PORTFOLIO RECOVERY ASSOCIATES INC
Form 10-Q
October 31, 2007

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

FORM 10-Q

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

For the quarterly period ended September 30, 2007

o **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: 000-50058

Portfolio Recovery Associates, Inc.

(Exact name of registrant as specified in its charter)

Delaware	75-3078675
(State or other jurisdiction of incorporation or organization)	*(I.R.S. Employer Identification No.)*
120 Corporate Boulevard, Norfolk, Virginia	23502
(Address of principal executive offices)	*(zip code)*

(888) 772-7326

(Registrant s telephone number, including area code)

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 past 90 days.

YES þ NO o

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer þ Accelerated filer o Non-accelerated filer o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

YES ¨ NO þ

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

Class	Outstanding as of October 19, 2007
Common Stock, $0.01 par value	15,107,554

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PORTFOLIO RECOVERY ASSOCIATES, INC.
CONSOLIDATED BALANCE SHEETS
September 30, 2007 and December 31, 2006
(unaudited)

	September 30, 2007	December 31, 2006
Assets		
Cash and cash equivalents	$ 14,464,166	$ 25,100,834
Finance receivables, net	326,476,130	226,447,495
Income tax receivable	2,621,064	1,512,823
Property and equipment, net	15,216,997	11,192,974
Goodwill	18,620,277	18,287,511
Intangible assets, net	5,399,315	6,754,014
Other assets	4,434,313	4,082,780
Total assets	$ 387,232,262	$ 293,378,431
Liabilities and Stockholders Equity		
Liabilities:		
Accounts payable	$ 2,814,410	$ 2,891,469
Accrued expenses	3,614,095	2,578,896
Accrued payroll and bonuses	6,445,192	6,244,852
Deferred tax liability	51,018,256	33,452,670
Lines of credit	100,000,000	
Long-term debt		689,892
Obligations under capital lease	138,345	242,385
Total liabilities	164,030,298	46,100,164
Commitments and contingencies (Note 11)		
Stockholders equity:		
Preferred stock, par value $0.01, authorized shares, 2,000,000, issued and outstanding shares - 0		
Common stock, par value $0.01, authorized shares, 30,000,000, issued and outstanding shares - 15,107,554 at September 30, 2007, and 15,987,432 at December 31, 2006	151,076	159,874
Additional paid-in capital	70,044,239	115,527,975
Retained earnings	153,006,649	131,590,418
Total stockholders equity	223,201,964	247,278,267
Total liabilities and stockholders equity	$ 387,232,262	$ 293,378,431

The accompanying notes are an integral part of these consolidated financial statements.

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PORTFOLIO RECOVERY ASSOCIATES, INC.
CONSOLIDATED INCOME STATEMENTS
For the Three and Nine months Ended September 30, 2007 and 2006
(unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2007	**2006**	**2007**	**2006**
Revenues:				
Income recognized on finance receivables, net	$ 46,110,666	$ 41,760,421	$ 137,963,747	$ 121,527,560
Commissions	8,528,882	6,076,231	25,459,826	17,835,053
Total revenues	54,639,548	47,836,652	163,423,573	139,362,613
Operating expenses:				
Compensation and employee services	17,322,123	14,550,391	50,437,917	42,981,680
Outside legal and other fees and services	11,846,689	10,582,130	34,529,893	29,382,631
Communications	2,038,385	1,474,423	5,927,222	4,392,290
Rent and occupancy	819,076	573,241	2,217,448	1,693,448
Other operating expenses	1,605,353	1,212,134	4,466,896	3,493,562
Depreciation and amortization	1,455,045	1,278,500	4,111,910	3,770,940
Total operating expenses	35,086,671	29,670,819	101,691,286	85,714,551
Income from operations	19,552,877	18,165,833	61,732,287	53,648,062
Other income and (expense):				
Interest income	64,801	170,812	364,492	414,672
Interest expense	(1,137,495)	(66,036)	(1,543,255)	(308,733)
Income before income taxes	18,480,183	18,270,609	60,553,524	53,754,001
Provision for income taxes	6,786,835	7,027,110	22,990,599	20,677,824
Net income	$ 11,693,348	$ 11,243,499	$ 37,562,925	$ 33,076,177
Net income per common share:				
Basic	$ 0.76	$ 0.71	$ 2.37	$ 2.08
Diluted	$ 0.75	$ 0.70	$ 2.35	$ 2.06
Weighted average number of shares outstanding:				
Basic	15,451,091	15,915,495	15,816,365	15,894,548

Diluted	15,577,079	16,071,292	15,961,556	16,073,860

The accompanying notes are an integral part of these consolidated financial statements.

PORTFOLIO RECOVERY ASSOCIATES, INC.
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY
For the Nine months Ended September 30, 2007
(unaudited)

	Common Stock	Additional Paid-in Capital	Retained Earnings	Total Stockholders Equity
Balance at December 31, 2006	$ 159,874	$ 115,527,975	$ 131,590,418	$ 247,278,267
Net income			37,562,925	37,562,925
Exercise of stock options and vesting of nonvested shares	1,194	1,459,951		1,461,145
Issuance of common stock for acquisition of The Palmer Group	8	49,992		50,000
Repurchase and cancellation of common stock	(10,000)	(50,546,924)		(50,556,924)
Cash dividends paid ($1.00 per common share)			(16,069,694)	(16,069,694)
Amortization of share-based compensation		2,218,168		2,218,168
Income tax benefit from share-based compensation		1,145,077		1,145,077
Adoption of FIN 48		190,000	(77,000)	113,000
Balance at September 30, 2007	$ 151,076	$ 70,044,239	$ 153,006,649	$ 223,201,964

The accompanying notes are an integral part of these consolidated financial statements.

PORTFOLIO RECOVERY ASSOCIATES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the Nine months Ended September 30, 2007 and 2006
(unaudited)

	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
Cash flows from operating activities:		
Net income	$ 37,562,925	$ 33,076,177
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of share-based compensation	2,218,168	1,543,670
Depreciation and amortization	4,111,910	3,770,940
Deferred tax expense	17,565,586	6,624,758
Changes in operating assets and liabilities:		
Other assets	(351,533)	800,635
Accounts payable	(77,059)	430,621
Income taxes	(918,241)	(3,716,571)
Accrued expenses	958,199	399,985
Accrued payroll and bonuses	200,340	575,311
Net cash provided by operating activities	61,270,295	43,505,526
Cash flows from investing activities:		
Purchases of property and equipment	(6,655,234)	(2,612,726)
Acquisition of finance receivables, net of buybacks	(159,130,357)	(74,203,321)
Collections applied to principal on finance receivables	59,101,722	56,084,521
Acquisition of The Palmer Group, including acquisition costs	(408,766)	
Net cash used in investing activities	(107,092,635)	(20,731,526)
Cash flows from financing activities:		
Dividends paid	(16,069,694)	
Proceeds from exercise of options and warrants	1,461,145	1,689,746
Income tax benefit from share-based compensation	1,145,077	1,664,837
Proceeds from lines of credit	103,000,000	
Principal payments on lines of credit	(3,000,000)	(15,000,000)
Repurchases of common stock	(50,556,924)	
Principal payments on long-term debt	(689,892)	(345,467)
Principal payments on capital lease obligations	(104,040)	(106,407)
Net cash provided by/(used in) financing activities	35,185,672	(12,097,291)

Net (decrease)/increase in cash and cash equivalents		(10,636,668)		10,676,709
Cash and cash equivalents, beginning of period		25,100,834		15,984,855
Cash and cash equivalents, end of period	$	14,464,166	$	26,661,564
Supplemental disclosure of cash flow information:				
Cash paid for interest	$	1,095,820	$	323,036
Cash paid for income taxes	$	5,284,825	$	16,104,800
Noncash investing and financing activities:				
Acquisition of The Palmer Group Common stock issued	$	50,000	$	
SFAS 123R adoption reclass of payroll liability to additional paid-in capital	$		$	426,752

The accompanying notes are an integral part of these consolidated financial statements.

PORTFOLIO RECOVERY ASSOCIATES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

1. Organization and Business:

Portfolio Recovery Associates, LLC (PRA) was formed on March 20, 1996. Portfolio Recovery Associates, Inc. (PRA Inc) was formed in August 2002. On November 8, 2002, PRA Inc completed its initial public offering (IPO) of common stock. As a result, all of the membership units and warrants of PRA were exchanged on a one to one basis for warrants and shares of a single class of common stock of PRA Inc. PRA Inc owns all outstanding membership units of PRA, PRA Holding I, LLC (PRA Holding I), PRA Holding II, LLC (PRA Holding II), PRA Receivables Management, LLC (d/b/a Anchor Receivables Management) (Anchor), PRA Location Services, LLC (d/b/a IGS Nevada) (IGS), PRA Government Services, LLC (d/b/a Alatax and RDS) (RDS) and PRA Bankruptcy Services, LLC (PRA BS). One of PRA Inc s wholly owned subsidiaries, Thomas West Associates, LLC (TWA), was dissolved as an entity on May 8, 2006. PRA Inc, a Delaware corporation, and its subsidiaries (collectively, the Company) are full-service providers of outsourced receivables management and related services. The Company is engaged in the business of purchasing, managing and collecting portfolios of defaulted consumer receivables as well as offering a broad range of accounts receivable management services. The majority of the Company s business activities involve the purchase, management and collection of defaulted consumer receivables. These are purchased from sellers of finance receivables and collected by a highly skilled staff whose purpose is to locate and contact customers and arrange payment or resolution of their debts. The Company, through its Legal Recovery Department, collects accounts judicially, either by using its own attorneys, or by contracting with independent attorneys throughout the country through whom the Company takes legal action to satisfy consumer debts. The Company also services receivables on behalf of clients on either a commission or transaction-fee basis. Clients include entities in the financial services, auto, retail, utility, health care and government sectors. Services provided to these clients include standard collection services on delinquent accounts, obtaining location information for clients in support of their collection activities (known as skip tracing), and the management of both delinquent and non-delinquent tax receivables for government entities.

The consolidated financial statements of the Company include the accounts of PRA Inc, PRA, PRA Holding I, PRA Holding II, Anchor, IGS, RDS and PRA BS.

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with Rule 10-01 of Regulation S-X promulgated by the Securities and Exchange Commission (SEC) and, therefore, do not include all information and disclosures required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of the Company, however, the accompanying unaudited consolidated financial statements contain all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the Company s balance sheet as of September 30, 2007, its income statements for the three and nine months ended September 30, 2007 and 2006, its statement of changes in stockholders equity for the nine months ended September 30, 2007 and its statements of cash flows for the nine months ended September 30, 2007 and 2006. The income statements of the Company for the three and nine months ended September 30, 2007 and 2006 may not be indicative of future results. These unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K, as filed for the year ended December 31, 2006.

2. Finance Receivables, net:

The Company s principal business consists of the acquisition and collection of accounts that have experienced deterioration of credit quality between origination and the Company s acquisition of the accounts. The amount paid for an account reflects the Company s determination that it is probable the Company will be unable to collect all amounts due according to the account s contractual terms. At acquisition, the Company reviews the portfolio both by account and aggregate pool to determine whether there is evidence of deterioration of credit quality since origination and if it is probable that the Company will be unable to collect all amounts due according to the account s contractual terms. If both conditions exist, the Company determines whether each such account is to be accounted for individually or whether such accounts will be assembled into pools based on common risk characteristics. The Company considers expected prepayments and estimates the amount and timing of undiscounted expected principal, interest and other cash flows for each acquired portfolio and subsequently aggregated pools of accounts. The Company determines the excess of the pool s scheduled contractual principal and contractual interest payments over all cash flows expected at acquisition as an amount that should not be accreted (nonaccretable difference) based on the Company s proprietary acquisition models. The remaining amount, representing the excess of the account s cash flows expected to be collected over the amount paid, is accreted into income recognized on finance receivables over the remaining life of the account or pool (accretable yield).

PORTFOLIO RECOVERY ASSOCIATES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Prior to January 1, 2005, the Company accounted for its investment in finance receivables using the interest method under the guidance of Practice Bulletin 6, Amortization of Discounts on Certain Acquired Loans. Effective January 1, 2005, the Company adopted and began to account for its investment in finance receivables using the interest method under the guidance of American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 03-3, Accounting for Loans or Certain Securities Acquired in a Transfer. For loans acquired in fiscal years beginning prior to December 15, 2004, Practice Bulletin 6 is still effective; however, Practice Bulletin 6 was amended by SOP 03-3 as described further in this note. For loans acquired in fiscal years beginning after December 15, 2004, SOP 03-3 is effective. Under the guidance of SOP 03-3 (and the amended Practice Bulletin 6), static pools of accounts may be established. These pools are aggregated based on certain common risk criteria. Each static pool is recorded at cost, which includes certain direct costs of acquisition paid to third parties, and is accounted for as a single unit for the recognition of income, principal payments and loss provision. Once a static pool is established for a quarter, individual receivable accounts are not added to the pool (unless replaced by the seller) or removed from the pool (unless sold or returned to the seller). SOP 03-3 (and the amended Practice Bulletin 6) requires that the excess of the contractual cash flows over expected cash flows not be recognized as an adjustment of revenue or expense or on the balance sheet. SOP 03-3 initially freezes the internal rate of return, referred to as IRR, estimated when the accounts receivable are purchased as the basis for subsequent impairment testing. Significant increases in actual, or expected future cash flows may be recognized prospectively through an upward adjustment of the IRR over a portfolio s remaining life. Any increase to the IRR then becomes the new benchmark for impairment testing. Effective for fiscal years beginning after December 15, 2004 under SOP 03-3 (and the amended Practice Bulletin 6), rather than lowering the estimated IRR if the collection estimates are not received or projected to be received, the carrying value of a pool would be written down to maintain the then current IRR and is shown as a reduction in revenue in the consolidated income statements with a corresponding valuation allowance offsetting the finance receivables, net, on the balance sheet. Income on finance receivables is accrued quarterly based on each static pool s effective IRR. Quarterly cash flows greater than the interest accrual will reduce the carrying value of the static pool. Likewise, cash flows that are less than the accrual will accrete the carrying balance. The IRR is estimated and periodically recalculated based on the timing and amount of anticipated cash flows using the Company s proprietary collection models. A pool can become fully amortized (zero carrying balance on the balance sheet) while still generating cash collections. In this case, all cash collections are recognized as revenue when received. Additionally, the Company uses the cost recovery method when collections on a particular pool of accounts cannot be reasonably predicted. These pools are not aggregated with other portfolios. Under the cost recovery method, no revenue is recognized until the Company has fully collected the cost of the portfolio, or until such time that the Company considers the collections to be probable and estimable and begins to recognize income based on the interest method as described above. At September 30, 2007 and 2006, the Company had unamortized purchased principal (purchase price) in pools accounted for under the cost recovery method of $4,998,673 and $1,429,416, respectively.

The Company establishes valuation allowances for all acquired accounts subject to SOP 03-3 to reflect only those losses incurred after acquisition (that is, the present value of cash flows initially expected at acquisition that are no longer expected to be collected). Valuation allowances are established only subsequent to acquisition of the accounts. At September 30, 2007 and 2006, the Company had an allowance against its finance receivables of $2,935,000 and $850,000, respectively. Prior to January 1, 2005, in the event that a reduction of the yield to as low as zero in conjunction with estimated future cash collections that were inadequate to amortize the carrying balance, an allowance charge would be taken with a corresponding write-off of the receivable balance.

The Company capitalizes certain fees paid to third parties related to the direct acquisition of a portfolio of accounts. These fees are added to the acquisition cost of the portfolio and accordingly are amortized over the life of the portfolio using the interest method. The balance of the unamortized capitalized fees at September 30, 2007 and 2006 was $2,133,480 and $1,222,051, respectively. During the three and nine months ended September 30, 2007, the Company capitalized $469,868 and $1,263,578, respectively, of these direct acquisition fees. During the three and nine months ended September 30, 2006, the Company capitalized $130,398 and $593,855, respectively, of these direct acquisition fees. During the three and nine months ended September 30, 2007, the Company amortized $135,110 and $452,819, respectively, of these direct acquisition fees. During the three and nine months ended September 30, 2006, the Company amortized $116,358 and $399,873, respectively, of these direct acquisition fees.

PORTFOLIO RECOVERY ASSOCIATES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

The agreements to purchase the aforementioned receivables include general representations and warranties from the sellers covering account holder death or bankruptcy and accounts settled or disputed prior to sale. The representation and warranty period permitting the return of these accounts from the Company to the seller is typically 90 to 180 days. Any funds received from the seller of finance receivables as a return of purchase price are referred to as buybacks. Buyback funds are simply applied against the finance receivable balance received and are not included in the Company s cash collections from operations. In some cases, the seller will replace the returned accounts with new accounts in lieu of returning the purchase price. In that case, the old account is removed from the pool and the new account is added.

Changes in finance receivables, net for the three and nine months ended September 30, 2007 and 2006 were as follows:

	Three Months Ended September 30, 2007	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
Balance at beginning of period	$ 288,648,041	$ 197,437,703	$ 226,447,495	$ 193,644,670
Acquisitions of finance receivables, net of buybacks	56,867,615	32,249,112	159,130,357	74,203,321
Cash collections	(65,150,192)	(59,683,766)	(197,065,469)	(177,612,081)
Income recognized on finance receivables, net	46,110,666	41,760,421	137,963,747	121,527,560
Cash collections applied to principal	(19,039,526)	(17,923,345)	(59,101,722)	(56,084,521)
Balance at end of period	$ 326,476,130	$ 211,763,470	$ 326,476,130	$ 211,763,470

At the time of acquisition, the life of each pool is generally estimated to be between 72 to 96 months based on projected amounts and timing of future cash receipts using the proprietary models of the Company. As of September 30, 2007, the Company had $326,476,130 in net finance receivables. Based upon current projections, cash collections applied to principal are estimated to be as follows for the twelve months in the periods ending:

September 30, 2008	$ 77,034,108
September 30, 2009	73,693,375
September 30, 2010	68,033,587
September 30, 2011	55,936,379
September 30, 2012	38,945,072
September 30, 2013	12,274,496
September 30, 2014	559,113
	$ 326,476,130

During the three and nine months ended September 30, 2007, the Company purchased approximately $2.61 billion and $7.45 billion, respectively, of face value of charged-off consumer receivables. During the three and nine months ended September 30, 2006 the Company purchased approximately $1.19 billion and $6.73 billion of face value of charged-off consumer receivables. At September 30, 2007, the estimated remaining collections on the receivables purchased in the three and nine months ended September 30, 2007 were $127,839,234 and $333,285,005, respectively. At September 30, 2007, the estimated remaining collections on the receivables purchased in the three and nine months ended September 30, 2006 were $57,843,872 and $114,102,089, respectively.

PORTFOLIO RECOVERY ASSOCIATES, INC.
NOTES TO CONSOLIDATED FINANCIAL STATEMENTS
(unaudited)

Accretable yield represents the amount of income recognized on finance receivables the Company can expect to generate over the remaining life of its existing portfolios based on estimated future cash flows as of September 30, 2007 and 2006. Reclassifications from nonaccretable difference to accretable yield primarily result from the Company s increase in its estimate of future cash flows. Changes in accretable yield for the three and nine months ended September 30, 2007 and 2006 were as follows:

	Three Months Ended September 30, 2007	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
Balance at beginning of period	$ 410,842,510	$ 309,144,275	$ 326,775,399	$ 299,280,328
Income recognized on finance receivables, net	(46,110,666)	(41,760,421)	(137,963,747)	(121,527,560)
Additions	71,600,992	42,156,860	198,190,174	91,190,556
Reclassifications from nonaccretable difference	10,055,403	11,887,947	59,386,413	52,485,337
Balance at end of period	$ 446,388,239	$ 321,428,661	$ 446,388,239	$ 321,428,661

During the three and nine months ended September 30, 2007, the Company recorded $1,180,000 and $1,880,000, respectively, in allowance charges on pools that had recently underperformed expectations. During the nine months ended September 30, 2007, the Company also reversed $245,000 of allowance charges recorded in prior periods. During the three and nine months ended September 30, 2006, the Company recorded $275,000 and $650,000, respectively, in allowance charges. The change in the valuation allowance for the three and nine months ended September 30, 2007 and 2006 is as follows:

	Three Months Ended September 30, 2007	Three Months Ended September 30, 2006	Nine Months Ended September 30, 2007	Nine Months Ended September 30, 2006
Balance at beginning of period	$ 1,755,000	$ 575,000	$ 1,300,000	$ 200,000
Allowance charges recorded	1,180,000	275,000	1,880,000	650,000
Reversal of previously recorded allowance charges			(245,000)	
Change in allowance charge	1,180,000	275,000	1,635,000	650,000
Balance at end of period	$ 2,935,000	$ 850,000	$ 2,935,000	$ 850,000

3. Lines of Credit:

On November 29, 2005, the Company entered into a Loan and Security Agreement for a revolving line of credit jointly offered by Bank of America, N. A. and Wachovia Bank, National Association. The agreement was amended on May 9, 2006 to include RBC Centura Bank as an additional lender and again on May 4, 2007 to increase the line of credit to $150,000,000 and incorporate a $50,000,000 non-revolving fixed rate sub-limit. The agreement is a revolving line of credit in an amount equal to the lesser of $150,000,000 or 30% of the Company s estimated remaining collections of all its eligible asset pools. Borrowings under the revolving credit facility bear interest at a floating rate equal to the LIBOR Market Index Rate plus 1.40% and the facility expires on May 4, 2010. The loan is collateralized by substantially all the tangible and intangible assets of the Company. The agreement provides as follows: