Encore Capital Group, Inc.
Fourth Quarter Conference Call Prepared Remarks
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Adam Sragovicz, Director of Finance & Treasury

Thank you, [Operator]. Good afternoon and welcome to Encore Capital Group's fourth quarter and full-year 2011 earnings call. With me on the call today are Brandon Black, our President and Chief Executive Officer, and Paul Grinberg, our Executive Vice President and Chief Financial Officer. Brandon and Paul will make prepared remarks, and then follow with a question and answer period.

Before we begin, we have a few housekeeping items to take care of. Throughout this conference call, we will use forward-looking statements, including predictions, expectations, estimates, or other information that might be considered forward-looking. While these forward-looking statements represent our current judgment, these statements are also subject to risks and uncertainties that may cause actual results to differ materially from statements being made today. As a result, we caution you against placing undue reliance on these forward-looking statements, which speak only as of the date they are made. We will also use rounding and abbreviations in our conference call for the sake of brevity. For more detailed numbers and explanations, please refer to our Form 10-K that was filed today with the SEC.

We will also be referencing both GAAP and non-GAAP financial results. We believe certain non-GAAP financial measures provide useful information about our business. However, the presentation of this additional information should not be considered an alternative to, or more meaningful than, our results prepared in accordance with GAAP. Management utilizes Adjusted EBITDA, which is similar to a financial measure contained in covenants used in our credit agreement, in the evaluation of our operations, and believes this measure is a useful indicator of our ability to generate cash collections in excess of operating expenses through the liquidation of our receivable portfolios. We included information concerning adjusted operating expenses excluding stock-based compensation expense and bankruptcy servicing operating expenses in order to facilitate a comparison of approximate cash costs to cash collections for the debt purchasing business in the periods presented. Once again, please be sure to see our 10-K, 10-Q, and other SEC filings, including a press release issued as an exhibit to our Current Report on Form 8-K filed today, for a more complete discussion of these factors and other risks.

As a reminder, this conference call will also be available for replay on the Investors section of our website, and we also plan to post the prepared remarks following the conclusion of this call.

With that, let me turn the call over to Brandon Black, our President and Chief Executive Officer.

Brandon Black – President and CEO:

Thank you, Adam, and good afternoon, everyone. I appreciate you joining us for a discussion of Encore's results for the fourth quarter and full-year 2011. Before beginning, I would like to recognize and thank Encore's 2,200 employees for a fantastic quarter and a record year. Our results are a direct reflection of their collective effort and I appreciate all of their hard work.

Throughout 2011, the Company was able to produce consistently strong results, with contributions coming from all of our collection channels. We have achieved these results while investing in areas we believe will provide long-term strategic advantages and build upon our industry-leading debt purchasing and recovery platform. Our deliberate and disciplined approach to portfolio underwriting and management led to record earnings, collections, and operating cash flow for the fourth quarter and the year.

Cash collections for the quarter were $186 million, which was a 25% increase over the 4th quarter of 2010. Looking at consumer behavior, we saw payer rates and payment sizes remain consistent as compared to prior periods. The strong collections were the result of our ability to identify and engage with those consumers with the greatest likelihood of recovery, even in this seasonally weak collection period.

When compared to the same period last year, our overall cost-to-collect in the fourth quarter decreased 30 basis points to 44.1%. This decrease reflects savings from various operational strategies, which were partially offset by investments in our Internal Legal initiative, the ramp up of our new operating site in Costa Rica, and additional spending required to manage the changing regulatory and legislative environment.

The success of our business has allowed us to increase both our domestic and international headcounts. We are pleased that we have continued to hire here in the United States during a time of economic uncertainty for many in the domestic labor force.

At the end of the fourth quarter, our U.S. operations employed 800 people up 17% from the end of last year. Similarly, the total number of employees in India increased by 18%, to 1,400 at the end of 2011. During 2011 we added incremental office space both in San Diego and in India, where we can accommodate an additional 450 employees.

One of our most noteworthy accomplishments during the fourth quarter was in the area of purchasing. We successfully deployed $137 million during the quarter, making it the largest purchasing quarter in the company's history. Our purchases consisted of 67 individual transactions from 15 unique sellers. Completing that many transactions isn't an easy task, as it requires precise coordination between our business development, information technology, accounting, finance and valuation teams. Each group did their job flawlessly in the fourth quarter and they have positioned us well going into 2012.The majority of our purchases, or $117 million, went toward the purchase of credit card and consumer loan portfolios. The balance of nearly $20 million was spent on telecommunication receivables. As we mentioned previously, we continue to deploy capital in those asset classes which we believe will yield the strongest returns. Telecommunications is one such asset class, where the efficiency of our collections platform enables us to apply effort to small balance accounts at a cost that is lower than many of our competitors'.

Total purchases for the year were $387 million dollars. This is a $25 million increase compared to 2010 and in line with the guidance that we provided in June at our annual shareholder meeting and investor day.

From a market perspective, portfolio pricing trends remain consistent, with moderate year-over-year increases across all types and ages of portfolios. Despite those increases, we have been able to find mismatches between portfolio returns and market clearing prices, and we will continue to capitalize upon these.

Following up on the strategic initiatives announced in June, our Internal Legal and near-shore call center projects are progressing nicely. Within our Internal Legal channel, we are now operational in five states and are planning to add five additional states in 2012. Our collections are tracking to plan and we are continuing to customize the underlying technology platform, which should give us substantial leverage in the future.

We are also pleased to report that we have completed the build-out of our operating site in Costa Rica, hired and trained our first group of account managers, and started collection efforts last week. Our extraordinary team worked tirelessly over the past few months to get the site operational in time for the seasonally strong first quarter.

Also of note, during the fourth quarter, Encore announced the launch of the Consumer Credit Research Institute, or CCRI. The CCRI is a research organization dedicated to better understanding financially distressed consumers' decisions, choices, and activities.

This work represents an industry-first effort by Encore to differentiate and describe an important, and often neglected, consumer segment. By partnering with leading universities, non-profit organizations, and governmental agencies, we hope the CCRI will advance thinking in the areas of public policy, financial education, and business operations.

Encore's relationship to low- and middle-income American consumers provides a unique perspective on household consumption and saving behavior, and the CCRI's research will increase knowledge about the consumers with whom we work.

Increasingly, developments like our Consumer Bill of Rights and the CCRI are allowing Encore to have differentiated discussions with regulators and legislators. 2012 is likely to be another year of public focus on the finance industry and our goal is to be one of the leaders that help shape the dialogue about the industry's future. Our proactive efforts to engage in conversations with federal and state regulators and legislators have begun to pay off and we expect to increase those efforts in 2012.

A recent example of the benefits from this approach occurred last month here in California with Senate Bill 890, which is designed to protect the rights of consumers whose accounts are acquired by debt collectors. The current language in the bill is very different from the initial draft and is the direct result of collaborative negotiations between Encore, the bill's sponsor, the attorney general's office and other industry representatives. In fact, members of our government relations team were in touch with the authors working on language changes in the final hours before its submission to the floor. It is this kind of partnership that will allow thoughtful regulation to be enacted around the collection industry. We appreciate the partnership and we expect to continue working with the Attorney General's office and the Senator's staff as the bill moves through the Assembly.

Finally, before turning the call over to Paul, I would also like to highlight two changes to our Board of Directors. First, Norman Sorensen was appointed to the Board back in December. Norman is the retiring chairman of Principal International, the International Asset Management and Accumulation division of the Principal Financial Group. Previously, he was a senior executive at AIG and held a number of senior international marketing and general management positions at Citigroup and at American Express. Moreover, Norman is a director of Sara Lee Corporation.

Norman has significant experience developing and nurturing consumer financial services products around the world. He will bring valuable perspective to the management team and the Board, and we believe Encore will benefit from his deep experience in corporate governance.

Additionally, John Oros resigned his position on the Board effective February 7th. John joined our Board shortly after J.C Flowers made their investment in Encore back in 2007. Since then, John has been a dedicated, insightful board member who has partnered with the management team to shape the strategic direction of the company and helped us navigate through this difficult economic cycle. His presence will be missed, but we understand the decision to leave now that J.C. Flowers has sold the majority of their investment.

With that, I will turn it over to Paul who will discuss our financial results in more detail.

Paul …

Paul Grinberg – EVP and CFO

Thank you, Brandon.

As Brandon discussed, we had a very strong 2011.

Collections reached an all-time high for a fourth quarter and the continued investments in our operating platform give us confidence in our ability to expand upon the operating leverage created over the past few years. We generated earnings of 67 cents per fully diluted share during the quarter, an increase of 20% over the fourth quarter of 2010. For 2011, we generated earnings of $2.37 per share, an increase of 22% over 2010.

Adjusted EBITDA, which represents the cash we generate that is available for future purchases, capital expenditures, debt service and taxes, was $105 million in the fourth quarter, an increase of 25% compared to the fourth quarter of 2010. This strong cash flow allowed us to fund a significant portion of our portfolio acquisitions during the quarter. In fact, our debt levels at year end increased by only $3.7 million from the prior year, despite purchases of over $380 million. As a result of our strong financial performance, we have kept borrowing costs at the lowest rate tier possible under the terms of our credit facility.

Our overall cost-to-collect decreased 150 basis points to 42.2% in 2011, down significantly from 43.7% in 2010. We achieved these results even as we made investments to expand our Internal Legal channel and launch our new operations center in Costa Rica. As I've mentioned previously, our goal is to maximize dollars collected less dollars spent, not minimize the ratio of dollars spent to dollars collected, and, where we can generate incremental collections, we will do so even when it may entail a slightly higher cost-to-collect.

Overall, we expect our cost-to-collect to continually improve, but it will fluctuate from quarter to quarter based on seasonality, the level of our investment in new operating initiatives, as well as ongoing legal costs. In 2012, we expect to invest 20 cents and 5 cents per share, respectively, in our Internal Legal platform and near-shore site in Costa Rica. We anticipate that these investments will contribute positively to our long-term financial performance.

Due primarily to the large purchasing volume and the strong performance of portfolios purchased over the last couple of years, our Estimated Remaining Collections, or ERC, at December 31st, increased by $182 million over the prior year, to approximately $1.6 billion. As we've discussed previously, we believe that our ERC, which reflects the estimated remaining value of our existing portfolios, is conservatively stated because of our cautious approach to setting initial curves and our practice of only increasing future expectations after a sustained period of over-performance.

As mentioned at the beginning of the call, fourth quarter collections were very strong, at $186 million, up 25% from $149 million for the fourth quarter of 2010. Our call centers contributed 43% of total collections, or $80 million, as compared to $69 million in 2010. Direct cost per dollar collected in our call centers declined to 7.4% for the fourth quarter of 2011, from 9.6% in 2010. For the full year, collections were $761 million, up 26% from 2010's $605 million. Just to put these numbers in context, in 2011 we collected over twice as much as we collected in 2007, during a period when the industry was in turmoil and the macroeconomic environment was extremely challenging.

This improvement is largely the result of enhancements in our analytical models, which allow us to focus our efforts on those consumers who we believe have the ability and are most likely to pay, and the growth of our operations center in India. In the fourth quarter of 2011, India accounted for 52% of total call center collections, as compared to 46% in the fourth quarter of 2010.

Legal channel collections grew to $96 million in the fourth quarter, compared to $70 million in 2010, and accounted for 52% of total collections. Cost-to-collect in the legal channel for the fourth quarter of 2011 was 41.4%, down from 42.4% in the fourth quarter of 2010. For the full year, legal collections grew to $377 million compared to $267 million in 2010, and accounted for 50% of total collections.

We are often asked about the growth in our legal channel. The growth in legal channel collections is primarily attributable to the continued refinement of our analytic capabilities and increased ability to predict consumer behavior, which has allowed us to become more precise about when to pursue litigation. It is not the result of increased volumes of accounts going through this channel. In fact, we have not grown the volume of placements in the legal channel for the last two years, and are not expecting to in 2012.

I'd like to reiterate that our long-stated preference is to work with our consumers to negotiate a mutually acceptable payment plan, which is tailored to their personal financial situation. These plans almost always involve substantial discounts from what is owed to us. We not only believe that this is the right thing to do for our consumers, but it is the right thing to do for our business.

Another impact of our refined placement strategy is a lower overall cost to collect. Cost-to-collect in the legal channel in 2011 was 41.6%, down meaningfully from 45.4% in 2010. We also incurred approximately $1.6 million in costs this quarter associated with the build-out of our Internal Legal platform.

Finally, 6% of collections came from third-party collection agencies. We expect collections from this channel to continue to decline as we shift more of our work to our internal call centers at a lower overall cost-to-collect.

Consistent with our stated practice and in keeping with our Consumer Bill of Rights, we had no portfolio sales in the fourth quarter.

Moving on, revenue from receivable portfolios in the fourth quarter was $116 million, an increase of 22% over the $96 million in 2010. As a percentage of collections, and excluding the effects of allowances, the revenue recognition rate was 64%, as compared to 68% in the fourth quarter of 2010. For the full year, revenue from receivable portfolios was $449 million, an increase of 23% over the $364 million in 2010.

Our revenue recognition rate is attributable to our cautious approach to setting initial IRRs and our policy of increasing them gradually, after periods of over-performance. For example, as a result of sustained over-performance, we have slowly increased the multiples on the 2009 and 2010 vintages over time, to 2.7 and 2.5 times respectively, up from 2.4 and 2.1 times, respectively.

Another byproduct of the accounting method we use is that revenue does not fluctuate from quarter to quarter in line with collections. Other than the impact of new purchases and allowance charges, revenue is relatively consistent from quarter to quarter. So in periods with seasonally strong collections, the additional costs incurred to generate those collections may result in lower earnings than in periods with seasonally weaker collections, when collection costs are lower. Accordingly, earnings are typically lower in the seasonally strong first quarter and higher in the fourth quarter.

During the fourth quarter of 2011, we expensed $2.7 million in net allowance charges, compared to $5.4 million in the comparable period of 2010. Looking at the breakdown by year, we had $100,000 of allowances in the 2005 vintage, $1.9 million in the 2006 vintage, $1 million in the 2007 vintage and $1.3 million in the 2008 vintage.

These allowances were offset by $1.6 million in reversals. We had no allowance charges for the 2009, 2010 or 2011 vintages in the quarter, as has been the case since we acquired these portfolios. This quarter, we over-performed our forecasted collection curves by 16%.

As many of you know, we account for the business on a quarterly pool basis, not at an overall level. When pools under-perform, we take allowance charges, which are reflected as an immediate reduction in revenue. We measure under-performance against the current yield that is assigned to a pool, not its original expectation. This pool-by-pool level accounting treatment leads inevitably to non-cash allowance charges in certain periods, even when we are over-performing a pool's initial expectations.

In contrast, when pools over-perform, that over-performance is not reflected immediately. Once we have evidence of sustained over-performance in a pool, we will increase that pool's yield.

Unlike allowance charges, which are realized immediately, this increased yield will be reflected as increased revenue in the current and in future quarters. Consistent with this practice, as a result of continued over-performance in certain pool groups, primarily in the 2009, 2010 and 2011 vintages, we increased yields in those pool groups this quarter.

Turning to Ascension, our fee-based bankruptcy-servicing business, revenue in the fourth quarter rose by 5% from the prior year, to $4.2 million.

As we discussed last quarter, performance from servicing one large new client was below our expectations, and we have parted ways with that client. This separation will have a negative financial impact on the next few quarters at Ascension, but it was the right long-term business decision.

Shifting now to expenses, our total operating expenses for the fourth quarter were $88 million, up from $72 million in the fourth quarter of 2010. For the full year, our total operating expenses were $347 million, up from $284 million in 2010. Included in operating expenses for the fourth quarter of 2011 were stock-based compensation expenses of approximately $1.7 million and Ascension operating expenses of $4.4 million.

The income tax provision for the fourth quarter and the full year was $10 million and $38 million, respectively. This reflects an overall tax rate of 37.7% for the quarter and 38.6%, for the full year, as compared to 39% for the quarter and 37.1% for the full year in 2010.

Finally, our fully diluted earnings per share during the fourth quarter were 67 cents, a 20% increase compared to quarterly earnings per share of 56 cents in the same period last year. For the full year, our fully diluted earnings per share increased 22%, to $2.37, from $1.95 in 2010.

Before turning the call back over to Brandon for some final remarks, I wanted to ask you to please mark your calendars for our annual meeting of shareholders and investor day, which will be held in New York on Wednesday, June 6th. More details will follow in the coming weeks.

With that, I will turn it back to Brandon before opening the call up for questions.

Brandon…

Brandon Black – President and CEO

Thank you, Paul.

Encore's fourth quarter and full-year performance were highlighted by record-setting cash collections and our continued deployment of capital at strong returns. Our proactive approach to engaging regulators and our new operating initiatives are paving the way for stable growth in an uncertain and changing macroeconomic environment. Encore's key differentiators were at work in the fourth quarter and we expect they will continue to be key drivers in the growth of cash flows and year-over-year earnings.

With that, we would be happy to answer any questions you may have.

Operator, please open up the line for questions.