

ENCORE CAPITAL GROUP INC

Form 10-Q

May 10, 2013

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, 2013

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**  
(Address of principal executive offices)

**92108**  
(Zip code)

**(877) 445 - 4581**

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

(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 30, 2013 |
|--------------------------------|-------------------------------|
| Common Stock, \$0.01 par value | 23,336,320 shares             |

**Table of Contents**

**ENCORE CAPITAL GROUP, INC.**

**INDEX TO FORM 10-Q**

|   | <b>Page</b> |
|---|-------------|
| <b><u>PART I FINANCIAL INFORMATION</u></b>  | 1           |
| <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> | 23          |
| <u>Item 3 Quantitative and Qualitative Disclosures About Market Risk</u>                            | 38          |
| <u>Item 4 Controls and Procedures</u>   | 38          |
| <b><u>PART II OTHER INFORMATION</u></b>   | 39          |
| <u>Item 1 Legal Proceedings</u>   | 39          |
| <u>Item 1A Risk Factors</u>   | 39          |
| <u>Item 2 Unregistered Sales of Equity Securities and Use of Proceeds</u>                           | 40          |
| <u>Item 6 Exhibits</u>  | 41          |
| <b><u>SIGNATURES</u></b>  | 42          |

**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,<br>2013   | December 31,<br>2012 |
|--|---------------------|----------------------|
| <b>Assets</b>  |                     |                      |
| Cash and cash equivalents  | \$ 29,904           | \$ 17,510            |
| Investment in receivable portfolios, net   | 801,525             | 873,119              |
| Deferred court costs, net  | 35,448              | 35,407               |
| Property tax payment agreements receivable, net  | 153,580             | 135,100              |
| Interest receivable  | 4,621               | 4,042                |
| Property and equipment, net  | 24,389              | 23,223               |
| Other assets   | 31,113              | 27,006               |
| Goodwill   | 51,437              | 55,446               |
| Identifiable intangible assets, net  | 462                 | 487                  |
| <b>Total assets</b>  | <b>\$ 1,132,479</b> | <b>\$ 1,171,340</b>  |
| <b>Liabilities and stockholders equity</b>   |                     |                      |
| <b>Liabilities:</b>  |                     |                      |
| Accounts payable and accrued liabilities   | \$ 42,120           | \$ 45,450            |
| Income tax payable   | 7,236               | 3,080                |
| Deferred tax liabilities, net  | 8,443               | 8,236                |
| Debt   | 646,011             | 706,036              |
| Other liabilities  | 1,738               | 2,722                |
| <b>Total liabilities</b>   | <b>705,548</b>      | <b>765,524</b>       |
| <b>Commitments and contingencies</b>   |                     |                      |
| <b>Stockholders equity:</b>  |                     |                      |
| Convertible preferred stock, \$.01 par value, 5,000 shares authorized, no shares issued and outstanding  |                     |                      |
| Common stock, \$.01 par value, 50,000 shares authorized, 23,336 shares and 23,191 shares issued and outstanding as of March 31, 2013 and December 31, 2012, respectively | 233                 | 232                  |
| Additional paid-in capital   | 89,189              | 88,029               |
| Accumulated earnings   | 338,777             | 319,329              |
| Accumulated other comprehensive loss   | (1,268)             | (1,774)              |
| <b>Total stockholders equity</b>   | <b>426,931</b>      | <b>405,816</b>       |
| <b>Total liabilities and stockholders equity</b>   | <b>\$ 1,132,479</b> | <b>\$ 1,171,340</b>  |

*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)

|   | Three Months Ended<br>March 31, |                  |
|---|---------------------------------|------------------|
|   | 2013                            | 2012             |
| <b>Revenues</b>                                       |                                 |                  |
| Revenue from receivable portfolios, net               | \$ 140,683                      | \$ 126,405       |
| Tax lien transfer                                     |                                 |                  |
| Interest income                                       | 4,715                           |                  |
| Interest expense                                      | (1,113)                         |                  |
| Net interest income                                   | 3,602                           |                  |
| <b>Total revenues</b>                                 | <b>144,285</b>                  | <b>126,405</b>   |
| <b>Operating expenses</b>                             |                                 |                  |
| Salaries and employee benefits                        | 28,832                          | 22,304           |
| Cost of legal collections                             | 42,258                          | 38,635           |
| Other operating expenses                              | 13,265                          | 11,598           |
| Collection agency commissions                         | 3,329                           | 3,959            |
| General and administrative expenses                   | 16,342                          | 13,658           |
| Depreciation and amortization                         | 1,846                           | 1,240            |
| <b>Total operating expenses</b>                       | <b>105,872</b>                  | <b>91,394</b>    |
| Income from operations                                | 38,413                          | 35,011           |
| <b>Other (expense) income</b>                         |                                 |                  |
| Interest expense                                      | (6,854)                         | (5,515)          |
| Other income  | 460                             | 272              |
| <b>Total other expense</b>                            | <b>(6,394)</b>                  | <b>(5,243)</b>   |
| Income from continuing operations before income taxes | 32,019                          | 29,768           |
| Provision for income taxes                            | (12,571)                        | (11,660)         |
| Income from continuing operations                     | 19,448                          | 18,108           |
| Loss from discontinued operations, net of tax         |                                 | (6,702)          |
| <b>Net income</b>                                     | <b>\$ 19,448</b>                | <b>\$ 11,406</b> |
| <b>Weighted average shares outstanding:</b>           |                                 |                  |
| Basic   | 23,446                          | 24,779           |
| Diluted   | 24,414                          | 25,740           |
| <b>Basic earnings (loss) per share from:</b>          |                                 |                  |
| Continuing operations                                 | \$ 0.83                         | \$ 0.73          |

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

|   |           |           |
|---|-----------|-----------|
| Discontinued operations                                     | \$ 0.00   | \$ (0.27) |
| Net basic earnings per share                                | \$ 0.83   | \$ 0.46   |
| Diluted earnings (loss) per share from:                     |           |           |
| Continuing operations                                       | \$ 0.80   | \$ 0.70   |
| Discontinued operations                                     | \$ 0.00   | \$ (0.26) |
| Net diluted earnings per share                              | \$ 0.80   | \$ 0.44   |
| Other comprehensive gain (loss):                            |           |           |
| Unrealized gain on derivative instruments, net of tax       | 620       | 682       |
| Unrealized loss on foreign currency translation, net of tax | (114)     |           |
| Other comprehensive gain, net of tax                        | 506       | 682       |
| Comprehensive income  | \$ 19,954 | \$ 12,088 |

*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 | Accumulated | Accumulated   | Total      |
|---|--------------|--------|------------|-------------|---------------|------------|
|   | Shares       | Par    | Paid-In    | Earnings    | Other         | Equity     |
|   |              |        | Capital    |             | (Loss) Income |            |
| <b>Balance at December 31, 2012</b>   | 23,191       | \$ 232 | \$ 88,029  | \$ 319,329  | \$ (1,774)    | \$ 405,816 |
| Net income  |              |        |            | 19,448      |               | 19,448     |
| Unrealized gain on derivative instruments, net of tax   |              |        |            |             | 620           | 620        |
| Unrealized loss on foreign currency translation adjustments, net of tax                                 |              |        |            |             | (114)         | (114)      |
| Exercise of stock options and issuance of share-based awards, net of shares withheld for employee taxes | 169          | 1      | (2,029)    |             |               | (2,028)    |
| Repurchase of common stock  | (24)         |        | (729)      |             |               | (729)      |
| Stock-based compensation  |              |        | 3,001      |             |               | 3,001      |
| Tax benefit related to stock-based compensation   |              |        | 902        |             |               | 902        |
| Tax benefit related to convertible notes, net   |              |        | 15         |             |               | 15         |
| <b>Balance at March 31, 2013</b>  | 23,336       | \$ 233 | \$ 89,189  | \$ 338,777  | \$ (1,268)    | \$ 426,931 |

*See accompanying notes to condensed consolidated financial statements*



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

(Unaudited, In Thousands)

|  | Three Months Ended<br>March 31, |           |
|--|---------------------------------|-----------|
|  | 2013                            | 2012      |
| <b>Operating activities:</b>   |                                 |           |
| Net income   | \$ 19,448                       | \$ 11,406 |
| Adjustments to reconcile net income to net cash provided by operating activities     |                                 |           |
| Depreciation and amortization  | 1,846                           | 1,363     |
| Impairment charge for goodwill and identifiable intangible assets                    |                                 | 10,349    |
| Amortization of loan costs and premium on property tax payment agreements receivable | 1,517                           | 466       |
| Stock-based compensation expense   | 3,001                           | 2,266     |
| Income tax provision in excess of income tax payments                                | 207                             | 623       |
| Excess tax benefit from stock-based payment arrangements                             | (983)                           | (1,067)   |
| (Reversal) provision for allowances on receivable portfolios, net                    | (1,006)                         | 373       |
| Changes in operating assets and liabilities  |                                 |           |
| Other assets   | (1,630)                         | (326)     |
| Deferred court costs   | (41)                            | (1,333)   |
| Prepaid income tax and income taxes payable  | 4,314                           | 2,130     |
| Accounts payable, accrued liabilities and other liabilities                          | (2,980)                         | 853       |
| Net cash provided by operating activities  | 23,693                          | 27,103    |
| <b>Investing activities:</b>   |                                 |           |
| Purchases of receivable portfolios   | (58,771)                        | (130,463) |
| Collections applied to investment in receivable portfolios, net                      | 130,493                         | 104,230   |
| Proceeds from put-backs of receivable portfolios                                     | 878                             | 734       |
| Originations of property tax payment agreements receivable                           | (27,446)                        |           |
| Collections applied to property tax payment agreements receivable, net               | 11,812                          |           |
| Purchases of property and equipment  | (2,315)                         | (1,555)   |
| Net cash provided by (used in) investing activities                                  | 54,651                          | (27,054)  |
| <b>Financing activities:</b>   |                                 |           |
| Payment of loan costs  | (2,340)                         |           |
| Repayment of senior secured notes  | (2,500)                         |           |
| Proceeds from revolving credit facilities  | 33,741                          | 43,500    |
| Repayment of revolving credit facilities   | (91,800)                        | (34,500)  |
| Repurchase of common stock   | (729)                           |           |
| Proceeds from exercise of stock options  | 846                             | 1,061     |
| Taxes paid related to net share settlement of equity awards                          | (2,872)                         | (2,093)   |
| Excess tax benefit from stock-based payment arrangements                             | 983                             | 1,067     |
| Repayment of capital lease obligations   | (1,279)                         | (1,685)   |
| Net cash (used in) provided by financing activities                                  | (65,950)                        | 7,350     |
| Net increase in cash and cash equivalents  | 12,394                          | 7,399     |
| Cash and cash equivalents, beginning of period                                       | 17,510                          | 8,047     |
| Cash and cash equivalents, end of period   | \$ 29,904                       | \$ 15,446 |

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

Supplemental disclosures of cash flow information:

|                            |    |       |    |       |
|----------------------------|----|-------|----|-------|
| Cash paid for interest     | \$ | 5,485 | \$ | 5,119 |
| Cash paid for income taxes |    | 7,520 |    | 4,075 |

Supplemental schedule of non-cash investing and financing activities:

|   |  |     |  |       |
|---|--|-----|--|-------|
| Fixed assets acquired through capital lease |  | 674 |  | 1,564 |
|---|--|-----|--|-------|

*See accompanying notes to condensed consolidated financial statements*

---

**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 leading provider of debt management and recovery solutions for consumers and property owners across a broad range of financial assets. The Company purchases portfolios of defaulted consumer receivables at deep discounts to face value and manages them by working 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. Defaulted receivables may also include receivables subject to bankruptcy proceedings. In addition, through its subsidiary, Propel Financial Services, LLC ( Propel ), the Company assists Texas property owners who are delinquent on their property taxes by paying these taxes on behalf of the property owners in exchange for payment agreements collateralized by tax liens on the property.

**Portfolio purchasing and recovery**

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 and telecommunication providers in the United States, and possesses one of the industry's best collection staff retention rates.

The Company uses insights discovered during its purchasing process to build account collection strategies. The Company's proprietary consumer-level collectability analysis is the primary determinant of whether an account will be actively serviced post-purchase. The Company continuously refines this analysis to determine the most effective collection strategy to pursue for each account it owns. 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 it believes are not able to pay from those who are able to pay. Consumers who the Company believes are financially incapable of making any payments, facing extenuating circumstances or hardships (such as medical issues), serving in the military, or currently receiving social security as their only source of income 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 perceived 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 whether or not to pursue collections through legal means.

**Tax lien transfer**

Propel's principal activity is originating and servicing property tax lien transfers in the state of Texas. With the property owner's consent, Propel pays the property owner's delinquent property taxes directly to the taxing authority, which then transfers its tax lien to Propel. Propel then enters into a payment agreement with the property owner creating an affordable payment plan. Tax lien transfers provide the local taxing authorities with much needed tax revenue and property owners with an alternative to paying their property tax bills in one lump sum. Tax lien transfers typically carry a lower interest rate and fee structure than what the local taxing authority would charge.

***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 U.S. Securities and Exchange Commission (the SEC ) 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.

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

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, 2012. 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.

On May 8, 2012, the Company completed its acquisition of Propel, BNC Retax, LLC, RioProp Ventures, LLC, and certain related affiliates (collectively, the Propel Entities ). The condensed consolidated statements of comprehensive income for the three months ended March 31, 2012 do not include the results of operations of the Propel Entities as the acquisition was not completed until May 8, 2012. For additional acquisition related information relating to the Propel Entities, please refer to the Company’s Current Report on Form 8-K filed with the SEC on July 24, 2012.

***Reclassification***

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

**Note 2: Discontinued Operations**

On May 16, 2012, the Company completed the sale of substantially all of the assets and certain of the liabilities of its bankruptcy servicing subsidiary, Ascension Capital Group, Inc. ( Ascension ), to a subsidiary of American InfoSource, L.P. ( AIS ). As part of the sale, the Company agreed to fund certain agreed-upon operating losses in the first year of AIS’ ownership of the Ascension business, not to exceed \$4.0 million. If the Ascension business becomes profitable under AIS’ ownership, the Company will be paid an earn-out equal to 30% to 40% of Ascension’s EBITDA for the first five years commencing May 16, 2012. The Company received no proceeds from the sale. Additionally, the Company recognized the entire \$4.0 million loss contingency during the second quarter of 2012.

The Company performed an interim goodwill impairment test for Ascension as of March 31, 2012 and concluded that the entire goodwill balance relating to Ascension of \$9.9 million was impaired. Additionally, the Company wrote-off the remaining identifiable intangible assets of approximately \$0.4 million relating to Ascension as of March 31, 2012.

Ascension’s operations are presented as discontinued operations for the three months ended March 31, 2012, in the Company’s condensed consolidated statements of comprehensive income. The following table presents the revenue and components of discontinued operations, net of tax (*in thousands*):

|   | <b>Three Months<br/>Ended<br/>March<br/>31, 2012</b> |
|---|--|
| Revenue   | \$ 3,812   |
| Loss from discontinued operations before income taxes | \$ (11,018)  |
| Income tax benefit                                    | 4,316  |
| Loss from discontinued operations                     | \$ (6,702)   |

**Note 3: Business Combinations**

***Merger Agreement***

On March 6, 2013, the Company and Pinnacle Sub, Inc., a wholly owned subsidiary of the Company ( Merger Sub ), entered into an agreement and plan of merger (the Merger Agreement ) with Asset Acceptance Capital Corp. ( AACC ), another leading provider of debt management and

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

recovery solutions. Pursuant to the Merger Agreement, Merger Sub will merge with and into AACC, and AACC will continue as the surviving corporation and will become a wholly owned subsidiary of the Company. The Merger Agreement has been approved by the board of directors of the Company and the board of directors of AACC.

Subject to the terms and conditions of the Merger Agreement, each holder of AACC common stock will be entitled to receive, at such holder's election, either \$6.50 in cash or 0.2162 validly issued, fully paid and nonassessable shares of Encore common stock, in each case without interest and less any applicable withholding taxes, for each share of AACC common stock such holder owns at the effective time of the merger. However, no more than 25% of the total shares of AACC common stock outstanding immediately prior to the merger may be exchanged for shares of the Company's common stock and any shares of AACC common stock elected to be exchanged for the Company's common stock in excess of such 25% limitation will be subject to proration in accordance with the terms of the Merger Agreement.

**Table of Contents**

The transaction is expected to close in the second quarter of 2013, and is subject to, among other items, customary closing conditions and regulatory approvals. Information regarding this transaction is set forth on the Company's Registration Statement on Form S-4, as amended, initially filed with the SEC on March 27, 2013.

The Company will account for the merger using the acquisition method of accounting. Under the acquisition method of accounting, the assets and liabilities of AACC will be recorded as of the closing date of the merger, at their respective fair values, and consolidated with those of the Company. The results of operations of AACC will be consolidated with those of the Company beginning on the closing date of the merger.

**Propel Acquisition**

On May 8, 2012, the Company acquired all of the outstanding equity interests of the Propel Entities for \$186.8 million in cash (the Propel Acquisition). The Propel Acquisition is accounted for using the acquisition method of accounting and, accordingly, the tangible and intangible assets acquired and liabilities assumed were recorded at their estimated fair values as of the date of the acquisition.

The Company has completed an independent valuation study and determined the fair value of the assets acquired and the liabilities assumed from the Propel Entities. Fair value measurements have been applied based on assumptions that market participants would use in the pricing of the respective assets and liabilities. During the three months ended March 31, 2013, the Company made an adjustment to the initial purchase price allocation, increasing property tax payment agreements receivable and decreasing goodwill by approximately \$4.0 million. The components of the final purchase price allocation for the Propel Entities are as follows (*in thousands*):

|  |            |
|--|------------|
| <b>Purchase price:</b>                     |            |
| Cash paid at acquisition                   | \$ 186,814 |
| Purchase price adjustment                  | 741        |
| <br>                                       |            |
| Total purchase price                       | \$ 187,555 |
| <br>                                       |            |
| <b>Allocation of purchase price:</b>       |            |
| Cash                                       | \$ 824     |
| Accounts receivable                        | 1,049      |
| Interest receivable                        | 3,679      |
| Property tax payment agreements receivable | 136,987    |
| Fixed assets                               | 461        |
| Other assets                               | 860        |
| Liabilities assumed                        | (2,265)    |
| Identifiable intangible assets             | 570        |
| Goodwill                                   | 45,390     |
| <br>                                       |            |
| Total net assets acquired                  | \$ 187,555 |

**Note 4: 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>2013</b>                         | <b>2012</b> |
| Income from continuing operations | \$ 19,448                           | \$ 18,108   |

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

|  |           |           |
|--|-----------|-----------|
| Loss from discontinued operations, net of tax      |           | (6,702)   |
| Net income available for common stockholders       | \$ 19,448 | \$ 11,406 |
| Weighted average common shares outstanding basic   | 23,446    | 24,779    |
| Dilutive effect of stock-based awards              | 968       | 961       |
| Weighted average common shares outstanding diluted | 24,414    | 25,740    |
| <b>Basic earnings (loss) per share from:</b>       |           |           |
| Continuing operations                              | \$ 0.83   | \$ 0.73   |
| Discontinued operations                            | \$ 0.00   | \$ (0.27) |
| Net basic earnings per share                       | \$ 0.83   | \$ 0.46   |
| <b>Diluted earnings (loss) per share from:</b>     |           |           |
| Continuing operations                              | \$ 0.80   | \$ 0.70   |
| Discontinued operations                            | \$ 0.00   | \$ (0.26) |
| Net diluted earnings per share                     | \$ 0.80   | \$ 0.44   |



**Table of Contents**

No anti-dilutive employee stock options were outstanding during the three months ended March 31, 2013. Employee stock options to purchase approximately 209,000 shares of common stock were outstanding during the three months ended March 31, 2012, 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 5: Fair Value Measurements**

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.

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, including inputs that reflect the reporting entity's own assumptions.

**Financial instruments required to be carried at fair value**

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

|                                     | Fair Value Measurements as of<br>March 31, 2013    |          |         | Total    |
|-------------------------------------|--|----------|---------|----------|
|                                     | Level 1  | Level 2  | Level 3 |          |
| <b>Liabilities</b>                  |  |          |         |          |
| Interest rate swap agreements       | \$   | \$ (423) | \$      | \$ (423) |
| Foreign currency exchange contracts |  | (1,248)  |         | (1,248)  |
|                                     |  |          |         |          |
|                                     | Fair Value Measurements as of<br>December 31, 2012 |          |         | Total    |
|                                     | Level 1  | Level 2  | Level 3 |          |
| <b>Liabilities</b>                  |  |          |         |          |
| Interest rate swap agreements       | \$   | \$ (645) | \$      | \$ (645) |
| Foreign currency exchange contracts |  | (2,010)  |         | (2,010)  |

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.

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

The Company records its investment in receivable portfolios at cost, which represents a significant discount from the contractual receivable balances due. The Company computes the fair value of its investment in receivable portfolios by discounting the estimated future cash flows, generated by its proprietary forecasting models, using an estimated market participant discount rate. Using this method, the fair value of investment in receivable portfolios was approximately \$1.2 billion and \$1.3 billion as of March 31, 2013 and December 31, 2012, respectively. A 100 basis point fluctuation in the discount rate used would result in an increase or decrease in the fair value by approximately \$20.0 million as of March 31, 2013. This fair value calculation does not represent, and should not be construed to represent, the underlying value of the Company or the amount which could be realized if its investment in receivable portfolios were sold. The carrying value of the investment in receivable portfolios was \$801.5 million and \$873.1 million as of March 31, 2013 and December 31, 2012, respectively.



---

## **Table of Contents**

The Company capitalizes deferred court costs and provides a reserve for those costs that it believes will ultimately be uncollectible. The carrying value of net deferred court costs approximates fair value.

The fair value of property tax payment agreements receivable is estimated by discounting the future cash flows of the portfolio using a discount rate equivalent to the current rate at which similar property tax payment agreements receivable would be originated. The carrying value of property tax payment agreements receivable approximates fair value. Additionally, the carrying value of interest receivable approximates fair value.

The Company's senior secured notes and borrowings under its revolving credit facilities and term loan facilities are carried at historical costs, adjusted for additional borrowings less principal repayments, which approximate fair value. The Company's convertible notes are carried at historical cost, adjusted for debt discount. The carrying value of the convertible notes was \$101.2 million as of March 31, 2013. The fair value estimate for these notes incorporates quoted market prices, which was approximately \$127.5 million as of March 31, 2013.

### **Note 6: 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, 2013, the Company had five interest rate swap agreements outstanding with a total notional amount of \$125.0 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***

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.

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, 2013, the total notional amount of the forward contracts to buy Indian rupees in exchange for U.S. dollars was \$41.6 million. All outstanding contracts qualified for hedge accounting treatment as of March 31, 2013. The Company estimates that approximately \$0.6 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, 2013 and 2012.



**Table of Contents**

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 condensed consolidated statements of financial condition (*in thousands*):

|  | March 31, 2013         |            | December 31, 2012      |            |
|--|------------------------|------------|------------------------|------------|
|  | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| Derivatives designated as hedging instruments: |                        |            |                        |            |
| Interest rate swaps                            | Other liabilities      | \$ (423)   | Other liabilities      | \$ (645)   |
| Foreign currency exchange contracts            | Other liabilities      | (1,248)    | Other liabilities      | (2,010)    |

The following tables summarize the effects of derivatives in cash flow hedging relationships in the Company's statements of comprehensive income during the periods presented (*in thousands*):

|                                     | Gain or (Loss) Recognized in OCI-Effective Portion |                                   | Location of Gain or (Loss) Recognized from OCI into Income - Effective Portion | Gain or (Loss) Reclassified from OCI into Income - Effective Portion |                                   | 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, 2013                  | Three Months Ended March 31, 2012 |  | Three Months Ended March 31, 2013                                    | Three Months Ended March 31, 2012 |  | Three Months Ended March 31, 2013  | Three Months Ended March 31, 2012 |
| Interest rate swaps                 | \$ 222   | \$ (221)                          | Interest expense   | \$   | \$                                | Other (expense) income   | \$   | \$                                |
| Foreign currency exchange contracts | 601  | 903                               | Salaries and employee benefits   | (49)   | (116)                             | Other (expense) income   |  |                                   |
| Foreign currency exchange contracts | 103  | 297                               | General and administrative expenses  | (9)  | (16)                              | Other (expense) income   |  |                                   |

**Note 7: Stock-Based Compensation**

On March 9, 2009, Encore's Board of Directors (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

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

advisors to, the Company. The amendment and restatement of the 2005 Plan increased the maximum number of shares of the Company's common stock that may be issued or be subject to awards under the plan by 2,000,000 shares, established a new 10-year term for the plan, and made certain other amendments. The 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. In addition, shares subject to options granted under the 2005 Plan that terminate or expire without being exercised become available for grant under the 2005 Plan. The benefit provided under the 2005 Plan is compensation subject to authoritative guidance for stock-based compensation.

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 stock-based compensation expense during the three months ended March 31, 2013 and 2012 was \$3.0 million and \$2.3 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 granted with an exercise price equal to the market price of the Company's stock at the date of issuance, generally vest over three to five years of continuous service, and have ten-year contractual terms.

**Table of Contents**

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 is estimated at the date of grant using a Black-Scholes option-pricing model. No stock options were granted during the three months ended March 31, 2013 and 2012.

Unrecognized compensation cost related to stock options as of March 31, 2013, was \$1.7 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, 2013, and changes during the three months then ended, is presented below:

|                                  | Number of<br>Shares | Option Price<br>Per Share | Weighted Average<br>Exercise Price | Aggregate<br>Intrinsic<br>Value<br>(in thousands) |
|----------------------------------|---------------------|---------------------------|------------------------------------|---|
| Outstanding at December 31, 2012 | 1,948,259           | \$ 2.89 \$24.65           | \$ 15.38                           |   |
| Exercised                        | (45,334)            | 11.0 24.65                | 18.65                              |   |
| Outstanding at March 31, 2013    | 1,902,925           | \$ 2.89 \$24.65           | \$ 15.30                           | \$ 28,168   |
| Exercisable at March 31, 2013    | 1,688,264           | \$ 2.89 \$24.65           | \$ 14.41                           | \$ 26,494   |

The total intrinsic value of options exercised during the three months ended March 31, 2013 and 2012 was \$0.5 million and \$1.1 million, respectively. As of March 31, 2013, the weighted-average remaining contractual life of options outstanding and options exercisable was 5.6 years and 5.2 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 authoritative guidance, the fair value of these 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, 2013, the non-vested shares are expected to vest over approximately one to three years of continuous service.

A summary of the status of the Company's restricted stock units and restricted stock awards as of March 31, 2013, and changes during the three months then ended, is presented below:

|                                 | Non-Vested<br>Shares | Weighted Average<br>Grant Date<br>Fair Value |
|---------------------------------|----------------------|--|
| Non-vested at December 31, 2012 | 744,016              | \$ 23.51                                     |
| Awarded                         | 135,800              | \$ 30.88                                     |
| Vested                          | (239,525)            | \$ 21.06                                     |
| Cancelled/forfeited             | (3,732)              | \$ 23.05                                     |
| Non-vested at March 31, 2013    | 636,559              | \$ 26.00                                     |

Unrecognized compensation expense related to non-vested shares as of March 31, 2013, was \$10.8 million. The weighted-average remaining expense period, based on the unamortized value of these outstanding non-vested shares, was approximately 2.2 years. The fair value of restricted stock units and restricted stock awards vested during the three months ended March 31, 2013 and 2012 was \$7.5 million and \$5.3 million, respectively.

**Note 8: 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.



**Table of Contents**

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, 2013, the total estimated remaining collections beyond the 84 to 96 month collection forecast, which are not included in the calculation of the Company's IRRs, were \$115.8 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.

Accretable 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 accretable 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.

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<br>Yield | Estimate of<br>Zero Basis<br>Cash Flows | Total        |
|---|---------------------|---|--------------|
| Balance at December 31, 2012                        | \$ 984,944          | \$ 17,366                               | \$ 1,002,310 |
| Revenue recognized, net                             | (135,072)           | (5,611)                                 | (140,683)    |
| Net additions to existing portfolios <sup>(1)</sup> | 173,634             | 7,061                                   | 180,695      |
| Additions for current purchases <sup>(1)</sup>      | 66,808              |   | 66,808       |
| Balance at March 31, 2013                           | \$ 1,090,314        | \$ 18,816                               | \$ 1,109,130 |

|   | Accretable<br>Yield | Estimate of<br>Zero Basis<br>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    |
| Balance at March 31, 2012                           | \$ 952,759          | \$ 29,219                               | \$ 981,978 |

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

<sup>(1)</sup> Estimated remaining collections and accretable yield include anticipated collections beyond the 84 to 96 month collection forecast. During the three months ended March 31, 2013, the Company purchased receivable portfolios with a face value of \$1.6 billion for \$58.8 million, or a purchase cost of 3.6% of face value. The estimated future collections at acquisition for these portfolios amounted to \$126.6 million. 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.

**Table of Contents**

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, 2013 and 2012, Zero Basis Revenue was approximately \$4.7 million and \$6.0 million, respectively.

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

|   | Three Months Ended March 31, 2013 |                       |                   |
|---|-----------------------------------|-----------------------|-------------------|
|   | Accrual Basis Portfolios          | Zero Basis Portfolios | Total             |
| Balance, beginning of period                          | \$ 873,119                        | \$                    | \$ 873,119        |
| Purchases of receivable portfolios                    | 58,771                            |                       | 58,771            |
| Gross collections <sup>(1)</sup>                      | (264,559)                         | (5,611)               | (270,170)         |
| Put-backs and recalls <sup>(2)</sup>                  | (878)                             |                       | (878)             |
| Revenue recognized                                    | 135,015                           | 4,662                 | 139,677           |
| Portfolio allowance reversals, net                    | 57                                | 949                   | 1,006             |
| <b>Balance, end of period</b>                         | <b>\$ 801,525</b>                 | <b>\$</b>             | <b>\$ 801,525</b> |
| Revenue as a percentage of collections <sup>(3)</sup> | 51.0%                             | 83.1%                 | 51.7%             |

|   | Three Months Ended March 31, 2012 |                       |                   |
|---|-----------------------------------|-----------------------|-------------------|
|   | Accrual Basis Portfolios          | Zero Basis Portfolios | Total             |
| 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>\$ 741,580</b> |
| Revenue as a percentage of collections <sup>(3)</sup>     | 53.9%                             | 85.4%                 | 54.9%             |

(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, 2013 | 2012       |
| Balance at beginning of period    | \$ 105,273                        | \$ 109,494 |
| Provision for portfolio allowance | 479                               | 1,759      |
| Reversal of prior allowance       | (1,485)                           | (1,386)    |

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

Balance at end of period \$ 104,267 \$ 109,867

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*):

|                     | <b>Three Months Ended March 31,</b> |                   |
|---------------------|-------------------------------------|-------------------|
|                     | <b>2013</b>                         | <b>2012</b>       |
| Collection sites    | \$ 126,562                          | \$ 109,870        |
| Legal collections   | 122,273                             | 109,572           |
| Collection agencies | 21,335                              | 11,586            |
|                     | <b>\$ 270,170</b>                   | <b>\$ 231,028</b> |

**Table of Contents****Note 9: Property Tax Payment Agreements Receivable, Net**

The Company's portfolio of property tax payment agreements receivable primarily consists of payment agreements collateralized by tax liens on residential and commercial properties in the state of Texas. The tax liens are in a priority position to most other liens on the properties, including those that existed at the time the tax lien was transferred from the respective taxing authority to the Company. Repayment of residential and commercial property tax payment agreements receivable is generally dependent on the property owner. However, repayment may ultimately come through payments from other lien holders or foreclosure on the properties. Risk of loss is mitigated by the Company's internal underwriting policies, including its policy relating to the amount of taxes it will pay relative to the value of the property. The Company will generally not originate a tax lien transfer if this percentage is in excess of 25% and, in most cases, this percentage is below 15%.

The Company evaluates the entire portfolio of property tax payment agreements receivable for impairment. The primary credit quality indicator the Company uses to evaluate its portfolio is lien to value ratio. The Company has not experienced any losses on the property tax payment agreements receivable in its portfolio. In addition, management believes, based on the fact that the tax liens that collateralize the payment agreements are in a priority position over most other liens on the properties, that it will not experience any material losses on the ultimate collection of its property tax payment agreements receivable. Therefore, no allowance has been provided for as of March 31, 2013.

The following table presents the Company's aging analysis of property tax payment agreements receivable as of March 31, 2013 and December 31, 2012 (*in thousands*):

|                     | March 31,<br>2013 | December 31,<br>2012 |
|---------------------|-------------------|----------------------|
| Current             | \$ 118,363        | \$ 101,052           |
| 31-60 days past due | 10,531            | 10,175               |
| 61-90 days past due | 4,013             | 1,982                |
| > 90 days past due  | 20,673            | 21,891               |
|                     | \$ 153,580        | \$ 135,100           |

**Note 10: 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. Historically, the Company wrote off Deferred Court Costs not recovered within three years of placement. However, as a result of a history of court cost recoveries beyond three years, the Company has determined that court costs are recovered over a longer period of time. As a result, on a prospective basis, the Company began increasing its deferral period from three years to five years in January 2013. Collections received from these debtors are first applied against related court costs with the balance applied to the debtors' account.

Deferred Court Costs consist of the following as of the dates presented (*in thousands*):

|                       | March 31,<br>2013 | December 31,<br>2012 |
|-----------------------|-------------------|----------------------|
| Court costs advanced  | \$ 304,161        | \$ 279,314           |
| Court costs recovered | (106,213)         | (94,827)             |
| Court costs reserve   | (162,500)         | (149,080)            |
|                       | \$ 35,448         | \$ 35,407            |



**Table of Contents**

A roll forward of the Company's court cost reserve is as follows (*in thousands*):

|  | Three Months Ended<br>March 31, |              |
|--|---------------------------------|--------------|
|  | 2013                            | 2012         |
| Balance at beginning of period                 | \$ (149,080)                    | \$ (130,454) |
| Provision for court costs                      | (13,420)                        | (12,343)     |
| Write-off of reserve after the deferral period |                                 | 13,410       |
| Balance at end of period                       | \$ (162,500)                    | \$ (129,387) |

**Note 11: Other Assets**

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

|  | March 31,<br>2013 | December 31,<br>2012 |
|--|-------------------|----------------------|
| Debt issuance costs, net of amortization | \$ 15,772         | \$ 14,397            |
| Prepaid expenses                         | 8,737             | 6,399                |
| Security deposit India building lease    | 1,825             | 1,696                |
| Recoverable legal fees                   | 1,410             | 1,521                |
| Service tax receivable                   | 1,537             | 1,344                |
| Other                                    | 1,832             | 1,649                |
|  | \$ 31,113         | \$ 27,006            |

**Note 12: Debt**

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

|                           | March 31,<br>2013 | December 31,<br>2012 |
|---------------------------|-------------------|----------------------|
| Revolving credit facility | \$ 186,000        | \$ 258,000           |
| Term loan facility        | 148,125           | 148,125              |
| Propel facility           | 131,542           | 117,601              |
| Senior secured notes      | 70,000            | 72,500               |
| Convertible notes         | 115,000           | 115,000              |
| Less: Debt discount       | (13,835)          | (14,442)             |
| Capital lease obligations | 9,179             | 9,252                |
|                           | \$ 646,011        | \$ 706,036           |

**Revolving Credit Facility and Term Loan Facility**

The Company's Amended and Restated Credit Agreement (the "Credit Agreement") includes a term loan facility tranche of \$150.0 million and a revolving credit facility tranche of \$445.0 million for a total commitment of \$595.0 million (the "Credit Facility"). The maturities of both facilities are five years, expiring in November 2017, except with respect to a \$50.0 million subtranche of the term loan facility, which has a three-year maturity, expiring in November 2015. The Credit Agreement includes several financial institutions and lenders and is led by an administrative agent. The Credit Agreement contains an accordion feature which allows the Company to request an increase in the facility of up to \$180.0

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

million (\$20.0 million of the original \$200.0 million was exercised in December 2012) by obtaining one or more commitments from one or more lenders or other financial institutions with the consent of the administrative agent, but does not require the Company to obtain the consent of the other lenders in the facility.

Provisions of the Credit Agreement include, but are not limited to:

A revolving loan component of \$425.0 million, interest at a floating rate equal to, at the Company's option, either: (1) reserve adjusted LIBOR, plus a spread that ranges from, depending on the Company's cash flow leverage ratio, 250 to 300 basis points for the five-year tranches and 200 to 250 basis points for the three-year tranche; or (2) Alternate Base Rate, plus a spread that ranges from, depending on the Company's cash flow leverage ratio, 150 to 200 basis points for the five year tranches and 100 to 150 basis points for the three-year tranche. Alternate Base Rate, as defined in the agreement, means the highest of (i) the per annum rate which the administrative agent publicly announces from time to time as its prime lending rate, as in effect from time to time, (ii) the federal funds effective rate from time to time, plus 0.5% and (iii) reserved adjusted LIBOR determined on a daily basis for a one month interest period, plus 1.0%;



**Table of Contents**

A \$100.0 million five-year term loan, interest at a floating rate equal to, at the Company's option, either: (1) reserve adjusted LIBOR, plus a spread that ranges from 250 to 300 basis points, depending on the Company's cash flow leverage ratio; or (2) Alternate Base Rate, plus a spread that ranges from 150 to 200 basis points, depending on the Company's cash flow leverage ratio. Principal amortizes \$1.3 million in 2012, \$5.0 million in 2013, \$5.6 million in 2014, \$8.1 million in 2015, \$10.0 million in 2016, \$5.0 million in 2017 with the remaining principal due at the end of the term;

A \$50.0 million three-year term loan, interest at a floating rate equal to, at the Company's option, either: (1) reserve adjusted LIBOR, plus a spread that ranges from 200 to 250 basis points, depending on the Company's cash flow leverage ratio; or (2) Alternate Base Rate, plus a spread that ranges from 100 to 150 basis points, depending on the Company's cash flow leverage ratio. Principal amortizes \$0.6 million in 2012, \$2.5 million in 2013, \$2.8 million in 2014, \$2.8 million in 2015 with the remaining principal due at the end of the term;

A borrowing base equal to (1) the lesser of (i) (a) 55% of eligible estimated remaining collections for consumer receivables subject to bankruptcy proceedings, provided that the amount described in this clause (i)(a) may not exceed 35% of the amount described in clauses (i)(a) and (i)(b), plus (b) 30% - 35% (depending on the Company's trailing 12-month cost per dollar collected) of all other 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) (x) the aggregate principal amount outstanding of the Prudential senior secured notes plus (y) the aggregate principal amount outstanding under the term loans;

The allowance of additional unsecured indebtedness not to exceed \$150.0 million;

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

Repurchases of up to \$50.0 million of Encore's common stock, subject to compliance with certain covenants and available borrowing capacity. The Company has repurchased approximately \$50.0 million common stock during the fourth quarter of 2012 and in January 2013. Refer to Note 18, "Common Stock Repurchases" for details of the stock repurchase program;

A change of control definition, which excludes acquisitions of stock by Red Mountain Capital Partners LLC, JCF FPK LLP 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;

An annual capital expenditure limit of \$20.0 million;

An annual rental expense limit of \$15.0 million;

An outstanding capital lease limit of \$15.0 million;

An acquisition limit of \$100.0 million; and

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

Collateralization by all assets of the Company, other than the assets of the Propel Entities.

At March 31, 2013, the outstanding balance on the revolving credit facility and term loan facility was \$334.1 million, which bore a weighted average interest rate of 3.14% and 4.15% for the three months ended March 31, 2013 and 2012, respectively.

On May 9, 2013, the Company exercised the remaining \$180.0 million of its accordion feature and entered into an amendment to its Credit Facility, restating the Credit Facility in its entirety (the Restated Credit Agreement). The Restated Credit Amendment reset the accordion feature to \$200.0 million and added new lenders. In conjunction with the amendment, the Company exercised \$37.5 million of the new accordion feature. This \$37.5 million exercise, when combined with the \$180.0 million exercise, increased the aggregate revolving loan commitment by \$217.5 million, from \$595.0 million to \$812.5 million, a portion of which is subject to ongoing principal amortization. Including the remaining accordion feature, the maximum amount that can be borrowed under the Credit Facility is \$975.0 million. See Note 19 Subsequent Events for additional information.

### ***Propel Facility***

The Company, through its Propel subsidiary has a \$160.0 million syndicated loan facility (the Propel Facility). The Propel Facility was used in part to fund a portion of the Propel Acquisition 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 cash flow leverage ratio; or (2) Prime Rate, which is defined in the agreement as the rate of interest per annum equal to the sum of (a) the interest rate quoted in the Money Rates section of *The Wall Street Journal* from time to time and designated as the Prime Rate plus (b) the Prime Rate Margin, which is a spread that ranges from 0 to 75 basis points, depending on Propel's cash flow leverage ratio;

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

---

**Table of Contents**

Interest payable monthly; principal and interest due at maturity;

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

Events of default which, upon occurrence, may permit the lender to terminate the Propel Facility and declare all amounts outstanding to be immediately due and payable; and

A \$40.0 million accordion feature.

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

At March 31, 2013, the outstanding balance on the Propel Facility was \$131.5 million and, for the three months ended March 31, 2013, bore a weighted average interest rate of 3.54%.

***Senior Secured Notes***

As of March 31, 2013, Encore had \$70.0 million in senior secured notes with certain affiliates of Prudential Capital Group (the Senior Secured Notes). 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 \$45.0 million of Senior Secured Notes bear an annual interest rate of 7.75%, mature in 2017 and require quarterly principal amortization payments of \$2.5 million. Prior to December 2012 these notes required quarterly interest only payments.

The Senior Secured Notes are guaranteed in full by certain of Encore's subsidiaries. Similar to, and *pari passu* with, the Credit Agreement, the Senior Secured Notes are also collateralized by all assets of the Company, other than the assets of the Propel Entities. 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 Encore, 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 Encore 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 of the senior secured notes. The covenants are substantially similar to those in the Credit Agreement. Prudential Capital Group and the administrative agent for the lenders of the Credit Agreement have an intercreditor agreement related to their pro rata rights to the collateral, actionable default, powers and duties and remedies, among other topics. Certain terms of the Senior Secured Notes were amended on May 8, 2012, to provide for the change in administrative and collateral agent, the Propel Acquisition, and the addition of the Propel Facility. The Senior Secured Notes were again amended on November 5, 2012 in connection with the Credit Agreement in order to properly align certain covenants.

On May 9, 2013, the Company entered into an amendment to its Senior Secured Notes. See Note 19 Subsequent Events for additional information.

***Convertible Senior Notes***

On November 27, 2012, Encore sold \$100.0 million in aggregate principal amount of 3.0% convertible senior notes due November 27, 2017 in a private placement transaction. On December 6, 2012, the initial purchasers exercised, in full, their option to purchase an additional \$15.0 million of the convertible senior notes, which resulted in an aggregate principal amount of \$115.0 million of the convertible senior notes outstanding (collectively, the Convertible Notes). Interest on the Convertible Notes is payable semi-annually, in arrears, on May 27 and November 27 of each year, beginning on May 27, 2013. The Convertible Notes are the Company's general unsecured obligations. The Convertible Notes will be convertible into cash up to the aggregate principal amount of the Convertible Notes to be converted and the Company will pay or deliver, as the case may be, cash, shares of the Company's common stock or a combination of cash and shares of the Company's common stock, at the Company's election, in respect of the remainder, if any, of the Company's conversion obligation in excess of the aggregate principal amount of the Convertible Notes being converted. The Convertible Notes will be convertible at an initial conversion rate of 31.6832 shares of the Company's common stock per \$1,000 principal amount of Convertible Notes, subject to adjustment upon certain events, which is equivalent to

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

an initial conversion price of approximately \$31.56 per share of the Company's common stock.

Concurrent with the pricing of the Convertible Notes, the Company entered into privately negotiated convertible note hedge transactions (together, the Convertible Note Hedge Transactions) with certain counterparties. The Convertible Note Hedge Transactions, collectively, cover, subject to customary anti-dilution adjustments, the number of shares of the Company's common stock underlying the Convertible Notes, as described below. Concurrently with entering into the Convertible Note Hedge Transactions, the Company also entered into separate, privately negotiated warrant transactions (together, the Warrant Transactions) with the same counterparties, whereby the Company sold to the counterparties warrants to purchase, collectively, subject to customary anti-dilution adjustments, up to the same number of shares of the Company's common stock as in the Convertible Note Hedge Transactions. Subject to certain conditions, the Company may settle the warrants in cash or on a net-share basis.

**Table of Contents**

The Convertible Note Hedge Transactions are expected generally to reduce the potential dilution and/or offset the potential cash payments the Company is required to make in excess of the principal amount upon conversion of the Convertible Notes in the event that the market price per share of the Company's common stock, is greater than the strike price of the Convertible Note Hedge Transactions, which initially corresponds to the conversion price of the Convertible Notes and is subject to anti-dilution adjustments. If, however, the market price per share of the Company's common stock, as measured under the terms of the Warrant Transactions, exceeds the strike price of the warrants, there would nevertheless be dilution to the extent that such market price exceeds the strike price of the warrants, unless the Company elects, subject to certain conditions, to settle the Warrant Transactions in cash. The strike price of the Warrant Transactions will initially be \$44.1875 per share of the Company's common stock and is subject to certain adjustments under the terms of the Warrant Transactions. Taken together, the Convertible Note Hedge Transactions and the Warrant Transactions have the effect of increasing the effective conversion price of the Convertible Notes to \$44.1875 per share.

The Convertible Note Hedge Transactions and the Warrant Transactions are separate transactions, in each case, entered into by the Company with certain counterparties, and are not part of the terms of the Convertible Notes and will not affect any holder's rights under the Convertible Notes. Holders of the Convertible Notes will not have any rights with respect to the Convertible Note Hedge Transactions or the Warrant Transactions. In accordance with authoritative guidance, as of December 31, 2012, the Company recorded the net cost of the Convertible Notes Hedge Transactions and the Warrant Transactions as a reduction in additional paid in capital, and will not recognize subsequent changes in fair value of these financial instruments in its consolidated financial statements.

The net proceeds from the sale of the Convertible Notes were approximately \$111.1 million, after deducting estimated fees and expenses. The Company used approximately \$11.5 million of the net proceeds to pay the cost of the Convertible Note Hedge Transactions, taking into account the proceeds to the Company of the Warrant Transactions; approximately \$25.0 million of the net proceeds to repurchase shares of the Company's common stock; approximately \$61.5 million of the net proceeds to repay borrowings under the Credit Agreement; and the balance of the net proceeds for general corporate purposes.

Authoritative guidance related to debt with conversion and other options requires that issuers of convertible debt instruments that, upon conversion, may be settled fully or partially in cash, must separately account for the liability and equity components in a manner that will reflect the entity's nonconvertible debt borrowing rate when interest cost is recognized in subsequent periods. Additionally, debt issuance costs are required to be allocated in proportion to the allocation of the liability and equity components and accounted for as debt issuance costs and equity issuance costs, respectively.

The Company determined that the fair value of the Convertible Notes at the date of issuance was approximately \$100.3 million, and designated the residual value of approximately \$14.7 million as the equity component. Additionally, the Company allocated approximately \$3.3 million of the \$3.8 million original Convertible Notes issuance cost as debt issuance cost and the remaining \$0.5 million as equity issuance cost.

The balances of the liability and equity components as of the dates presented, were as follows (*in thousands*):

|  | <b>March 31,<br/>2013</b> | <b>December 31,<br/>2012</b> |
|--|---------------------------|------------------------------|
| Liability component principal amount           | \$ 115,000                | \$ 115,000                   |
| Unamortized debt discount                      | (13,835)                  | (14,442)                     |
| <b>Liability component net carrying amount</b> | <b>\$ 101,165</b>         | <b>\$ 100,558</b>            |
| Equity component                               | \$ 14,702                 | \$ 14,702                    |

The debt discount is being amortized into interest expense over the remaining life of the Convertible Notes using the effective interest rate. The effective interest rate on the liability component was 6.0 %.

Interest expense related to the Convertible Notes was as follows (*in thousands*):

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

|   | <b>Three Months Ended</b> |
|---|---------------------------|
|   | <b>March 31, 2013</b>     |
| Interest expense stated coupon rate             | \$ 858                    |
| Interest expense amortization of debt discount  | 607                       |
| <b>Total interest expense convertible notes</b> | <b>\$ 1,465</b>           |

The Company is in compliance with all covenants under its financing arrangements.

**Table of Contents****Capital Lease Obligations**

The Company has capital lease obligations primarily for computer equipment. As of March 31, 2013, the Company's combined obligations for these equipment leases were approximately \$9.1 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 13: Income Taxes**

During the three months ended March 31, 2013, the Company recorded an income tax provision of \$12.6 million, reflecting an effective rate of 39.3% of pretax income from continuing operations. The effective tax rate for the three months ended March 31, 2013 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 6.6%.

During the three months ended March 31, 2012, the Company recorded an income tax provision of \$11.7 million, reflecting an effective rate of 39.2% of pretax income from continuing operations. 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's subsidiary in Costa Rica is operating under a 100% tax holiday through December 31, 2018 and a 50% tax holiday for the subsequent four years. The impact of the tax holiday in Costa Rica for the three months ended March 31, 2013 was immaterial.

As of March 31, 2013, the Company had a gross unrecognized tax benefit of \$2.6 million that, if recognized, would result in a net tax benefit of approximately \$1.8 million and would have a positive effect on the Company's effective tax rate. During the three months ended March 31, 2013, there was no material change in the gross unrecognized tax benefit of \$2.6 million.

During the three months ended March 31, 2013, the Company did not provide for United States income taxes or foreign withholding taxes on the quarterly undistributed earnings from continuing operations of its subsidiaries operating outside of the United States. Undistributed earnings of these subsidiaries during the three months ended March 31, 2013 and 2012, were approximately \$1.7 million and \$2.4 million, respectively. Such undistributed earnings are considered permanently reinvested.

**Note 14: Purchase Concentrations**

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

|                | <b>Three Months Ended<br/>March 31, 2013</b> |          |
|----------------|--|----------|
|                | <b>Cost</b>                                  | <b>%</b> |
| Seller 1       | \$ 15,042                                    | 25.6%    |
| Seller 2       | 11,656                                       | 19.9%    |
| Seller 3       | 8,067  | 13.7%    |
| Seller 4       | 7,071  | 12.0%    |
| Seller 5       | 6,942  | 11.8%    |
| Other sellers  | 9,993  | 17.0%    |
| Purchases, net | \$ 58,771                                    | 100.0%   |

**Note 15: 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

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

connection with its efforts to contact consumers. These cases are frequently styled as supposed class actions.

On May 19, 2008, an action captioned *Brent v. Midland Credit Management, Inc. et. al* was filed in the United States District Court for the Northern District of Ohio Western Division, in which the plaintiff filed a class action counter-claim against two of the Company's subsidiaries (the Midland Defendants). The complaint alleged that the Midland Defendants' business practices violated consumers' rights under the FDCPA and the Ohio Consumer Sales Practices Act. The plaintiff sought actual and statutory damages for



**Table of Contents**

the class of Ohio residents, plus attorney's fees and costs of class notice and class administration. The dollar amount of damages originally sought in the case was an unspecified amount in excess of \$25,000. On August 12, 2011, the court issued an order granting final approval to the parties agreed upon settlement of this lawsuit, as well as two other pending lawsuits in the Northern District of Ohio entitled *Franklin v. Midland Funding LLC* and *Vassalle v. Midland Funding LLC*, on a national class basis, and dismissed the cases against the Midland Defendants with prejudice. That order was subsequently appealed by certain objectors to the settlement, and on February 26, 2013, the Court of Appeals for the Sixth Circuit reversed the district court's order approving the settlement, vacated the judgment certifying a nationwide settlement class, and remanded the case back to the Northern District of Ohio for further proceedings consistent with the Sixth Circuit's ruling, where it remains pending.

On March 8, 2013, March 19, 2013 and March 20, 2013, three actions entitled *Shell v. Asset Acceptance Capital Corp., et. al., Neumann v. Asset Acceptance Capital Corp., et. al.,* and *Jaluka v. Asset Acceptance Capital Corp. et. al.*, respectively, were filed in the Macomb County Circuit Court of the State of Michigan. On April 19, 2013, a fourth action entitled *Dix v. Asset Acceptance Capital Corp. et al* was filed in the Court of Chancery of the State of Delaware. These actions were brought by purported stockholders of Asset Acceptance Capital Corporation ( AACC ) against the Company, AACC, and certain other named entities and individuals, and allege, among other things, that the Company has aided and abetted AACC's directors in breaching their fiduciary duties of care, loyalty and candor or disclosure owed to AACC stockholders. Plaintiffs in the actions seek, among other things, injunctive relief prohibiting consummation of the proposed acquisition, or rescission of the proposed acquisition (in the event the transaction has already been consummated), as well as costs and disbursements, including reasonable attorneys' and experts' fees, and other equitable or injunctive relief as the court may deem just and proper. The plaintiffs have not specified the dollar amount of damages sought in each action.

Except as described above, there have been no material developments in any of the legal proceedings disclosed in the Company's Annual Report on Form 10-K for the year ended December 31, 2012.

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. As of March 31, 2013, the Company has no material reserves for litigation. Additionally, based on the current status of litigation matters, either the estimate of exposure is immaterial to the Company's financial statements or an estimate cannot yet be determined. 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, 2013, the Company has entered into agreements to purchase receivable portfolios with a face value of approximately \$876.7 million for a purchase price of approximately \$55.0 million. The Company has no purchase commitments beyond December 2014.

**Note 16: Segment Information**

The Company conducts business through two operating segments: portfolio purchasing and recovery and tax lien transfer. The Company's management relies on internal management reporting processes that provide segment revenue, segment operating income, and segment asset information in order to make financial decisions and allocate resources. The operating results from the Company's tax lien transfer segment are immaterial to the Company's total consolidated operating results. However, total assets from this segment are significant as compared to the Company's total consolidated assets. As a result, in accordance with authoritative guidance on segment reporting, the Company's tax lien transfer segment is determined to be a reportable segment.

**Table of Contents**

Segment operating income includes income from operations before depreciation, amortization of intangible assets, and stock-based compensation expense. The following table provides a reconciliation of revenue and segment operating income by reportable segment to consolidated results and was derived from the segments' internal financial information as used for corporate management purposes (*in thousands*):

|   | Three Months Ended |            |
|---|--------------------|------------|
|   | March 31,          |            |
|   | 2013               | 2012       |
| <b>Revenues:</b>                                      |                    |            |
| Portfolio purchasing and recovery                     | \$ 140,683         | \$ 126,405 |
| Tax lien transfer                                     | 3,602              |            |
|   | \$ 144,285         | \$ 126,405 |
| <b>Operating income:</b>                              |                    |            |
| Portfolio purchasing and recovery                     | \$ 42,680          | \$ 38,517  |
| Tax lien transfer <sup>(1)</sup>                      | 580                |            |
|   | 43,260             | 38,517     |
| Depreciation and amortization                         | (1,846)            | (1,240)    |
| Stock-based compensation                              | (3,001)            | (2,266)    |
| Other expense   | (6,394)            | (5,243)    |
| Income from continuing operations before income taxes | \$ 32,019          | \$ 29,768  |

<sup>(1)</sup> Does not include service fee revenue of \$0.3 million that was included in Other Income in the unaudited condensed consolidated statements of comprehensive income for the three months ended March 31, 2013.

Additionally, assets are allocated to operating segments for management review. As of March 31, 2013, total segment assets were \$926.4 million and \$206.1 million for the portfolio purchasing and recovery segment and tax lien transfer segment, respectively.

**Note 17: 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.

As of March 31, 2013, the Company has two reporting units that carry goodwill: portfolio purchasing and recovery and tax lien transfer. Annual testing is performed as of October 1<sup>st</sup> for the portfolio purchasing and recovery reporting unit and as of April 1<sup>st</sup> for the tax lien transfer reporting unit.

As discussed in Note 3, Business Combinations, as a result of its final purchase price allocation related to the Propel Acquisition, the Company made an adjustment of approximately \$4.0 million to reduce goodwill attributable to the tax lien transfer reporting unit during the three months ended March 31, 2013.

As discussed in Note 2, Discontinued Operations, on May 16, 2012, the Company completed the sale of substantially all of the assets and certain liabilities of Ascension to AIS. In connection with the preparation of its financial statements and based, in part, on the anticipated disposition of Ascension, the Company performed an interim goodwill impairment test for Ascension as of March 31, 2012 and concluded that Ascension's entire goodwill balance of \$9.9 million was impaired. Additionally, the Company wrote-off Ascension's remaining identifiable intangible assets of approximately \$0.4 million as of March 31, 2012.



**Table of Contents**

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

|  | As of March 31, 2013  |                          |                     | As of December 31, 2012 |                          |                     |
|--|-----------------------|--------------------------|---------------------|-------------------------|--------------------------|---------------------|
|  | Gross Carrying Amount | Accumulated Amortization | Net Carrying Amount | Gross Carrying Amount   | Accumulated Amortization | Net Carrying Amount |
| Intangible assets subject to amortization:     |                       |                          |                     |                         |                          |                     |
| Trade name and other                           | \$ 570                | \$ (108)                 | \$ 462              | \$ 570                  | \$ (83)                  | \$ 487              |
| Intangible assets not subject to amortization: |                       |                          |                     |                         |                          |                     |
| Goodwill portfolio purchasing and recovery     |                       |                          | \$ 6,047            |                         |                          | \$ 6,047            |
| Goodwill tax lien transfer                     |                       |                          | 45,390              |                         |                          | 49,399              |
| Total goodwill                                 |                       |                          | \$ 51,437           |                         |                          | \$ 55,446           |

**Note 18: Common Stock Repurchases**

The Company had a \$50.0 million share repurchase program authorized by its Board of Directors. Under this program, the Company had the ability to repurchase up to \$50.0 million of the Company's common stock, subject to available borrowing capacity and other covenants contained in the Company's financing agreements, including the Credit Agreement. During 2012, the Company repurchased 1.9 million shares of common stock at a cost of \$49.3 million. During the three months ended March 31, 2013, the Company repurchased 24,400 shares under the share repurchase program for \$0.7 million. As of March 31, 2013, the Company did not have any stock repurchase capacity under this program.

**Note 19: Subsequent Events**

On April 8, 2013, the Company announced that it had hired Kenneth A. Vecchione to replace J. Brandon Black as President and Chief Executive Officer. Mr. Black will remain on the Board through his current term and is not expected to seek re-election. Mr. Vecchione joined the Board as of April 8, 2013. As part of the transition, the Company entered into a consulting agreement with Mr. Black and an employment agreement with Mr. Vecchione. Information regarding this event is set forth on the Company's Form 8-K filed on April 9, 2013.

On May 9, 2013, the Company exercised the remaining \$180.0 million of its accordion feature and entered into the Restated Credit Agreement and amended and restated its Senior Secured Notes. The Restated Credit Amendment reset the accordion feature to \$200.0 million and added new lenders. In conjunction with the amendment, the Company exercised \$37.5 million of the new accordion feature. This \$37.5 million exercise, when combined with the \$180.0 million exercise, increased the aggregate revolving loan commitment by \$217.5 million, from \$595.0 million to \$812.5 million, a portion of which is subject to ongoing principal amortization. Including the remaining accordion feature, the maximum amount that can be borrowed under the Credit Facility is \$975.0 million.

Additionally, both amendments include, but are not limited to, the following key provisions:

Allow for the AACC merger discussed in Note 3 Business Combinations ;

Introduce a basket to allow for investments in unrestricted subsidiaries; and

Increase the subordinated debt basket to \$300.0 million.

**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 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.*

**Our Business and Operating Segments**

We are a leading provider of debt management and recovery solutions for consumers and property owners across a broad range of financial assets. We purchase portfolios of defaulted consumer receivables at deep discounts to face value and manage them by working 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. Defaulted receivables may also include receivables subject to bankruptcy proceedings. In addition, through our subsidiary, Propel, we assist Texas property owners who are delinquent on their property taxes by paying these taxes on behalf of the property owners in exchange for payment agreements collateralized by tax liens on the property.

We conduct business through two operating segments: portfolio purchasing and recovery and tax lien transfer. The operating results from our tax lien transfer segment are immaterial to our total consolidated operating results. However, the total segment assets are significant as compared to our total consolidated assets. As a result, in accordance with authoritative guidance on segment reporting, our tax lien transfer segment is determined to be a reportable segment.

**Portfolio purchasing and recovery**

Our portfolio purchasing and recovery segment purchases receivables based on robust, account-level valuation methods and employs proprietary statistical and behavioral models across the full extent of our operations. These investments allow us to value portfolios accurately (and limit the risk of overpaying), avoid buying portfolios that are incompatible with our methods or goals and align the accounts we purchase with our operational channels to maximize future collections. As a result, we have been able to realize significant returns from the receivables we acquire. We maintain strong relationships with many of the largest credit and telecommunication providers in the United States and believe we possess one of the industry's best collection staff retention rates.

While seasonality does not have a material impact on our portfolio purchasing and recovery segment, 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 with respect to our portfolio purchasing and recovery segment 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 (e.g., the fourth calendar quarter), revenue as a percentage of collections can be higher than in quarters with higher collections (e.g., the first calendar quarter).

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

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 (*e.g.*, the first calendar quarter), all else being equal, earnings could be lower than in quarters with slower collections and lower costs (*e.g.*, 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.

## Table of Contents

### **Tax lien transfer**

Our tax lien transfer segment focuses on the property tax financing industry. Our principal activity is originating and servicing property tax lien transfers in the state of Texas. With the property owner's consent, we pay the property owner's delinquent property taxes directly to the taxing authority, which then transfers its tax lien to us. We then enter into a payment agreement with the property owner, creating an affordable payment plan. Revenue from our tax lien transfer segment comprised 2% of total consolidated revenues for the three months ended March 31, 2013. Operating income from our tax lien transfer segment comprised 1% of our total consolidated operating income for the three months ended March 31, 2013.

### **Merger Agreement**

On March 6, 2013, we and our wholly owned subsidiary, Pinnacle Sub, Inc. ( Merger Sub ), entered into an agreement and plan of merger (the Merger Agreement ) with AACC, another leading provider of debt management and recovery solutions. Pursuant to the Merger Agreement, Merger Sub will merge with and into AACC, and AACC will continue as the surviving corporation and will become our wholly owned subsidiary. The Merger Agreement has been approved by our board of directors and by the board of directors of AACC.

The transaction is expected to close in the second quarter of 2013, and is subject to, among other items, customary closing conditions and regulatory approvals. Information regarding this transaction is set forth on our Registration Statement on Form S-4, as amended, initially filed with the SEC on March 27, 2013.

We will account for the merger using the acquisition method of accounting. Under the acquisition method of accounting, the assets and liabilities of AACC will be recorded as of the closing date of the merger, at their respective fair values, and consolidated with our assets and liabilities. The results of operations of AACC will be consolidated with our results of operations beginning on the closing date of the merger.

### **Discontinued Operations**

On May 16, 2012, we completed the sale of substantially all of the assets and certain of the liabilities of our bankruptcy servicing subsidiary Ascension Capital Group, Inc. ( Ascension ). Accordingly, Ascension's results of operations are reflected as discontinued operations in our condensed consolidated statements of comprehensive income.

### **Purchases and Collections**

#### *Purchases by Type*

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

|             | <b>Three Months Ended March 31,</b> |                   |
|-------------|-------------------------------------|-------------------|
|             | <b>2013</b>                         | <b>2012</b>       |
| Credit card | \$ 43,414                           | \$ 107,935        |
| Telecom     | 15,357                              | 22,528            |
|             | <b>\$ 58,771</b>                    | <b>\$ 130,463</b> |

During the three months ended March 31, 2013, we invested \$58.8 million to acquire charged-off credit card and telecom portfolios, with face values aggregating \$1.6 billion, for an average purchase price of 3.6% of face value. This is a \$71.7 million decrease, or 55.0%, in the amount invested, compared with the \$130.5 million invested during the three months ended March 31, 2012, to acquire charged-off credit card portfolios with a face value aggregating \$2.9 billion, for an average purchase price of 4.5% 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.

Meaningful increases in the prices for portfolios offered for sale directly from credit issuers continued into the first quarter 2013 especially for fresh portfolios. Fresh portfolios are portfolios that are generally transacted within six months of the consumer's account being charged-off by the

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

financial institution. We believe this price increase is due to a reduction in the supply of charged-off accounts and continued demand in the marketplace. We believe that the reduction in supply is partially due to shifts in underwriting standards by financial institutions which have resulted in lower volumes of charged-off accounts. We expect that pricing will remain at these elevated levels for a period of time. We believe that pricing will not decline until buyers who have paid prices that are too high recognize that they are unable to realize a profit. Should pricing trends continue in this manner, we expect to continue to adjust our purchasing strategies away from fresh portfolios, and toward portfolios in alternative asset classes or aged portfolios, where pricing is not as elevated and where we believe that our operational model allows us to maintain acceptable profit margins. Additionally, as discussed above, we entered into an agreement to purchase AACC, another leading provider of debt management and recovery solutions, including their investment in receivable portfolios. We expect this transaction to close in the second or third quarter of 2013 and for this transaction to account for a significant portion of our 2013 purchases.



**Table of Contents****Collections by Channel**

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 the respective periods (*in thousands*):

|                     | <b>Three Months Ended March 31,</b> |                   |
|---------------------|-------------------------------------|-------------------|
|                     | <b>2013</b>                         | <b>2012</b>       |
| Collection sites    | \$ 126,562                          | \$ 109,870        |
| Legal collections   | 122,273                             | 109,572           |
| Collection agencies | 21,335                              | 11,586            |
|                     | <b>\$ 270,170</b>                   | <b>\$ 231,028</b> |

Gross collections increased \$39.1 million, or 16.9%, to \$270.2 million during the three months ended March 31, 2013, from \$231.0 million during the three months ended March 31, 2012.

**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*):

|  | <b>Three Months Ended March 31,</b> |               |                 |               |
|--|-------------------------------------|---------------|-----------------|---------------|
|  | <b>2013</b>                         |               | <b>2012</b>     |               |
| <b>Revenues</b>  |                                     |               |                 |               |
| Revenue from receivable portfolios, net                      | \$ 140,683                          | 97.5%         | \$ 126,405      | 100.0%        |
| Net interest income tax lien transfer                        | 3,602                               | 2.5%          |                 | 0.0%          |
| <b>Total revenues</b>  | <b>144,285</b>                      | <b>100.0%</b> | <b>126,405</b>  | <b>100.0%</b> |
| <b>Operating expenses</b>                                    |                                     |               |                 |               |
| Salaries and employee benefits                               | 28,832                              | 20.0%         | 22,304          | 17.6%         |
| Cost of legal collections                                    | 42,258                              | 29.3%         | 38,635          | 30.6%         |
| Other operating expenses                                     | 13,265                              | 9.2%          | 11,598          | 9.2%          |
| Collection agency commissions                                | 3,329                               | 2.3%          | 3,959           | 3.1%          |
| General and administrative expenses                          | 16,342                              | 11.3%         | 13,658          | 10.8%         |
| Depreciation and amortization                                | 1,846                               | 1.3%          | 1,240           | 1.0%          |
| <b>Total operating expenses</b>                              | <b>105,872</b>                      | <b>73.4%</b>  | <b>91,394</b>   | <b>72.3%</b>  |
| <b>Income from operations</b>                                | <b>38,413</b>                       | <b>26.6%</b>  | <b>35,011</b>   | <b>27.7%</b>  |
| <b>Other (expense) income</b>                                |                                     |               |                 |               |
| Interest expense   | (6,854)                             | (4.7)%        | (5,515)         | (4.4)%        |
| Other income   | 460                                 | 0.3%          | 272             | 0.2%          |
| <b>Total other expense</b>                                   | <b>(6,394)</b>                      | <b>(4.4)%</b> | <b>(5,243)</b>  | <b>(4.2)%</b> |
| <b>Income from continuing operations before income taxes</b> | <b>32,019</b>                       | <b>22.2%</b>  | <b>29,768</b>   | <b>23.5%</b>  |
| <b>Provision for income taxes</b>                            | <b>(12,571)</b>                     | <b>(8.7)%</b> | <b>(11,660)</b> | <b>(9.2)%</b> |
| <b>Income from continuing operations</b>                     | <b>19,448</b>                       | <b>13.5%</b>  | <b>18,108</b>   | <b>14.3%</b>  |

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

|   |           |       |           |        |
|---|-----------|-------|-----------|--------|
| Loss from discontinued operations, net of tax |           | 0.0%  | (6,702)   | (5.3)% |
| Net income                                    | \$ 19,448 | 13.5% | \$ 11,406 | 9.0%   |

### Non-GAAP Disclosure

In addition to the financial information prepared in conformity with Generally Accepted Accounting Principles ( GAAP ), we provide certain historical non-GAAP financial information. Management believes that the presentation of such non-GAAP financial information is meaningful and useful in understanding the activities and business metrics of our operations. Management believes that these non-GAAP financial measures reflect an additional way of viewing aspects of our business that, when viewed with our GAAP results, provide a more complete understanding of factors and trends affecting our business.

Management believes that the presentation of these measures provides investors with greater transparency and facilitates comparison of operating results across a broad spectrum of companies with varying capital structures, compensation strategies, derivative instruments, and amortization methods, which provide a more complete understanding of our financial performance, competitive position, and prospects for the future. Readers should consider the information in addition to, but not instead of, our financial statements prepared in accordance with GAAP. This non-GAAP financial information may be determined or calculated differently by other companies, limiting the usefulness of these measures for comparative purposes.

**Table of Contents**

**Adjusted Income from Continuing Operations Per Share.** Management believes that investors regularly rely on non-GAAP adjusted earnings and adjusted earnings per share, to assess operating performance, in order to highlight trends in our business that may not otherwise be apparent when relying on financial measures calculated in accordance with GAAP. Adjusted income from continuing operations excludes non-cash interest and issuance cost amortization, relating to our convertible notes, and acquisition related expenses, net of tax. The following table provides a reconciliation between income from continuing operations and diluted income from continuing operations per share calculated in accordance with GAAP to adjusted income from continuing operations and adjusted income from continuing operations per share, respectively (*in thousands, except per share data*):

|  | Three Months Ended March 31, |                   |           |                   |
|--|------------------------------|-------------------|-----------|-------------------|
|  | 2013                         |                   | 2012      |                   |
|  | \$                           | Per Diluted Share | \$        | Per Diluted Share |
| GAAP income from continuing operations, as reported                            | \$ 19,448                    | \$ 0.80           | \$ 18,108 | \$ 0.70           |
| Adjustments:   |                              |                   |           |                   |
| Convertible notes non-cash interest and issuance cost amortization, net of tax | 673                          | 0.03              |           |                   |
| Acquisition related expenses, net of tax                                       | 775                          | 0.03              |           |                   |
| Adjusted income from continuing operations                                     | \$ 20,896                    | \$ 0.86           | \$ 18,108 | \$ 0.70           |

**Adjusted EBITDA.** Management utilizes adjusted EBITDA (defined as net income before interest, taxes, depreciation and amortization, stock-based compensation expenses, portfolio amortization, and acquisition related expenses), which is materially similar to a financial measure contained in covenants used in our credit agreement, in the evaluation of our operations and believes that 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 (*in thousands*):

|  | Three Months Ended March 31, |            |
|--|------------------------------|------------|
|  | 2013                         | 2012       |
| GAAP net income, as reported                         | \$ 19,448                    | \$ 11,406  |
| Adjustments:   |                              |            |
| Loss from discontinued operations, net of tax        |                              | 6,702      |
| Interest expense                                     | 6,854                        | 5,515      |
| Provision for income taxes                           | 12,571                       | 11,660     |
| Depreciation and amortization                        | 1,846                        | 1,240      |
| Amount applied to principal on receivable portfolios | 129,487                      | 104,603    |
| Stock-based compensation expense                     | 3,001                        | 2,266      |
| Acquisition related expenses                         | 1,276                        | 489        |
| Adjusted EBITDA                                      | \$ 174,483                   | \$ 143,881 |

**Adjusted operating expenses.** We have included information concerning adjusted operating expenses, excluding stock-based compensation expense, tax lien transfer segment operating expenses, and acquisition related expenses, in order to facilitate a comparison of approximate cash costs to cash collections for the portfolio purchasing and recovery business in the periods presented. (*in thousands*):

|  | Three Months Ended March 31, |           |
|--|------------------------------|-----------|
|  | 2013                         | 2012      |
| GAAP total operating expenses, as reported   | \$ 105,872                   | \$ 91,394 |
| Adjustments:                                 |                              |           |
| Stock-based compensation expense             | (3,001)                      | (2,266)   |
| Tax lien transfer segment operating expenses | (3,022)                      |           |
| Acquisition related expenses                 | (1,276)                      | (489)     |

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

|  |           |           |
|--|-----------|-----------|
| Adjusted operating expenses for the portfolio purchasing and recovery business | \$ 98,573 | \$ 88,639 |
|--|-----------|-----------|

**Table of Contents****Comparison of Results of Operations****Revenues**

Our revenues consist primarily of portfolio revenue and interest income net of related interest expense from property tax payment agreements receivable.

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 IRR 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 portfolios utilizing the interest method in accordance with the authoritative guidance for loans and debt securities acquired with deteriorated credit quality. Interest income, net of related interest expense represents net interest income on property tax payment agreements receivable.

The following tables summarize collections, revenue, end of period receivable balance and other related supplemental data, by year of purchase from our portfolio purchasing and recovery segment (*in thousands, except percentages*):

|                    | Three Months Ended March 31, 2013 |                              |   |  | As of<br>March 31, 2013    |                      |             |
|--------------------|-----------------------------------|------------------------------|---|--|----------------------------|----------------------|-------------|
|                    | Collections <sup>(1)</sup>        | Gross Revenue <sup>(2)</sup> | Revenue Recognition Rate <sup>(3)</sup> | Portfolio Allowance Reversal (Allowance) | Revenue % of Total Revenue | Unamortized Balances | Monthly IRR |
| ZBA <sup>(4)</sup> | \$ 5,611                          | \$ 4,662                     | 83.1%                                   | \$ 949                                   | 3.4%                       | \$                   |             |
| 2005               | 2,251                             | 233                          | 10.4%                                   | 10                                       | 0.2%                       | 108                  | 5.3%        |
| 2006               | 2,503                             | 1,140                        | 45.5%                                   | (459)                                    | 0.8%                       | 6,415                | 5.1%        |
| 2007               | 3,378                             | 1,554                        | 46.0%                                   | 343                                      | 1.1%                       | 8,966                | 5.1%        |
| 2008               | 12,114                            | 7,031                        | 58.0%                                   | 163                                      | 5.0%                       | 29,395               | 7.1%        |
| 2009               | 23,232                            | 14,695                       | 63.3%                                   |  | 10.5%                      | 38,683               | 10.9%       |
| 2010               | 45,224                            | 28,392                       | 62.8%                                   |  | 20.3%                      | 87,624               | 9.5%        |
| 2011               | 67,236                            | 36,348                       | 54.1%                                   |  | 26.0%                      | 164,466              | 6.5%        |
| 2012               | 104,172                           | 43,295                       | 41.6%                                   |  | 31.0%                      | 409,360              | 3.1%        |
| 2013               | 4,449                             | 2,327                        | 52.3%                                   |  | 1.7%                       | 56,508               | 3.8%        |
| <b>Total</b>       | <b>\$ 270,170</b>                 | <b>\$ 139,677</b>            | <b>51.7%</b>                            | <b>\$ 1,006</b>                          | <b>100.0%</b>              | <b>\$ 801,525</b>    | <b>5.1%</b> |

|                    | Three Months Ended March 31, 2012 |                              |   |  | As of<br>March 31, 2012    |                      |             |
|--------------------|-----------------------------------|------------------------------|---|--|----------------------------|----------------------|-------------|
|                    | Collections <sup>(1)</sup>        | Gross Revenue <sup>(2)</sup> | Revenue Recognition Rate <sup>(3)</sup> | Portfolio Allowance Reversal (Allowance) | 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%        |

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

|       |            |            |       |          |        |            |      |
|-------|------------|------------|-------|----------|--------|------------|------|
| 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% |

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

(2) Gross revenue excludes the effects of net portfolio allowances or net portfolio allowance reversals.

(3) Revenue recognition rate excludes the effects of net portfolio allowances or net portfolio allowance reversals.

(4) ZBA revenue typically has a 100% revenue recognition rate. However, collections on ZBA pool groups where a valuation allowance remains must first be recorded as an allowance reversal until the allowance for that pool group is zero. Once the valuation allowance is reversed, the revenue recognition rate will become 100%.

**Table of Contents**

Total revenues were \$144.3 million during the three months ended March 31, 2013, an increase of \$17.9 million, or 14.1%, compared to total revenues of \$126.4 million during the three months ended March 31, 2012.

Revenue from our portfolio purchasing and recovery segment was \$140.7 million during the three months ended March 31, 2013, an increase of \$14.3 million, or 11.3%, compared to revenue of \$126.4 million during the three months ended March 31, 2012. The increase in portfolio revenue during the three months ended March 31, 2013, was primarily the result of additional accretion revenue associated with collection over performance compared with our cash projections, resulting in increases to certain portfolio IRRs during the three months ended March 31, 2013 compared to the same periods of the prior year. Additionally, during the three months ended March 31, 2013, we recorded a net portfolio allowance reversal of \$1.0 million, compared to a net portfolio allowance provision of \$0.4 million during the three months ended March 31, 2012.

Net interest income from our tax lien transfer segment was \$3.6 million for the three months ended March 31, 2012.

**Operating Expenses**

Total operating expenses were \$105.9 million during the three months ended March 31, 2013, an increase of \$14.5 million, or 15.8%, compared to total operating expenses of \$91.4 million during the three months ended March 31, 2012.

Operating expenses are explained in more detail as follows:

**Salaries and employee benefits**

Salaries and employee benefits increased \$6.5 million, or 29.3%, to \$28.8 million during the three months ended March 31, 2013, from \$22.3 million during the three months ended March 31, 2012. The increase was primarily the result of increases in headcount and related compensation expense to support the growth in our portfolio purchasing and recovery business and the acquisition of Propel. The increase was also attributable to higher stock-based compensation expenses of \$0.7 million. Salaries and employee benefits related to our internal legal channel were approximately \$2.8 million and \$1.3 million for the three months ended March 31, 2013 and 2012, respectively.

Salaries and employee benefits broken down between the reportable segments are as follows (*in thousands*):

|                                   | <b>Three Months Ended March 31,</b> |             |
|-----------------------------------|-------------------------------------|-------------|
|                                   | <b>2013</b>                         | <b>2012</b> |
| Salaries and employee benefits:   |                                     |             |
| Portfolio purchasing and recovery | \$ 27,414                           | \$ 22,304   |
| Tax lien transfer                 | 1,418                               |             |
|                                   | \$ 28,832                           | \$ 22,304   |

**Cost of legal collections Portfolio purchasing and recovery**

The cost of legal collections increased \$3.7 million, or 9.4%, to \$42.3 million during the three months ended March 31, 2013, compared to \$38.6 million during the three months ended March 31, 2012. These costs represent contingent fees paid to our nationwide network of attorneys and costs of litigation. The increase in the cost of legal collections was primarily the result of an increase of \$12.7 million, or 11.6%, in gross collections through our legal channel. Gross legal collections were \$122.3 million during the three months ended March 31, 2013, up from \$109.6 million collected during the three months ended March 31, 2012. The cost of legal collections, decreased as a percentage of gross collections through this channel to 34.6% during the three months ended March 31, 2013 from 35.3% during the same period in the prior year. This decrease was primarily due to increased collections in our internal legal channel for which we do not pay a commission.

**Table of Contents**

The following table summarizes our legal collection channel performance and related direct costs (*in thousands, except percentages*):

|                      |                                  | <b>Three Months Ended March 31,</b> |        |             |        |
|----------------------|----------------------------------|-------------------------------------|--------|-------------|--------|
|                      |                                  | <b>2013</b>                         |        | <b>2012</b> |        |
| <b>Collections:</b>  |                                  |                                     |        |             |        |
| Collections          | legal outsourcing                | \$ 112,642                          | 92.1%  | \$ 106,702  | 97.4%  |
| Collections          | internal legal                   | 9,631                               | 7.9%   | 2,870       | 2.6%   |
| Total collections    | legal networks                   | \$ 122,273                          | 100.0% | \$ 109,572  | 100.0% |
| <b>Costs:</b>        |                                  |                                     |        |             |        |
| Commissions          | legal outsourcing                | \$ 28,810                           | 25.6%  | \$ 27,567   | 25.8%  |
| Court cost expense   | legal outsourcing <sup>(1)</sup> | 10,015                              |        | 9,247       |        |
| Court cost expense   | internal legal <sup>(1)</sup>    | 2,515                               |        | 1,242       |        |
| Other <sup>(2)</sup> |                                  | 918                                 |        | 579         |        |
| Total direct costs   | legal networks                   | \$ 42,258                           | 34.6%  | \$ 38,635   | 35.3%  |

(1) We advance certain out-of-pocket court costs and capitalize these costs in our consolidated financial statements and provide a reserve and corresponding court cost expense for the costs that we believe will be ultimately uncollectible. This amount includes changes in our anticipated recovery rate of court costs expensed.

(2) Other costs consist of costs related to counter claims and legal network subscription fees.

**Other operating expenses**

Other operating expenses increased \$1.7 million, or 14.4%, to \$13.3 million during the three months ended March 31, 2013, from \$11.6 million during the three months ended March 31, 2012. The increase was primarily the result of Propel other operating expenses of \$0.9 million, an increase of \$0.3 million in direct mail campaign expenses, an increase of \$0.3 million in telephone expenses, and a net increase in various other operating expenses of \$0.2 million, primarily to support our growth.

Other operating expenses broken down between the reportable segments are as follows (*in thousands*):

|                                   | <b>Three Months Ended March 31,</b> |             |
|-----------------------------------|-------------------------------------|-------------|
|                                   | <b>2013</b>                         | <b>2012</b> |
| <b>Other operating expenses:</b>  |                                     |             |
| Portfolio purchasing and recovery | \$ 12,380                           | \$ 11,598   |
| Tax lien transfer                 | 885                                 |             |
|                                   | \$ 13,265                           | \$ 11,598   |

**Collection agency commissions Portfolio purchasing and recovery**

During the three months ended March 31, 2013, we incurred \$3.3 million in commissions to third party collection agencies, or 15.6% of the related gross collections of \$21.3 million, compared to \$4.0 million in commissions, or 34.2%, of the related gross collections of \$11.6 million, during the three months ended March 31, 2012. During the three months ended March 31, 2013, we experienced an increase in collection agency collections as a result of increased purchases of bankruptcy portfolios, which are primarily serviced by an outside service provider. During the period, the commission rate decreased as compared to the prior year due to bankruptcy commission rates being lower than commission rates on non-bankruptcy portfolios.

**General and administrative expenses**



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

General and administrative expenses increased \$2.7 million, or 19.7%, to \$16.3 million during the three months ended March 31, 2013, from \$13.7 million during the three months ended March 31, 2012. The increase was primarily the result of acquisition related costs of \$1.3 million, an increase in IT consulting and other IT expenses of \$2.1 million, general and administrative expenses related to Propel of \$0.7 million, and a net increase in other general and administrative expenses of \$0.7 million. The increase was offset by a reduction in corporate settlement expense of \$2.0 million.

General and administrative expenses broken down between the reportable segments are as follows (*in thousands*):

|   | <b>Three Months Ended March 31,</b> |             |
|---|-------------------------------------|-------------|
|   | <b>2013</b>                         | <b>2012</b> |
| <b>General and administrative expenses:</b> |                                     |             |
| Portfolio purchasing and recovery           | \$ 15,623                           | \$ 13,658   |
| Tax lien transfer                           | 719                                 |             |
|   | \$ 16,342                           | \$ 13,658   |

**Table of Contents****Depreciation and amortization**

Depreciation and amortization expense increased \$0.6 million, or 48.9%, to \$1.8 million during the three months ended March 31, 2013, from \$1.2 million during the three months ended March 31, 2012. The increase during the three months ended March 31, 2013 was primarily related to increased depreciation expense resulting from our acquisition of fixed assets in recent periods.

**Cost per Dollar Collected Portfolio purchasing and recovery**

The following tables summarize our cost per dollar collected (*in thousands, except percentages*):

|                                     | Three Months Ended March 31, |                          |                                   |                                 |             |                          |                                   |                                 |
|-------------------------------------|------------------------------|--------------------------|-----------------------------------|---------------------------------|-------------|--------------------------|-----------------------------------|---------------------------------|
|                                     | 2013                         |                          |                                   |                                 | 2012        |                          |                                   |                                 |
|                                     | Collections                  | Cost                     | Cost Per Channel Dollar Collected | Cost Per Total Dollar Collected | Collections | Cost                     | Cost Per Channel Dollar Collected | Cost Per Total Dollar Collected |
| Collection sites <sup>(1)</sup>     | \$ 126,562                   | \$ 7,243                 | 5.7%                              | 2.7%                            | \$ 109,870  | \$ 6,476                 | 5.9%                              | 2.8%                            |
| Legal outsourcing                   | 112,642                      | 39,590                   | 35.1%                             | 14.7%                           | 106,702     | 37,345                   | 35.0%                             | 16.1%                           |
| Internal legal                      | 9,631                        | 2,668                    | 27.7%                             | 1.0%                            | 2,870       | 1,290                    | 44.9%                             | 0.6%                            |
| Collection agency outsourcing       | 21,335                       | 3,329                    | 15.6%                             | 1.2%                            | 11,586      | 3,959                    | 34.2%                             | 1.7%                            |
| Other indirect costs <sup>(2)</sup> |                              | 45,743                   |                                   | 16.9%                           |             | 39,569                   |                                   | 17.2%                           |
| Total                               | \$ 270,170                   | \$ 98,573 <sup>(3)</sup> |                                   | 36.5%                           | \$ 231,028  | \$ 88,639 <sup>(3)</sup> |                                   | 38.4%                           |

(1) Cost in collection sites represents only account managers and their supervisors' salaries, variable compensation, and employee benefits.

(2) Other indirect costs represent non-collection site salaries and employee benefits, general and administrative expenses, other operating expenses and depreciation and amortization. Included in other indirect costs were costs related to our internal legal channel of approximately \$4.1 million and \$1.8 million for the three months ended March 31, 2013 and 2012, respectively.

(3) Represents all operating expenses, excluding stock-based compensation expense, tax lien transfer segment operating expenses, and acquisition related expenses. We include this information in order to facilitate a comparison of approximate cash costs to cash collections for the debt purchasing business in the periods presented. Refer to the Non-GAAP Disclosure section for further details.

During the three months ended March 31, 2013, cost per dollar collected decreased by 190 basis points to 36.5% of gross collections from 38.4% of gross collections during the three months ended March 31, 2012. This decrease was due to several factors, including:

The cost of legal collections through our legal outsourcing channel, as a percentage of total collections, decreased to 14.7% during the three months ended March 31, 2013, from 16.1% during the three months ended March 31, 2012 and, as a percentage of channel collections, remained relatively consistent compared to the same period of 2012. The decrease in cost of total collections through our legal outsourcing channel was primarily due to legal outsourcing collections decreasing as a percentage of total collections as collections from our internal legal channel continue to increase.

The cost of legal collections through our internal legal channel, as a percentage of total collections, increased to 1.0% during the three months ended March 31, 2013, from 0.6% during the three months ended March 31, 2012 and, as a percentage of channel collections, decreased to 27.7% during the three months ended March 31, 2013, from 44.9% during the three months ended March 31, 2012. The increase in cost of total collections through our internal legal channel was primarily due to increased collections from this channel as a percentage of total collections. The decrease in cost of channel collections was primarily due to increased productivity as we continue to ramp up our internal legal platform.

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

The cost from our collection sites, which includes account manager salaries, variable compensation, and employee benefits, as a percentage of total collections, decreased slightly to 2.7% during the three months ended March 31, 2013, from 2.8% during the three months ended March 31, 2012 and, as a percentage of our site collections, decreased to 5.7% from 5.9%. These decreases were primarily due to the continued growth of our collection workforce in India and improvements in our consumer insights, which allow us to more effectively determine which consumers have the ability to pay and how to best engage with them.

Collection agency commissions, as a percentage of total collections, decreased to 1.2% during the three months ended March 31, 2013, from 1.7% during the same period in the prior year. Our collection agency commission rate decreased to 15.6% during the three months ended March 31, 2013, from 34.2% during the same period in the prior year. During the three months ended March 31, 2013, we experienced an increase in collection agency collections as a result of increased purchases of bankruptcy portfolios, which are primarily serviced by an outside service provider. During the same period, the commission rate decreased as compared to the prior year, due to bankruptcy commission rates being lower than commission rates on non-bankruptcy portfolios.

**Table of Contents**

Other costs not directly attributable to specific channel collections (other indirect costs), as a percentage of total collections, decreased 30 basis points, to 16.9% for the three months ended March 31, 2013, from 17.2% for the three months ended March 31, 2012. These costs include non-collection site salaries and employee benefits, internal legal salaries and other internal legal operating expenses, general and administrative expenses, other operating expenses, and depreciation and amortization. This decrease was due to collections growth outpacing the increase in other indirect costs.

**Interest Expense Portfolio purchasing and recovery**

Interest expense increased \$1.3 million, or 24.3%, to \$6.9 million during the three months ended March 31, 2013, from \$5.5 million during the three months ended March 31, 2012.

The following table summarizes our interest expense (*in thousands, except percentages*):

|   | Three Months Ended March 31, |          |           |          |
|---|------------------------------|----------|-----------|----------|
|   | 2013                         | 2012     | \$ Change | % Change |
| Stated interest on debt obligations             | \$ 5,477                     | \$ 5,049 | \$ 428    | 8.5%     |
| Amortization of loan fees and other loan costs  | 770                          | 466      | 304       | 65.2%    |
| Amortization of debt discount convertible notes | 607                          |          | 607       |          |
| Total interest expense                          | \$ 6,854                     | \$ 5,515 | \$ 1,339  | 24.3%    |

The increase in interest expense was primarily due to higher outstanding debt balances and increased amortization of debt discount and loan fees related to the \$115.0 million convertible notes we issued in November and December 2012.

**Provision for Income Taxes**

During the three months ended March 31, 2013, we recorded an income tax provision of \$12.6 million, reflecting an effective rate of 39.3% of pretax income from continuing operations. The effective tax rate for the three months ended March 31, 2013 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 6.6%.

During the three months ended March 31, 2012, we recorded an income tax provision of \$11.7 million, reflecting an effective rate of 39.2% of pretax income from continuing operations. 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 provision for state taxes of 6.5%.

**Table of Contents**

**Supplemental Performance Data Portfolio purchasing and recovery**

**Cumulative Collections to Purchase Price Multiple**

The following table summarizes our purchases and related gross collections by year of purchase (in thousands, except multiples):

| Year of Purchase                         | Purchase Price <sup>(1)</sup> | Cumulative Collections through March 31, 2013 |                   |                   |                   |                   |                   |                   |                   |                      | CCM <sup>(3)</sup> |
|--|-------------------------------|---|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|----------------------|--------------------|
|  |                               | <2007   | 2007              | 2008              | 2009              | 2010              | 2011              | 2012              | 2013              | Total <sup>(2)</sup> |                    |
| <b>Charged-off consumer receivables:</b> |                               |   |                   |                   |                   |                   |                   |                   |                   |                      |                    |
| 2006                                     | \$ 578,054 <sup>(4)</sup>     | \$ 1,334,922                                  | \$ 194,411        | \$ 113,239        | \$ 70,095         | \$ 47,196         | \$ 33,831         | \$ 24,130         | \$ 5,043          | \$ 1,822,867         | 3.2                |
| 2006                                     | 141,027                       | 42,354  | 92,265            | 70,743            | 44,553            | 26,201            | 18,306            | 12,825            | 2,553             | 309,800              | 2.2                |
| 2007                                     | 204,066                       | 68,048  | 145,272           | 111,117           | 70,572            | 44,035            | 29,619            | 5,746             | 474,409           | 2.3                  |                    |
| 2008                                     | 227,785                       |   | 69,049            | 165,164           | 127,799           | 87,850            | 59,507            | 12,178            | 521,547           | 2.3                  |                    |
| 2009                                     | 253,319                       |   |                   | 96,529            | 206,773           | 164,605           | 111,569           | 23,273            | 602,749           | 2.4                  |                    |
| 2010                                     | 346,105                       |   |                   |                   | 125,465           | 284,541           | 215,088           | 43,731            | 668,825           | 1.9                  |                    |
| 2011                                     | 382,869                       |   |                   |                   |                   | 122,224           | 300,536           | 67,218            | 489,978           | 1.3                  |                    |
| 2012                                     | 477,078                       |   |                   |                   |                   |                   | 186,472           | 95,750            | 282,222           | 0.6                  |                    |
| 2013                                     | 58,636                        |   |                   |                   |                   |                   |                   | 4,450             | 4,450             | 0.1                  |                    |
| Subtotal                                 | \$ 2,668,939                  | \$ 1,377,276                                  | \$ 354,724        | \$ 398,303        | \$ 487,458        | \$ 604,006        | \$ 755,392        | \$ 939,746        | \$ 259,942        | \$ 5,176,847         | 1.9                |
| <b>Purchased bankruptcy receivables:</b> |                               |   |                   |                   |                   |                   |                   |                   |                   |                      |                    |
| 2010                                     | \$ 11,975                     | \$  | \$                | \$                | \$                | \$ 388            | \$ 4,247          | \$ 5,598          | \$ 1,504          | \$ 11,737            | 1.0                |
| 2011                                     | 1,644                         |   |                   |                   |                   |                   | 1,372             | 1,413             | 302               | 3,087                | 1.9                |
| 2012                                     | 83,705                        |   |                   |                   |                   |                   |                   | 1,249             | 8,422             | 9,671                | 0.1                |
| Subtotal                                 | \$ 97,324                     | \$  | \$                | \$                | \$                | \$ 388            | \$ 5,619          | \$ 8,260          | \$ 10,228         | \$ 24,495            | 0.3                |
| <b>Total</b>                             | <b>\$ 2,766,263</b>           | <b>\$ 1,377,276</b>                           | <b>\$ 354,724</b> | <b>\$ 398,303</b> | <b>\$ 487,458</b> | <b>\$ 604,394</b> | <b>\$ 761,011</b> | <b>\$ 948,006</b> | <b>\$ 270,170</b> | <b>\$ 5,201,342</b>  | <b>1.9</b>         |

(1) Adjusted for put-backs and account recalls. 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 ).

(2) Cumulative collections from inception through March 31, 2013, excluding collections on behalf of others.

(3) Cumulative Collections Multiple ( CCM ) through March 31, 2013 collections as a multiple of purchase price.

**Total Estimated Collections to Purchase Price Multiple**

The following table summarizes our purchases, resulting historical gross collections, and estimated remaining gross collections by year of purchase (in thousands, except multiples):

|  | Purchase Price <sup>(1)</sup> | Historical Collections <sup>(2)</sup> | Estimated Remaining Collections <sup>(3)</sup> | Total Estimated Gross Collections | Total Estimated Gross Collections to Purchase Price |
|--|-------------------------------|---------------------------------------|--|-----------------------------------|---|
| <b>Charged-off consumer receivables:</b> |                               |                                       |  |                                   |   |
| <2006                                    | \$ 578,054                    | \$ 1,822,867                          | \$ 8,025                                       | \$ 1,830,892                      | 3.2   |
| 2006                                     | 141,027                       | 309,800                               | 12,803   | 322,603                           | 2.3   |
| 2007                                     | 204,066                       | 474,409                               | 31,468   | 505,877                           | 2.5   |
| 2008                                     | 227,785                       | 521,547                               | 71,845   | 593,392                           | 2.6   |
| 2009                                     | 253,319                       | 602,749                               | 145,048  | 747,797                           | 3.0   |

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

|                                   |                     |                     |                     |                     |            |
|-----------------------------------|---------------------|---------------------|---------------------|---------------------|------------|
| 2010                              | 346,105             | 668,825             | 298,392             | 967,217             | 2.8        |
| 2011                              | 382,869             | 489,978             | 448,267             | 938,245             | 2.5        |
| 2012                              | 477,078             | 282,222             | 672,582             | 954,804             | 2.0        |
| 2013                              | 58,636              | 4,450               | 121,129             | 125,579             | 2.1        |
| <b>Subtotal</b>                   | <b>\$ 2,668,939</b> | <b>\$ 5,176,847</b> | <b>\$ 1,809,559</b> | <b>\$ 6,986,406</b> | <b>2.6</b> |
| Purchased bankruptcy receivables: |                     |                     |                     |                     |            |
| 2010                              | \$ 11,975           | \$ 11,737           | \$ 11,307           | \$ 23,044           | 1.9        |
| 2011                              | 1,644               | 3,087               | 1,025               | 4,112               | 2.5        |
| 2012                              | 83,705              | 9,671               | 88,764              | 98,435              | 1.2        |
| <b>Subtotal</b>                   | <b>\$ 97,324</b>    | <b>\$ 24,495</b>    | <b>\$ 101,096</b>   | <b>\$ 125,591</b>   | <b>1.3</b> |
| <b>Total</b>                      | <b>\$ 2,766,263</b> | <b>\$ 5,201,342</b> | <b>\$ 1,910,655</b> | <b>\$ 7,111,997</b> | <b>2.6</b> |

- (1) Adjusted for Put-Backs and Recalls.
- (2) Cumulative collections from inception through March 31, 2013, excluding collections on behalf of others.
- (3) Estimated remaining collections for charged off consumer receivables includes \$100.8 million related to accounts that converted to bankruptcy after purchase.

**Table of Contents****Estimated Remaining Gross Collections by Year of Purchase**

The following table summarizes our estimated remaining gross collections by year of purchase (*in thousands*):

|                                   | Estimated Remaining Gross Collections by Year of Purchase <sup>(1), (2)</sup> |            |            |            |            |           |           |           |           |          |              |
|-----------------------------------|---|------------|------------|------------|------------|-----------|-----------|-----------|-----------|----------|--------------|
|                                   | 2013  | 2014       | 2015       | 2016       | 2017       | 2018      | 2019      | 2020      | 2021      | >2022    | Total        |
| Charged-off consumer receivables: |   |            |            |            |            |           |           |           |           |          |              |
| <2006                             | \$ 3,326  | \$ 3,625   | \$ 1,074   | \$         | \$         | \$        | \$        | \$        | \$        | \$       | \$ 8,025     |
| 2006                              | 5,897   | 4,392      | 1,780      | 734        |            |           |           |           |           |          | 12,803       |
| 2007                              | 12,713  | 9,149      | 4,694      | 3,592      | 1,320      |           |           |           |           |          | 31,468       |
| 2008                              | 26,037  | 22,064     | 11,941     | 6,461      | 3,820      | 1,522     |           |           |           |          | 71,845       |
| 2009                              | 42,655  | 43,521     | 26,426     | 16,069     | 8,941      | 5,323     | 2,113     |           |           |          | 145,048      |
| 2010                              | 82,389  | 83,432     | 56,915     | 34,029     | 21,490     | 10,461    | 6,821     | 2,855     |           |          | 298,392      |
| 2011                              | 124,343   | 123,975    | 83,319     | 51,137     | 29,428     | 17,341    | 9,582     | 6,483     | 2,659     |          | 448,267      |
| 2012                              | 177,525   | 191,081    | 121,884    | 73,541     | 43,596     | 25,615    | 18,673    | 10,675    | 7,559     | 2,433    | 672,582      |
| 2013                              | 28,650  | 40,007     | 24,852     | 12,637     | 6,758      | 4,035     | 2,519     | 915       | 434       | 322      | 121,129      |
| Subtotal                          | \$ 503,535  | \$ 521,246 | \$ 332,885 | \$ 198,200 | \$ 115,353 | \$ 64,297 | \$ 39,708 | \$ 20,928 | \$ 10,652 | \$ 2,755 | \$ 1,809,559 |
| Purchased bankruptcy receivables: |   |            |            |            |            |           |           |           |           |          |              |
| 2010                              | \$ 4,048  | \$ 4,021   | \$ 2,533   | \$ 705     | \$         | \$        | \$        | \$        | \$        | \$       | \$ 11,307    |
| 2011                              | 663   | 247        | 68         | 43         | 4          |           |           |           |           |          | 1,025        |
| 2012                              | 20,161  | 25,088     | 20,605     | 13,201     | 7,365      | 2,344     |           |           |           |          | 88,764       |
| Subtotal                          | \$ 24,872   | \$ 29,356  | \$ 23,206  | \$ 13,949  | \$ 7,369   | \$ 2,344  | \$        | \$        | \$        | \$       | \$ 101,096   |
| Total                             | \$ 528,407  | \$ 550,602 | \$ 356,091 | \$ 212,149 | \$ 122,722 | \$ 66,641 | \$ 39,708 | \$ 20,928 | \$ 10,652 | \$ 2,755 | \$ 1,910,655 |

(1) Estimated remaining collections for Zero Basis Portfolios can extend beyond our collection forecasts.

(2) Estimated remaining collections for charged off consumer receivables includes \$100.8 million related to accounts that converted to bankruptcy after purchase.

**Unamortized Balances of Portfolios**

The following table summarizes the remaining unamortized balances of our purchased receivable portfolios by year of purchase (*in thousands, except percentages*):

|                                   | Unamortized<br>Balance as of<br>March 31, 2013 | Purchase<br>Price <sup>(1)</sup> | Unamortized<br>Balance as a<br>Percentage of<br>Purchase Price | Unamortized<br>Balance as a<br>Percentage<br>of Total |
|-----------------------------------|--|----------------------------------|--|---|
| Charged-off consumer receivables: |  |                                  |  |   |
| 2005                              | \$ 108   | \$ 192,585                       | 0.1%   | 0.0%  |
| 2006                              | 6,415  | 141,027                          | 4.5%   | 0.9%  |
| 2007                              | 8,966  | 204,066                          | 4.4%   | 1.2%  |
| 2008                              | 29,395   | 227,785                          | 12.9%  | 4.0%  |
| 2009                              | 38,683   | 253,319                          | 15.3%  | 5.4%  |
| 2010                              | 81,289   | 346,105                          | 23.5%  | 11.3%   |
| 2011                              | 164,323  | 382,869                          | 42.9%  | 22.9%   |
| 2012                              | 333,243  | 477,078                          | 69.9%  | 46.4%   |
| 2013                              | 56,508   | 58,636                           | 96.4%  | 7.9%  |

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

|                                   |            |              |       |        |
|-----------------------------------|------------|--------------|-------|--------|
| Subtotal                          | \$ 718,930 | \$ 2,283,470 | 31.5% | 100.0% |
| Purchased bankruptcy receivables: |            |              |       |        |
| 2010                              | \$ 6,335   | \$ 11,975    | 52.9% | 7.6%   |
| 2011                              | 143        | 1,644        | 8.7%  | 0.2%   |
| 2012                              | 76,117     | 83,705       | 90.9% | 92.2%  |
| Subtotal                          | \$ 82,595  | \$ 97,324    | 84.9% | 100.0% |
| Total                             | \$ 801,525 | \$ 2,380,794 | 33.7% | 100.0% |

(1) Purchase price refers to the cash paid to a seller to acquire a portfolio less Put-Backs, plus an allocation of our forward flow asset (if applicable), and less the purchase price for accounts that were sold at the time of purchase to another debt purchaser.



**Table of Contents****Changes in the Investment in Receivable Portfolios**

Revenue related to our investment in receivable portfolios comprises two groups. First, revenue from those portfolios that have a remaining book value and are accounted for on the accrual basis ( Accrual Basis Portfolios ), and second, revenue from those portfolios that have fully recovered their book value ( Zero Basis Portfolios ) and, therefore, every dollar of gross collections is recorded entirely as Zero Basis Revenue. If the amount and timing of future cash collections on a pool of receivables are not reasonably estimable, we account for such portfolios on the cost recovery method ( Cost Recovery Portfolios ). No revenue is recognized on Cost Recovery Portfolios until the cost basis has been fully recovered, at which time they become Zero Basis Portfolios.

The following tables summarize the changes in the balance of the investment in receivable portfolios and the proportion of revenue recognized as a percentage of collections (*in thousands, except percentages*):

|   | Three Months Ended March 31, 2013 |                             |            |
|---|-----------------------------------|-----------------------------|------------|
|   | Accrual<br>Basis<br>Portfolios    | Zero<br>Basis<br>Portfolios | Total      |
| Balance, beginning of period                          | \$ 873,119                        | \$                          | \$ 873,119 |
| Purchases of receivable portfolios                    | 58,771                            |                             | 58,771     |
| Gross collections <sup>(1)</sup>                      | (264,543)                         | (5,627)                     | (270,170)  |
| Put-backs and recalls                                 | (878)                             |                             | (878)      |
| Revenue recognized                                    | 135,015                           | 4,662                       | 139,677    |
| Portfolio allowance reversals, net                    | 41                                | 965                         | 1,006      |
| Balance, end of period                                | \$ 801,525                        | \$                          | \$ 801,525 |
| Revenue as a percentage of collections <sup>(2)</sup> | 51.0%                             | 82.9%                       | 51.7%      |

|   | Three Months Ended March 31, 2012 |                             |            |
|---|-----------------------------------|-----------------------------|------------|
|   | Accrual<br>Basis<br>Portfolios    | Zero<br>Basis<br>Portfolios | Total      |
| 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                                     | (734)                             |                             | (734)      |
| Revenue recognized  | 120,746                           | 6,032                       | 126,778    |
| (Portfolio allowances) portfolio allowance reversals, net | (1,406)                           | 1,033                       | (373)      |
| Balance, end of period                                    | \$ 741,580                        | \$                          | \$ 741,580 |
| Revenue as a percentage of collections <sup>(2)</sup>     | 53.9%                             | 85.4%                       | 54.9%      |

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

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

As of March 31, 2013, we had \$801.5 million in investment in receivable portfolios. This balance will be amortized based upon current projections of cash collections in excess of revenue applied to the principal balance. The estimated amortization of the investment in receivable portfolios balance is as follows (*in thousands*):

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

| <b>Year Ended December 31,</b> | <b>Charged-off<br/>Consumer<br/>Receivables</b> | <b>Purchased<br/>Bankruptcy<br/>Receivables</b> | <b>Total<br/>Amortization</b> |
|--------------------------------|---|---|-------------------------------|
| 2013 <sup>(1)</sup>            | \$ 176,646                                      | \$ 17,764                                       | \$ 194,410                    |
| 2014                           | 204,294   | 23,176  | 227,470                       |
| 2015                           | 144,498   | 19,865  | 164,363                       |
| 2016                           | 92,464  | 12,600  | 105,064                       |
| 2017                           | 60,647  | 6,892   | 67,539                        |
| 2018                           | 29,266  | 2,297   | 31,563                        |
| 2019                           | 10,795  |   | 10,795                        |
| 2020                           | 321   |   | 321                           |
| <b>Total</b>                   | <b>\$ 718,931</b>                               | <b>\$ 82,594</b>                                | <b>\$ 801,525</b>             |

<sup>(1)</sup> 2013 amount consists of nine months data from April 1, 2013 to December 31, 2013.

**Table of Contents****Legal Outsourcing Costs as a Percentage of Gross Collections by Year of Collection**

The following table summarizes our legal outsourcing court cost expense and commissions as a percentage of gross collections by year of collection:

| Placement | Collection Year |       |       |       |       |       |       |       |       |       |       | Cumulative<br>Average |
|-----------|-----------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-------|-----------------------|
|           | 2003            | 2004  | 2005  | 2006  | 2007  | 2008  | 2009  | 2010  | 2011  | 2012  | 2013  |                       |
| 2003      | 41.7%           | 39.2% | 35.2% | 33.4% | 31.0% | 32.0% | 32.9% | 33.2% | 31.3% | 34.0% | 33.7% | 36.9%                 |
| 2004      |                 | 41.7% | 39.8% | 35.7% | 32.4% | 32.8% | 33.2% | 34.6% | 32.2% | 33.7% | 33.0% | 38.0%                 |
| 2005      |                 |       | 46.1% | 40.6% | 32.6% | 32.1% | 32.3% | 34.0% | 32.5% | 32.4% | 32.4% | 38.4%                 |
| 2006      |                 |       |       | 54.9% | 41.0% | 32.8% | 30.5% | 33.5% | 32.7% | 32.0% | 32.3% | 39.5%                 |
| 2007      |                 |       |       |       | 64.8% | 43.5% | 31.3% | 32.2% | 32.5% | 32.3% | 32.7% | 42.1%                 |
| 2008      |                 |       |       |       |       | 69.7% | 43.0% | 33.1% | 31.4% | 30.2% | 30.5% | 41.9%                 |
| 2009      |                 |       |       |       |       |       | 69.7% | 41.4% | 31.1% | 28.6% | 29.2% | 41.3%                 |
| 2010      |                 |       |       |       |       |       |       | 72.5% | 39.1% | 29.2% | 29.4% | 41.4%                 |
| 2011      |                 |       |       |       |       |       |       |       | 64.5% | 33.2% | 27.8% | 41.5%                 |
| 2012      |                 |       |       |       |       |       |       |       |       | 56.4% | 39.5% | 50.0%                 |
| 2013      |                 |       |       |       |       |       |       |       |       |       | 76.4% | 76.4%                 |

**Headcount by Function by Site**

The following table summarizes our headcount by function by site:

|                          | Headcount as of March 31, |               |          |               |
|--------------------------|---------------------------|---------------|----------|---------------|
|                          | 2013                      |               | 2012     |               |
|                          | Domestic                  | International | Domestic | International |
| General & Administrative | 610                       | 600           | 473      | 367           |
| Account Manager          | 180                       | 1,399         | 213      | 1,165         |
| Bankruptcy Specialist    |                           |               | 94       | 83            |
|                          | 790                       | 1,999         | 780      | 1,615         |

**Gross Collections by Account Manager**

The following table summarizes our collection performance by account manager (*in thousands, except headcount*):

|   | Three Months Ended March 31, |            |
|---|------------------------------|------------|
|   | 2013                         | 2012       |
| Gross collections collection sites                            | \$ 126,562                   | \$ 109,870 |
| Average active account managers                               | 1,589                        | 1,239      |
| Collections per average active account manager <sup>(1)</sup> | \$ 79.6                      | \$ 88.7    |

(1) The decrease in collections per average active account manager is primarily driven by short-term ramp up cost as part of our long-term strategy in developing lower cost-to-collect international call centers, including our near-shore call center in Costa Rica. As we ramped up headcount in our international call centers, our overall collector productivity, as expected, has declined. Once we are fully ramped up and the new account managers become experienced, we expect productivity to move back towards previous levels.

**Gross Collections per Hour Paid**

The following table summarizes our gross collections per hour paid to account managers (*in thousands, except gross collections per hour paid*):

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

|  | <b>Three Months Ended March 31,</b> |             |
|--|-------------------------------------|-------------|
|  | <b>2013</b>                         | <b>2012</b> |
| Gross collections collection sites       | \$ 126,562                          | \$ 109,870  |
| Total hours paid                         | 728                                 | 544         |
| Collections per hour paid <sup>(1)</sup> | \$ 173.8                            | \$ 202.0    |

- (1) The decrease in collections per hour paid is primarily driven by short-term ramp up cost as part of our long-term strategy in developing lower cost-to-collect international call centers, including our near-shore call center in Costa Rica. As we ramped up headcount in our international call centers, our overall collector productivity, as expected, has declined. Once we are fully ramped up and the new account managers become experienced, we expect productivity to move back towards previous levels.

**Table of Contents****Collection Sites Direct Cost per Dollar Collected**

The following table summarizes our gross collections in collection sites and the related direct cost (*in thousands, except percentages*):

|                                    | <b>Three Months Ended March 31,</b> |             |
|------------------------------------|-------------------------------------|-------------|
|                                    | <b>2013</b>                         | <b>2012</b> |
| Gross collections collection sites | \$ 126,562                          | \$ 109,870  |
| Direct cost <sup>(1)</sup>         | \$ 7,243                            | \$ 6,476    |
| Cost per dollar collected          | 5.7%                                | 5.9%        |

<sup>(1)</sup> Represent account managers and their supervisors salaries, variable compensation, and employee benefits.

**Salaries and Employee Benefits by Function**

The following table summarizes our salaries and employee benefits by function (excluding stock-based compensation) (*in thousands*):

|   | <b>Three Months Ended March 31,</b> |             |
|---|-------------------------------------|-------------|
|   | <b>2013</b>                         | <b>2012</b> |
| Portfolio purchasing and recovery activities                      |                                     |             |
| Collection site salaries and employee benefits <sup>(1)</sup>     | \$ 7,243                            | \$ 6,476    |
| Non-collection site salaries and employee benefits <sup>(2)</sup> | 17,170                              | 13,562      |
| Subtotal  | 24,413                              | 20,038      |
| Tax lien transfer   | 1,418                               |             |
|   | \$ 25,831                           | \$ 20,038   |

<sup>(1)</sup> Represent account managers and their supervisors salaries, variable compensation, and employee benefits.

<sup>(2)</sup> Includes internal legal channel salaries and employee benefits of \$2.8 million and \$1.3 million for the three months ended March 31, 2013 and 2012, respectively.

**Purchases by Quarter**

The following table summarizes the purchases we made by quarter, and the respective purchase prices (in thousands):

| <b>Quarter</b> | <b># of<br/>Accounts</b> | <b>Face Value</b> | <b>Purchase<br/>Price</b> |
|----------------|--------------------------|-------------------|---------------------------|
| Q1 2010        | 839                      | \$ 2,112,332      | \$ 81,632                 |
| Q2 2010        | 1,002                    | 2,245,713         | 83,336                    |
| Q3 2010        | 1,101                    | 2,616,678         | 77,889                    |
| Q4 2010        | 1,206                    | 3,882,646         | 119,100                   |
| Q1 2011        | 1,243                    | 2,895,805         | 90,675                    |
| Q2 2011        | 1,477                    | 2,998,564         | 93,701                    |
| Q3 2011        | 1,633                    | 2,025,024         | 65,731                    |
| Q4 2011        | 2,776                    | 3,782,595         | 136,743                   |
| Q1 2012        | 2,132                    | 2,902,409         | 130,463                   |
| Q2 2012        | 3,679                    | 6,034,499         | 230,983                   |
| Q3 2012        | 1,037                    | 1,052,191         | 47,311                    |

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

|         |       |           |         |
|---------|-------|-----------|---------|
| Q4 2012 | 3,125 | 8,467,400 | 153,578 |
| Q1 2013 | 1,678 | 1,615,214 | 58,771  |

**Table of Contents****Liquidity and Capital Resources**

Historically, we have met our cash requirements by utilizing our cash flows from operations, bank borrowings, convertible debt offerings, and equity offerings. Our primary cash requirements have included the purchase of receivable portfolios, operating expenses, and the payment of interest and principal on bank borrowings and tax payments.

The following table summarizes our cash flows by category for the periods presented (*in thousands*):

|   | <b>Three Months Ended March 31,</b> |             |
|---|-------------------------------------|-------------|
|   | <b>2013</b>                         | <b>2012</b> |
| Net cash provided by operating activities           | \$ 23,693                           | \$ 27,103   |
| Net cash provided by (used in) investing activities | 54,651                              | (27,054)    |
| Net cash (used in) provided by financing activities | (65,950)                            | 7,350       |

Currently, all of our portfolio purchases are funded with cash from operations and borrowings under our Credit Agreement. All of our tax lien transfers are funded with cash from Propel operations and borrowings under the Propel Facility. See Note 12 Debt to our consolidated financial statements for a further discussion of our debt.

On May 9, 2013, we exercised the remaining \$180.0 million of our accordion feature and entered into an amendment to our Credit Facility, restating the Credit Facility in its entirety (the Restated Credit Agreement). The Restated Credit Amendment reset the accordion feature to \$200.0 million and added new lenders. In conjunction with the amendment, we exercised \$37.5 million of the new accordion feature. This \$37.5 million exercise, when combined with the \$180.0 million exercise, increased the aggregate revolving loan commitment by \$217.5 million, from \$595.0 million to \$812.5 million, a portion of which is subject to ongoing principal amortization. Including the remaining accordion feature, the maximum amount that can be borrowed under the Credit Facility is \$975.0 million. See Note 19 Subsequent Events to our consolidated financial statements for additional information.

**Share Repurchase Program**

Subject to compliance with the Credit Agreement, we were authorized by our Board of Directors to repurchase up to \$50.0 million of Encore's common stock. We repurchased the entire \$50.0 million of common stock authorized under this program during the fourth quarter of 2012 and in January 2013.

**Operating Cash Flows**

Net cash provided by operating activities was \$23.7 million and \$27.1 million during the three months ended March 31, 2013 and 2012, respectively.

Cash provided by operating activities during the three months ended March 31, 2013, was primarily related to net income of \$19.4 million and various non-cash add backs in operating activities and changes in operating assets and liabilities. Cash provided by operating activities during the three months ended March 31, 2012, was primarily related to net income of \$11.4 million and a \$10.3 million non-cash add back related to impairment charges for goodwill and identifiable intangible assets related to Ascension, our bankruptcy servicing reporting unit.

**Investing Cash Flows**

Net cash provided by investing activities was \$54.7 million during the three months ended March 31, 2013. Net cash used in investing activities was \$27.1 million during the three months ended March 31, 2012.

The cash flows provided by investing activities during the three months ended March 31, 2013, were primarily related to gross collection proceeds applied to the principal of our receivable portfolios in the amount of \$130.5 million, collections applied to our property tax payment agreements receivable of \$11.8 million, offset by receivable portfolio purchases of \$58.8 million and originations of property tax payment agreements receivable of \$27.4 million. The cash flows used in investing activities during the three months ended March 31, 2012, were primarily related to receivable portfolio purchases of \$130.5 million, offset by gross collection proceeds applied to the principal of our receivable portfolios in the amount of \$104.2 million.

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

Capital expenditures for fixed assets acquired with internal cash flow were \$2.3 million and \$1.6 million for three months ended March 31, 2013 and 2012, respectively.



---

## **Table of Contents**

### ***Financing Cash Flows***

Net cash used in financing activities was \$66.0 million during the three months ended March 31, 2013. Net cash provided by financing activities was \$7.4 million during the three months ended March 31, 2012.

The cash used in financing activities during the three months ended March 31, 2013, reflects \$91.8 million in repayments of amounts outstanding under our Credit Agreement, \$2.5 million in repayment of our Senior Secured Notes, offset by \$33.7 million in borrowings under our Credit Agreement. The cash provided by financing activities during the three months ended March 31, 2012, reflects \$43.5 million in borrowings under our Credit Agreement, offset by \$34.5 million in repayments of amounts outstanding under our Credit Agreement.

We are in compliance with all covenants under our financing arrangements. We believe that we have sufficient liquidity to fund our operations for at least the next twelve months, given our expectation of continued positive cash flows from operations, our cash and cash equivalents of \$29.9 million as of March 31, 2013, our access to capital markets, and availability under our credit facilities.

Our future cash needs will depend on our acquisitions of portfolios and businesses, including the merger with AACC. We expect to use cash and borrowings under our Credit Agreement to fund the merger with AACC.

### **Item 3. Quantitative and Qualitative Disclosures About Market Risk**

*Foreign Currency.* At March 31, 2013, there had not been a material change in any of the foreign currency risk information disclosed in Item 7A, Quantitative and Qualitative Disclosures About Market Risk, of our Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

*Interest Rate.* At March 31, 2013, there had not been a material change in the interest rate risk information disclosed in Item 7A, Quantitative and Qualitative Disclosures About Market Risk, of our Annual Report on Form 10-K for the fiscal year ended December 31, 2012.

### **Item 4. Controls and Procedures**

#### ***Evaluation of Disclosure Controls and Procedures***

We maintain disclosure controls and procedures that are designed to ensure that information required to be disclosed in our periodic reports filed or submitted under the Securities Exchange Act of 1934, as amended (the Exchange Act), is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the Securities and Exchange Commission (the SEC) and that such information is accumulated and communicated to our management, including our principal executive officer and principal financial officer, as appropriate, to allow timely decisions regarding required disclosure. In designing and evaluating the disclosure controls and procedures, our management recognizes that any controls and procedures, no matter how well designed and operated, can provide only reasonable assurance of achieving the desired control objectives and accordingly, management is required to apply its judgment in evaluating the cost-benefit relationship of possible controls and procedures.

Based on their most recent evaluation, as of the end of the period covered by this Quarterly Report on Form 10-Q, our Chief Executive Officer and Chief Financial Officer have concluded our disclosure controls and procedures, as defined in Rules 13a-15(e) and 15d-15(e) of the Exchange Act are effective.

#### ***Changes in Internal Control over Financial Reporting***

There was no change in our internal control over financial reporting during the most recent fiscal quarter that has materially affected, or is reasonably likely to materially affect, our internal control over financial reporting.

**Table of Contents****PART II OTHER INFORMATION****Item 1 Legal Proceedings**

We are involved in disputes and legal actions from time to time in the ordinary course of business. We, along with others in our industry, are routinely subject to legal actions based on the FDCPA, comparable state statutes, the 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 we lack specified licenses to conduct our business, attempt to collect debts on which the statute of limitations has run, have made inaccurate assertions of fact in support of our collection actions and/or have acted improperly in connection with our efforts to contact consumers. These cases are frequently styled as supposed class actions.

On May 19, 2008, an action captioned *Brent v. Midland Credit Management, Inc. et. al* was filed in the United States District Court for the Northern District of Ohio Western Division, in which the plaintiff filed a class action counter-claim against two of our subsidiaries (the Midland Defendants). The complaint alleged that the Midland Defendants' business practices violated consumers' rights under the FDCPA and the Ohio Consumer Sales Practices Act. The plaintiff sought actual and statutory damages for the class of Ohio residents, plus attorney's fees and costs of class notice and class administration. The dollar amount of damages originally sought in the case was an unspecified amount in excess of \$25,000. On August 12, 2011, the court issued an order granting final approval to the parties agreed upon settlement of this lawsuit, as well as two other pending lawsuits in the Northern District of Ohio entitled *Franklin v. Midland Funding LLC* and *Vassalle v. Midland Funding LLC*, on a national class basis, and dismissed the cases against the Midland Defendants with prejudice. That order was subsequently appealed by certain objectors to the settlement, and on February 26, 2013, the Court of Appeals for the Sixth Circuit reversed the district court's order approving the settlement, vacated the judgment certifying a nationwide settlement class, and remanded the case back to the Northern District of Ohio for further proceedings consistent with the Sixth Circuit's ruling, where it remains pending.

On March 8, 2013, March 19, 2013 and March 20, 2013, three actions entitled *Shell v. Asset Acceptance Capital Corp., et. al.*, *Neumann v. Asset Acceptance Capital Corp., et. al.*, and *Jaluka v. Asset Acceptance Capital Corp. et. al.*, respectively, were filed in the Macomb County Circuit Court of the State of Michigan. On April 19, 2013, a fourth action entitled *Dix v. Asset Acceptance Capital Corp. et al* was filed in the Court of Chancery of the State of Delaware. These actions were brought by purported stockholders of Asset Acceptance Capital Corporation (AACC) against us, AACC, and certain other named entities and individuals, and allege, among other things, that we have aided and abetted AACC's directors in breaching their fiduciary duties of care, loyalty and candor or disclosure owed to AACC stockholders. Plaintiffs in the actions seek, among other things, injunctive relief prohibiting consummation of the proposed acquisition, or rescission of the proposed acquisition (in the event the transaction has already been consummated), as well as costs and disbursements, including reasonable attorneys' and experts' fees, and other equitable or injunctive relief as the court may deem just and proper. The plaintiffs have not specified the dollar amount of damages sought in each action.

Except as set forth above, there has been no material development in any of the legal proceedings disclosed in our Annual Report on Form 10-K for the year ended December 31, 2012.

In certain legal proceedings, we may have recourse to insurance or third party contractual indemnities to cover all or portions of our litigation expenses, judgments, or settlements. In accordance with authoritative guidance, we record loss contingencies in our 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, we record the minimum estimated liability. We continuously assess the potential liability related to our pending litigation and revise our estimates when additional information becomes available. As of March 31, 2013, we have no material reserves for litigation. Additionally, based on the current status of litigation matters, either the estimate of exposure is immaterial to our financial statements or an estimate cannot yet be determined. Our legal costs are recorded to expense as incurred.

**Item 1A Risk Factors**

There is no material change in the information reported under Part I Item 1A Risk Factors contained in our Annual Report on Form 10-K for the fiscal year ended December 31, 2012 and Part II, Item 1A Risk Factors in our subsequent quarterly reports on Form 10-Q with the exception of the following:

***Failure to complete the merger with AACC could negatively impact the market price of our common stock and our future business and financial results.***

If the merger is not completed, our ongoing business may be adversely affected and we will be subject to several risks and consequences, including the following:

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

we will be required to pay certain costs relating to the merger, whether or not the merger is completed, such as legal, accounting, filing, financial advisor and printing fees;

## **Table of Contents**

we would not realize the expected benefits of the merger;

matters relating to the merger may require substantial commitments of time and resources by our management, which could otherwise have been devoted to other opportunities that may have been beneficial to us.

In addition, if the merger is not completed, we may experience negative reactions from the financial markets and from third-party affiliates and employees. We could also be subject to litigation related to any failure to complete the merger or to enforcement proceedings commenced against us to attempt to force us to perform our obligations under the merger agreement.

### ***We may fail to realize the anticipated benefits of the merger with AACC.***

The success of the merger will depend on, among other things, our ability to realize anticipated cost savings and to combine our business and AACC's business in a manner that does not materially disrupt the existing business relationships of either company nor result in decreased revenues from any disruption in our business operations. The success of the merger will also depend upon the integration of employees, systems, operating procedures and information technologies, as well as the retention of key employees. If we are not able to successfully achieve these objectives, the anticipated benefits of the merger may not be realized fully or at all or may take longer to realize than expected, and any such events could adversely affect the value of our common stock.

Our business and AACC's business will operate as independent businesses until the completion of the merger. It is possible that the integration process could result in the loss of key employees, the disruption of AACC's ongoing businesses or inconsistencies in standards, controls, procedures and policies that adversely affect our ability to maintain relationships with our third-party vendors and employees or to achieve the anticipated benefits of the merger.

### ***Unanticipated costs relating to the merger with AACC could reduce our future earnings per share.***

We believe that we have reasonably estimated the likely costs of integrating our operations with that of AACC, and the incremental costs of operating as a combined company. However, it is possible that unexpected transaction costs, such as taxes, fees or professional expenses or unexpected future operating expenses such as increased personnel costs or increased taxes, as well as other types of unanticipated adverse developments, could have a material adverse effect on the results of operations and financial condition of the combined company. If unexpected costs are incurred, the earnings per share of our common stock could be less than they would have been if the merger had not been completed.

### ***If the merger with AACC is consummated, we will incur additional debt to finance the cash portion of the merger consideration.***

In connection with the merger, we will borrow up to \$381.7 million under our revolving credit facility. This additional indebtedness could have important consequences to our business, including increasing our vulnerability to general adverse economic and industry conditions, limiting our flexibility in planning for, or reacting to, changes in our business and the industry in which we operate and restricting us from pursuing certain business opportunities.

## **Item 2 Unregistered Sales of Equity Securities and Use of Proceeds**

Our revolving credit facilities contain restrictions and covenants, which limit, among other things, the payment of dividends.

**Table of Contents**

**Item 6. Exhibits**

- 2.1 Agreement and Plan of Merger dated March 6, 2013, by and among Encore Capital Group, Inc., Pinnacle Sub, Inc. and Asset Acceptance Capital Corp. (incorporated by reference to Exhibit 2.1 to the Company's Current Report on Form 8-K filed on March 6, 2013).
- 10.1+ Transition and consulting letter agreement, dated as of April 8, 2013, by and between Encore Capital Group, Inc. and J. Brandon Black (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on April 9, 2013).
- 10.2+ Employment offer letter, dated as of April 8, 2013, by and between Encore Capital Group, Inc. and Kenneth A. Vecchione (incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed on April 9, 2013).
- 10.3 Amendment No. 1 and Limited Waiver, dated May 9, 2013, to Amended and Restated Credit Agreement, dated as of November 5, 2012, by and among Encore Capital Group, Inc., the several banks and other financial institutions and lenders from time to time party thereto and SunTrust Bank, as administrative agent and collateral agent (filed herewith).
- 10.4 Second Amended and Restated Senior Secured Note Purchase Agreement, dated May 9, 2013, by and among Encore Capital Group, Inc., The Prudential Insurance Company of America, Pruco Life Insurance Company, Prudential Retirement Insurance and Annuity Company and Prudential Annuities Life Assurance Corporation (filed herewith).
- 31.1 Certification of the Principal Executive Officer pursuant to Rule 13a-14(a) or 15d-14(a) under the Securities Exchange Act of 1934 (filed herewith).
- 31.2 Certification of the Principal Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934 (filed herewith).
- 32.1 Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished herewith).
- 101 The following financial information from the Encore Capital Group, Inc. Quarterly Report on Form 10-Q for the quarter ended March 31, 2013 formatted in eXtensible Business Reporting Language (XBRL): (i) Condensed Consolidated Statements of Financial Condition; (ii) Condensed Consolidated Statements of Comprehensive Income; (iii) Condensed Consolidated Statements of Stockholders' Equity; (iv) Condensed Consolidated Statements of Cash Flows; and (v) the Notes to Condensed Consolidated Financial Statements.\*

+ Management contract or compensatory plan or arrangement.

\* Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.

**Table of Contents**

**SIGNATURES**

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

**ENCORE CAPITAL GROUP, INC.**

By: /s/ Paul Grinberg  
Paul Grinberg  
Executive Vice President,  
Chief Financial Officer and Treasurer

Date: May 9, 2013

**Table of Contents**

**EXHIBIT INDEX**

- 2.1 Agreement and Plan of Merger dated March 6, 2013, by and among Encore Capital Group, Inc., Pinnacle Sub, Inc. and Asset Acceptance Capital Corp. (incorporated by reference to Exhibit 2.1 to the Company's Current Report on Form 8-K filed on March 6, 2013).
- 10.1+ Transition and consulting letter agreement, dated as of April 8, 2013, by and between Encore Capital Group, Inc. and J. Brandon Black (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on April 9, 2013).
- 10.2+ Employment offer letter, dated as of April 8, 2013, by and between Encore Capital Group, Inc. and Kenneth A. Vecchione (incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed on April 9, 2013).
- 10.3 Amendment No. 1 and Limited Waiver, dated May 9, 2013, to Amended and Restated Credit Agreement, dated as of November 5, 2012, by and among Encore Capital Group, Inc., the several banks and other financial institutions and lenders from time to time party thereto and SunTrust Bank, as administrative agent and collateral agent (filed herewith).
- 10.4 Second Amended and Restated Senior Secured Note Purchase Agreement, dated May 9, 2013, by and among Encore Capital Group, Inc., The Prudential Insurance Company of America, Pruco Life Insurance Company, Prudential Retirement Insurance and Annuity Company and Prudential Annuities Life Assurance Corporation (filed herewith).
- 31.1 Certification of the Principal Executive Officer pursuant to Rule 13a-14(a) or 15d-14(a) under the Securities Exchange Act of 1934 (filed herewith).
- 31.2 Certification of the Principal Financial Officer pursuant to Rule 13a-14(a) under the Securities Exchange Act of 1934 (filed herewith).
- 32.1 Certifications of Chief Executive Officer and Chief Financial Officer pursuant to 18 U.S.C. Section 1350, as adopted pursuant to Section 906 of the Sarbanes-Oxley Act of 2002 (furnished herewith).
- 101 The following financial information from the Encore Capital Group, Inc. Quarterly Report on Form 10-Q for the quarter ended March 31, 2013 formatted in eXtensible Business Reporting Language (XBRL): (i) Condensed Consolidated Statements of Financial Condition; (ii) Condensed Consolidated Statements of Comprehensive Income; (iii) Condensed Consolidated Statements of Stockholders' Equity; (iv) Condensed Consolidated Statements of Cash Flows; and (v) the Notes to Condensed Consolidated Financial Statements.\*

+ Management contract or compensatory plan or arrangement.

\* Pursuant to Rule 406T of Regulation S-T, the Interactive Data Files on Exhibit 101 hereto are deemed not filed or part of a registration statement or prospectus for purposes of Sections 11 or 12 of the Securities Act of 1933, as amended, are deemed not filed for purposes of Section 18 of the Securities and Exchange Act of 1934, as amended, and otherwise are not subject to liability under those sections.