Europe's Debt Collection Companies Are Looking To Pay Down Their Own Debt In 2019

February 4, 2019

Key Takeaways

- After another year of expansion in 2018, we expect 2019 to be the year when Europe's debt collection companies begin to manage their own debt, entering a more conservative phase of growth, and shore up their balance sheets.
- The companies, now firmly part of the financial infrastructure in Europe, are increasingly profitable across a diverse range of business lines, supporting plans to reduce debt in the year ahead.
- However, if the firms prove unable to balance their appetite for expansion with the need for sustainable debt reduction, we could see a deterioration in our key debt metrics in the coming 12 months, with potential negative actions for some ratings.
- Furthermore, as they turn to alternative sources of capital to fund expansion, owing to the tight speculative-grade market, we expect recovery prospects for unsecured creditors to erode, with potential downgrades of some issues.

Europe's debt collection companies are usually in the business of buying debt, but S&P Global Ratings believes they'll be thinking more about how to pay off their own debt this year.

A steady supply of cheap financing has enabled Europe's debt collection companies to grow into increasingly diversified businesses, with their traditional purchases of nonperforming loans (NPL) and growing debt-servicing businesses supporting financial institutions across Europe. Nearly all debt collection companies we rate expanded their geographic diversification in 2018, whether through M&A or in some cases through aggressive price competition to win market share. We expect 2019 to be the year this diversification starts to deliver, supporting debt reduction through earnings growth and cash generation, with competition beginning to calm and pricing discipline returning to the market.

Toward the end of 2018, however, credit conditions tightened in the speculative-grade bond markets where the companies typically borrow. That leaves our issuers, rated between 'B+' and 'BB+', with less room to maneuver entering 2019, and €9.3 billion of speculative-grade issuance weighing heavily on their balance sheets. We don't believe the companies will face a liquidity squeeze for now since they have extended maturities across capital structures, but we expect to see a shift in the funding mix to meet short-term working capital and refinancing needs. This will

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likely involve the extension of revolving credit facilities (RCFs) and access to securitization markets, which we would expect, all else being equal, to reduce recoveries for creditors over the coming year.

All told, debt collection companies will be travelling down a narrow path in 2019. Those companies that have not laid the groundwork for deleveraging already may face negative rating actions over the coming 12 months if their performance wavers. Similarly, as speculative-grade markets stutter, the need to draw on alternative funding may become a necessary tool in 2019, and for some issuers this will force recoveries down to levels that could lead us to lower issue level ratings.

Table 1

Ratings And Business Mix For Rated European Debt Collection Companies

Company	Issuer credit rating and outlook	Senior secured debt rating	Business lines	Countries present in
AnaCap Financial Europe S.A.	BB-/Stable	BB-	Distressed debt purchaser that operates exclusively within the financial services market	Italy, Portugal, Romania, Spain, U.K.
Arrow Global Group PLC	BB-/Stable	BB	Distressed debt purchaser and credit service provider focusing mainly on consumer and small and midsize enterprise accounts from the financial services industry.	Belgium, Ireland, Italy, Netherlands, Portugal, U.K.
B2Holding ASA	BB-/Stable	BB-	Distressed debt purchaser and credit service provider focusing mainly on the financial services industry.	Austria, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Republic, Denmark, Estonia, Finland, Greece, Hungary, Italy, Latvia, Lithuania, Luxembourg, Montenegro, Netherlands, Norway, Poland, Romania, Serbia, Slovenia, Spain, Sweden
Cabot Financial Ltd.	B+/Positive	B+	Distressed debt purchaser and credit service provider focusing mainly on the financial services industry.	Ireland, France, Portugal, Spain, U.K.
Garfunkelux HoldCo 2	B+/Stable	B+*	Distressed debt purchaser and credit service provider focusing mainly on financial services, telecommunications and retail. Operating activities conducted through primary operating entities GFKL and Lowell.	Austria, Croatia, Denmark, Estonia, Finland, Germany, Norway, Slovenia, Sweden, Switzerland, U.K.
Intrum AB	BB+/Stable	BB+	Distressed debt purchaser and credit service provider focusing mainly on telecommunications, energy, and the financial services industry across Europe.	Austria, Belgium, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Latvia, Lithuania, Netherlands, Norway, Poland, Portugal, Romania, Slovakia, Spain, Sweden, Switzerland, U.K.

Table 1

Ratings And Business Mix For Rated European Debt Collection Companies (cont.)

Company	Issuer credit rating and outlook	Senior secured debt rating	Business lines	Countries present in
Louvre Bidco SAS (MCS Group)§	BB-/Stable	BB-	Distressed debt purchaser and credit service provider, servicing a diverse client base across financial institutions and utilities providers.	France

*The senior secured debt rated 'B+' is issued at Garfunlelux HoldCo 3 S.A. §Louvre BidCo is the holding company that owns operating companies MCS et Associés (MCS) and DSO, a French debt-servicing company acquired in 2018. Sources: S&P Global Ratings, company reports.

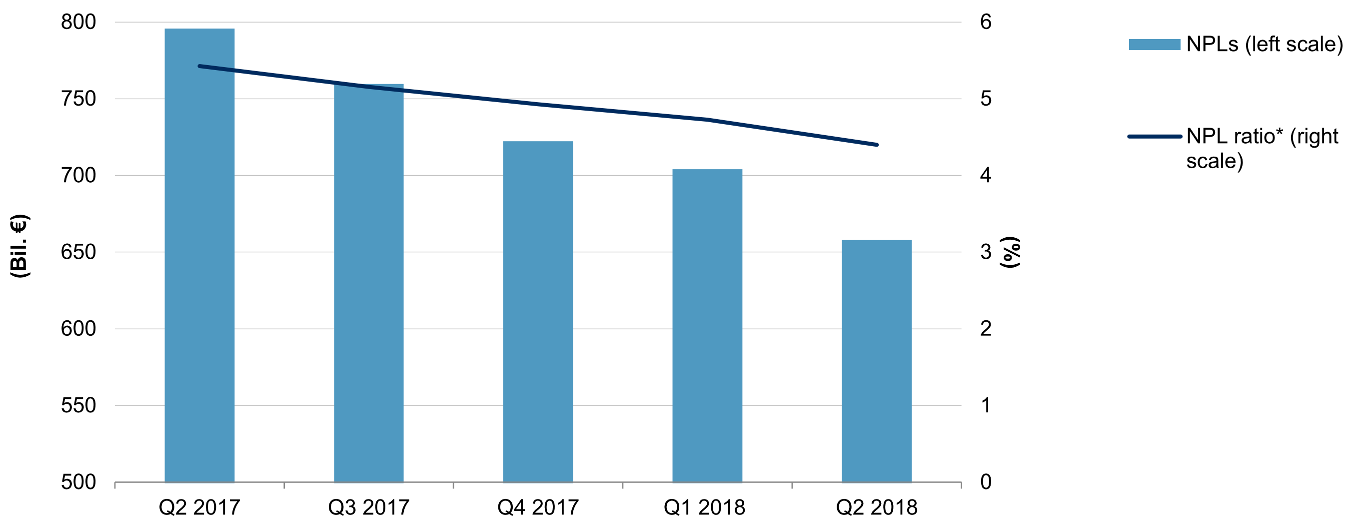
Cash-Generative Business Models Will Begin To Support Deleveraging

We regard most debt collection companies in Europe as well-positioned, cash-generative businesses that are suitably placed for further growth should debt markets loosen for speculative-grade companies. The role of debt purchasers in the financial system went undiminished in 2018, with our rated companies able to source new nonperforming loans (NPLs) from a stable pipeline across Europe, accelerated by the implementation of IFRS 9. In 2019, we expect this role to grow, cemented by:

- Implementation of the European Commission's new legislation for NPL provisioning, which should push banks to move the loans off their balance sheets and onto third-party balance sheets at an earlier stage; and
- The beginning of a turn in the credit cycle across Europe.

Chart 1

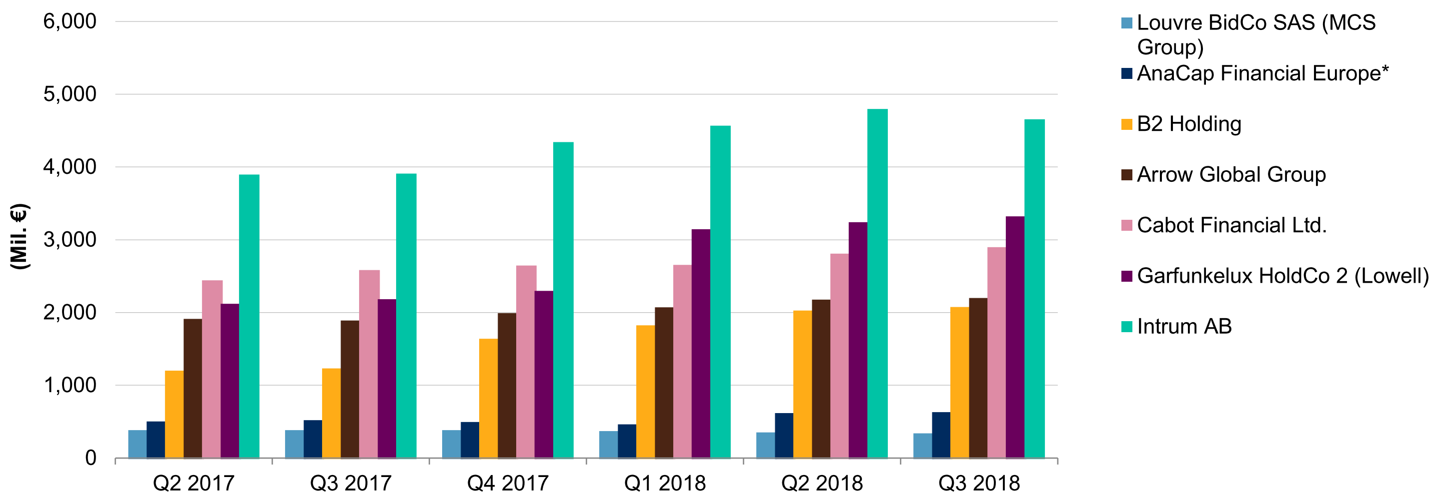
Nonperforming Loans For European Banks Continue To Fall



*NPL ratio is NPLs divided by total loans and advances. NPL--Nonperforming loans. Source: European Central Bank.

Chart 2

Remaining Collections For DCCs Continue To Rise
Company Estimates On 120-Month Basis



*AnaCap Financial Europe records remaining collections data only on an 84-month basis. Source: Company reports.

In this context we expect that older back books of debt (purchased before the current financial year) will remain profitable, and that returns on front books (purchased in the current financial year) will remain resilient despite lingering price inflation from the aggressive competition that drove up the value of distressed debt in 2018. Last year, competition eroded gross returns, known as gross money multiples (GMM, equal to company estimates of remaining collections of acquired debt/book value), to below 2x for a number of players--a first for incumbents in the industry. We believe prices will stabilize, or fall modestly, and support profitability in 2019, complemented by growing revenue from business lines outside of traditional investment activities. We expect these lines to include third-party collection, as well as growing advisory and asset management fees for more diversified players.

Our Positive Outlook On Cabot Financial

Our positive outlook on Cabot Financial reflects improving business diversification across geographies and expansion of activities beyond traditional NPL acquisition. The business' strategic shift away from its traditional U.K.-centered portfolio activities should support deleveraging of the business in the coming 12-18 months and enhance its competitive position.

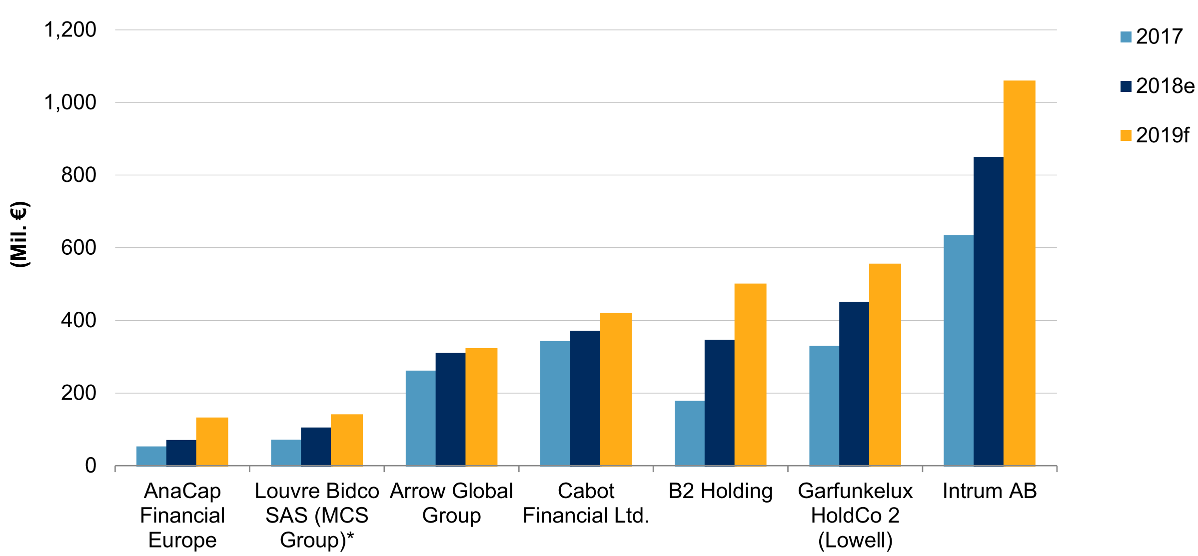
For most of the companies we rate, we believe our key credit metrics will remain at their current, sustainable levels in 2019 and expect modest deleveraging toward the end of the year. As most of the companies move toward a steady-state phase of development, we expect that their balance sheets should largely stabilize with only modest net portfolio growth. In this steady state, we anticipate that portfolio investment activities will be largely self-funding, with companies moving toward cash retention over the year, and net debt potentially starting to fall slightly in the latter part of the year.

Our primary debt metric is likely to stabilize

Under our base case forecast, we see net debt to EBITDA, our primary debt metric, at least stabilizing for most companies mainly because of purchases of debt with profitable back books and a return to stability for the front book in 2019, which should lead to solid EBITDA growth. However, this leaves debt collection companies sensitive to any deterioration in profitability given that cash retention will not be enough to materially reduce the companies' leverage before the latter part of 2019. For that reason, we are watching for any rapid deterioration in EBITDA and GMMs over the coming 12 months as signs of growth in leverage beyond our current expectations.

Chart 3

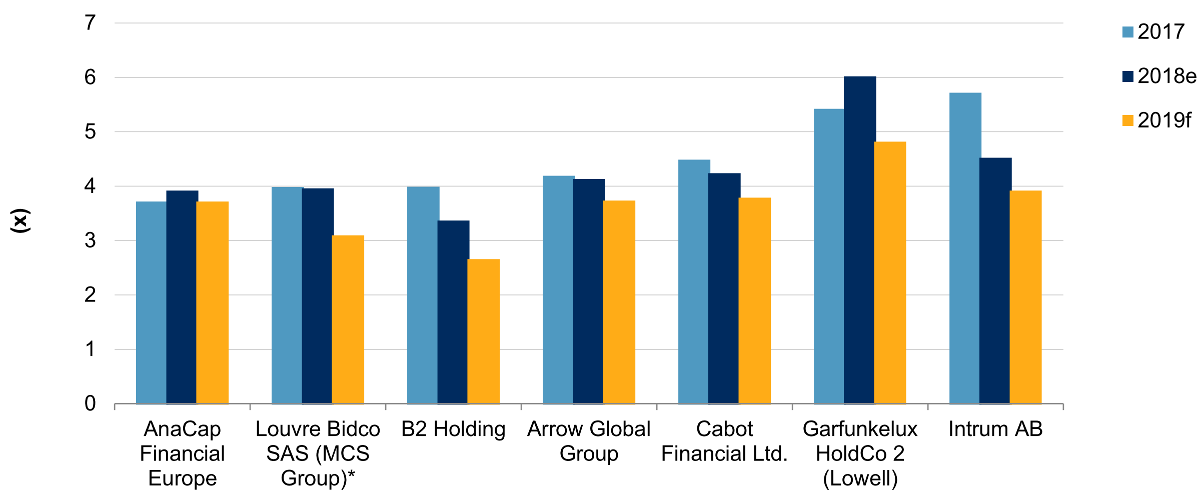
S&P Global Ratings Adjusted EBITDA For Debt Collection Companies



*2018 EBITDA is pro forma, as if DSO had been acquired on Jan. 1, 2018. e--S&P Global Ratings' estimate. f--S&P Global Ratings' forecast. Source: S&P Global Ratings.

Chart 4

S&P Global Ratings Net Debt/EBITDA For Debt Collection Companies Is Expected To Fall Under Our Base Case



*2018 EBITDA is pro-forma, as if DSO had been acquired on Jan. 1, 2018. e--S&P Global Ratings' estimate. f--S&P Global Ratings' forecast. Source: S&P Global Ratings.

We acknowledge some skepticism from the market about the companies' EBITDA metrics, especially on a statutory basis, particularly about management assumptions and their impact on revenue recognition for back books. Still, we believe that the companies' underlying cash EBITDA continues to capture their performance fairly, incorporating both 12-month ERC forecasts and same-year collections from newly acquired books. We also monitor alternative debt metrics, such as net debt/book value, which we expect to be broadly flat for most groups.

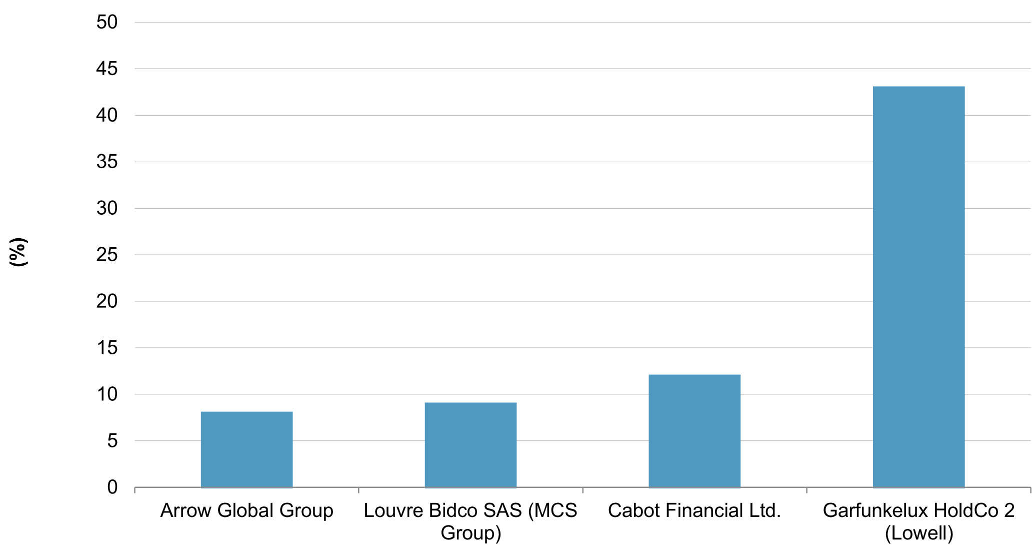
Our base case scenario doesn't take into account a rapid deterioration in European credit conditions in 2019. However, if this were to happen, we believe most players would attempt to accelerate purchases of distressed debt--seeking the same outsized returns that they obtained from back books dating to the financial crisis. This scenario could lead to a reversal of the fledgling deleveraging trend, as management uses retained cash for balance sheet expansion rather than deleveraging.

Forward flow agreements should support profitability

Any improvement to the financial position of the companies could also face roadblocks from their exposure to forward flow agreements, where a debt buyer and debt seller transact up to a fixed amount of debt, over a fixed period, for a predetermined price. If the companies are locked into unprofitable contracts, debt metrics could, contrary to our base case, deteriorate in the next 12 months as lower-quality portfolios weigh on their balance sheets and earnings. However, we believe these agreements should broadly support profitability. First, our understanding is that, in general, materially underperforming forward flows are open for price renegotiation. In other words, if performance deteriorates on these books, the debt collection companies will be able to reprice them, restoring a degree of profitability to future purchases. Second, for our rated companies that have greater exposure to unsecured portfolios, forward flows have been and will remain a logical way to manage portfolios. In our view, the in-depth knowledge of originators and the performance of their NPLs that comes with comprehensive, long-term forward flow agreements should help maintain the financial position of debt collection companies rather than hinder it.

Chart 5

Forward Flow Agreements For Our Rated Debt Collection Companies Reflect The Composition Of Their Books
As a percentage Of book value



*Not all DCCs make forward flow data publically available. For Louvre BidCo, Arrow Global, and Cabot, data as of fiscal year ended Dec. 31, 2017. For Garfunkelux, data as of Sept. 30, 2018. Source: Company reports, investor calls.

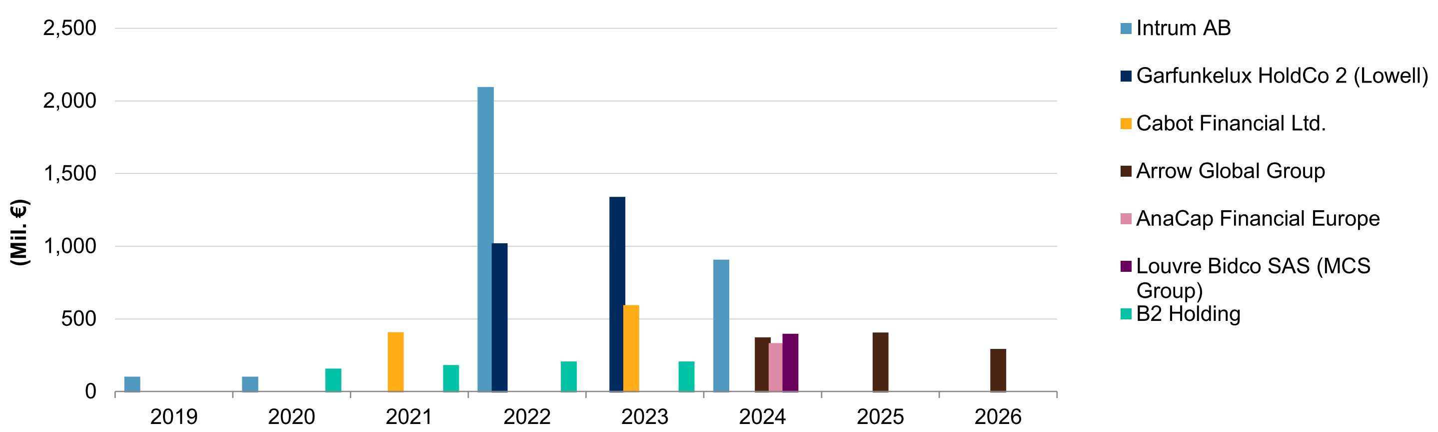
Garfunkelux Holdco 2 S.A. (commonly known as Lowell, B+/Stable) is the most leveraged company in our rated universe at year-end 2018, and its high indebtedness will certainly become a more acute weakness as interest rates normalize in the next 12 months. Similarly, we note that Intrum AB, the largest and highest rated member of the cohort (BB+/Stable), has built its strong business position in Europe at the expense of temporarily worsened debt metrics, including higher and more regular use of its RCF. For both of these issuers, we expect debt metrics to remain at the higher end of their rating levels over 2019, and we continue to monitor whether the modest deleveraging we expect begins to gain momentum. Any failure by the companies to begin deleveraging over 2019 could be credit negative.

Constrained Access To Speculative-Grade Markets Will Start A Search For Alternatives

Until now, debt collection companies have relied heavily on debt markets to fund expansion, with €9.3 billion of speculative-grade debt outstanding at the end of third-quarter 2018. However, throughout the second half of 2018, we have seen the speculative-grade markets progressively tighten for our issuers with spreads widening by 280 basis points (bps) above three-month LIBOR on a range of their publically traded bonds over 2018. However, we see limited refinancing risk in 2019 because of the long weighted average maturity--around 2023--for the rated companies. Furthermore, the tightening of these markets may force them to accelerate efforts to slow portfolio growth and reduce debt, which should be supportive to the ratings.

Chart 6

Extended Debt Maturity Profiles For Debt Collection Companies Support Their Short-Term Liquidity

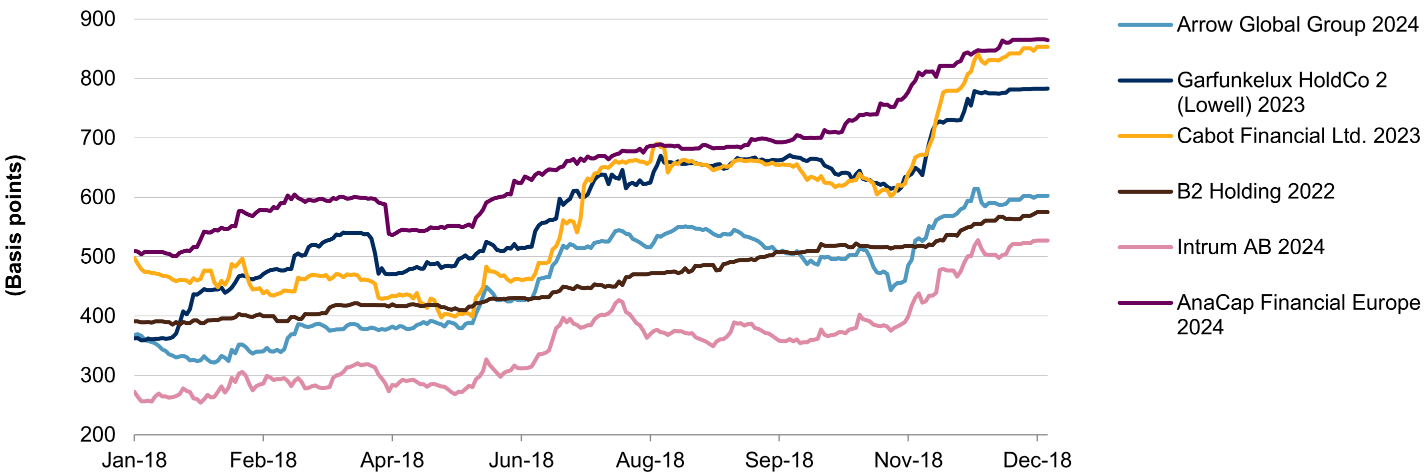


Note: Data is principal and accrued interest at maturity only on bonds and loan notes.

Source: Company reports, S&P Global Ratings, Bloomberg.

Chart 7

Widening Bond Spreads For Debt Collection Companies Signal Tightening Bond Markets



Source: Bloomberg zero volatility spreads. Data as of Dec. 31, 2018.

If speculative-grade markets remain closed or unaffordable, debt collection companies will need to turn to alternative sources of capital to fund small refinancings and portfolio acquisitions. Alternative funding sources available to cover requirements include securitization of ERC balances or the extension of RCFs. We believe both options are detrimental to recovery prospects for unsecured creditors, who would face the prospect of either a smaller enterprise value available for recoveries (securitization) or further subordination in the waterfall (RCF extensions). Ultimately, this could weigh on issue level ratings on the most junior instruments in our waterfalls, with headroom likely to diminish as alternative funding sources begin to play a more significant role in the capital structures of debt collection companies.

Table 2

Recovery Rating Summaries For Rated European Debt Collection Companies

	Claim type	Maturities	Recovery rating	Final rounded recovery (%)
AnaCap Financial Europe	Senior secured	2024	3	60
Arrow Global Group PLC	Senior secured	2024 to 2026	2	70
Intrum AB	Senior unsecured	2020 to 2023	4	40
Louvre Bidco SAS (MCS Group)	Senior secured	2024	4	40

Source: S&P Global Ratings.

Alternative Funding Could Weigh On Recovery Ratings

Since 2017, two of our issuers, Cabot Financial and Lowell, pledged £510 million and £350 million of ERC, respectively, to asset-backed note programs. Lowell used the proceeds to pay down drawings on its RCF, and Cabot used part of the funds raised to pay off £150 million of bonds. The asset-backed transactions reduced recovery prospects by 10 points across the board for investors, with senior secured claims now approaching the 30% recovery rate where we could consider a negative rating action at the issue level. This is more of a risk for Lowell where a similar transaction would push it to the borderline of the threshold.

Table 3

The Impact Of Securitization On Debt Collection Companies' Recovery Ratings

	Claim type	Maturities	Recovery rating	Final rounded recovery (%)
Cabot Financial Ltd. - Pre-Securitization	Senior secured	2020 to 2023	3*	60
Cabot Financial Ltd. - Post-Securitization	Senior secured	2020 to 2023	3*	55
Garfunkelux HoldCo 2 - Pre-Securitization	Senior secured	2022 and 2023	3	50
	Senior unsecured	2023	6	0
Garfunkelux HoldCo 2 - Post-Securitization	Senior secured	2022 and 2023	4	40
	Senior unsecured	2023	6	0

*Based on £300 million of pledged estimated remaining collections. We don't expect extension of facility by £50 million after third-quarter 2018 to reduce recoveries below 30% threshold. Source: S&P Global Ratings.

All in all, we do not regard the state of the bond market as an immediate risk to our issuer credit ratings. Instead, we believe that it could accelerate issuers' plans to accumulate cash and reduce debt, which should support these ratings. However, limited access to traditional funding sources for debt consolidation companies will mean that as they necessarily diversify into securitization markets or expand existing RCFs, diminishing enterprise value or further subordinating existing creditors, we could begin to see negative pressure on recovery and issue level ratings.

Major M&A Is Likely To Slow In 2019

M&A continued in 2018 with players bolting on regional debt purchasers and a number of servicing businesses to diversify their business models or enhance competitive positions in primary markets. We note that this spree continued until Intrum's acquisition of 80% of Banco Sabadell's Spanish real estate servicing business in mid-December. We see the trend slowing in 2019 as the capital markets slow down for speculative-grade issuers, and management teams at debt collection companies look to use cash flow for reinvestment rather than to support acquisitions. In place of traditional M&A, we expect that 2019 will see a more prominent role for partnerships and joint ventures with large institutions (for instance the Intrum and Intesa Sanpaolo partnership) or smaller specialist players across Europe.

Table 4

Timeline Of Recent M&A Activity For Debt Collection Companies

Date	Event
Jun-17	B2 Holding acquired Nordic Debt Collection A/S, a company based in Denmark.
Jun-17	Intrum Justitia AB and Locl Lower Holdings (Lindorff) merger is finalized
Aug-17	B2 Holding acquires 74% of UAB Skolu Rizikos Sprendimai, a Lithuanian company specializing in third-party services.
Nov-17	Cabot Credit Management completes the acquisition of debt services provider for the U.K. retail banking sector, Wescot.
Nov-17	B2 Holding acquires 80% of Spanish company Verifica, with an option of acquiring the remaining 20%, to expand operations in Spain.
Mar-18	Arrow Global acquires 100% of Parr Credit Srl, a company that manages unsecured performing and nonperforming loans. The value of the acquisition is €25 million.
Mar-18	Lowell GFKL acquires 100% of Fair Play Please AS and Lindorff Sverige AB, the carve-out business of Intrum for €741 million. The carve-out comprises Lindorff's businesses in Denmark, Estonia, Finland, and Sweden.
Apr-18	Intrum and Intesa Sanpaolo enter into a long-term partnership, creating a new plaform for servicing NPLs in Italy. Estimated consideration for the transaction is €670 million funded through an asset-backed facility.
Jul-18	Intrum acquires 51% of iPlatform, a Brazilian credit management company. The purchase consideration is Swedish krona 15 million.
Sep-18	Arrow Global acquires 100% of Europa Investimenti SpA which, together with Zenith and Parr, will support the group's growth in Italy. The fair value of the acquisition is €65.5 million.
Oct-18	MCS acquires DSO group, an independent French debt collection management company focused on debt servicing and debt purchasing, for €82 million.
Dec-18	Intrum acquries 80% of Solvia, a leading real estate service provider in Spain. The value of the transaction is €300 million.

Source: Various news reports and press releases.

Table 5

Debt Collection Companies And The Analysts Who Cover Them

Entity	Primary Contact
AnaCap Financial Europe S.A.	Pierre Gautier, William Edwards
Arrow Global Group PLC	Nigel Greenwood, William Edwards
B2Holding ASA	Heiko Verhaag
Cabot Financial Ltd.	Letitzia Conversano
Garfunkelux HoldCo 2 (Lowell)	Pierre Gautier, William Edwards
Intrum AB	Michal Selbka
Louvre Bidco (MCS)	Stanislas De Bazelaire

Related Research

- Rating Factor Assessments For European Financial Services Finance Companies (January 2019), Jan. 31, 2019
- End Not Yet In Sight For European Debt Collection Companies' Growth Spurt, Jan. 24, 2018
- When The Cycle Turns: Rising Interest Rates Will Lift, Not Propel, Western European Banks' Profitability, Jan. 14, 2019
- Global Banks 2019 Outlook: Bracing For More Volatility, Dec. 3, 2018

This report does not constitute a rating action.

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