

Market Data
Market Cap $1.4B, P/E (2016) 23.1x, ev/sales (2016) 0.9x, ev/ebitda (2016) 9.6x.

Have a great weekend.

The Global Alpha team