

ENCORE CAPITAL GROUP INC

Form 10-Q

April 27, 2010

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, 2010

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)  
  
**8875 Aero Drive, Suite 200**  
  
**San Diego, California**  
(Address of principal executive offices)

**48-1090909**  
(IRS Employer  
Identification No.)

**92123**  
(Zip code)

**(877) 445 - 4581**

(Registrant's telephone number, including area code)

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

(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 16, 2010 |
|--------------------------------|-------------------------------|
| Common Stock, \$0.01 par value | 23,460,019 shares             |

**Table of Contents**

**ENCORE CAPITAL GROUP, INC.**

**INDEX TO FORM 10-Q**

|   | <b>Page</b> |
|---|-------------|
| <b><u>PART I FINANCIAL INFORMATION</u></b>  | <b>1</b>    |
| <u>Item 1 Condensed Consolidated Financial Statements (Unaudited)</u>                               | 1           |
| <u>Condensed Consolidated Statements of Financial Condition</u>                                     | 1           |
| <u>Condensed Consolidated Statements of Income</u>  | 2           |
| <u>Condensed Consolidated Statements of Stockholders' Equity and Comprehensive Income</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> | 18          |
| <u>Supplemental Performance Data</u>  | 25          |
| <u>Liquidity and Capital Resources</u>  | 32          |
| <u>Item 3 Quantitative and Qualitative Disclosures About Market Risk</u>                            | 33          |
| <u>Item 4 Controls and Procedures</u>   | 33          |
| <b><u>PART II OTHER INFORMATION</u></b>   | <b>34</b>   |
| <u>Item 1 Legal Proceedings</u>   | 34          |
| <u>Item 1A Risk Factors</u>   | 35          |
| <u>Item 5 Exhibits</u>  | 38          |
| <b><u>SIGNATURES</u></b>  | <b>39</b>   |

**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>2010 | December 31,<br>2009 |
|--|-------------------|----------------------|
| <b>Assets</b>  |                   |                      |
| Cash and cash equivalents  | \$ 7,575          | \$ 8,388             |
| Accounts receivable, net   | 2,523             | 3,134                |
| Investment in receivable portfolios, net   | 549,660           | 526,877              |
| Deferred court costs   | 25,603            | 25,957               |
| Property and equipment, net  | 9,922             | 9,427                |
| Other assets   | 10,194            | 4,252                |
| Goodwill   | 15,985            | 15,985               |
| Identifiable intangible assets, net  | 1,041             | 1,139                |
| <b>Total assets</b>  | <b>\$ 622,503</b> | <b>\$ 595,159</b>    |
| <b>Liabilities and stockholders equity</b>   |                   |                      |
| Liabilities:   |                   |                      |
| Accounts payable and accrued liabilities   | \$ 18,253         | \$ 21,815            |
| Income taxes payable   | 5,188             | 2,681                |
| Deferred tax liabilities, net  | 17,097            | 16,980               |
| Deferred revenue   | 5,464             | 5,481                |
| Debt   | 318,014           | 303,075              |
| Other liabilities  | 1,321             | 2,036                |
| <b>Total liabilities</b>   | <b>365,337</b>    | <b>352,068</b>       |
| Commitments and contingencies  |                   |                      |
| Stockholders equity:   |                   |                      |
| Convertible preferred stock, \$.01 par value, 5,000 shares authorized, no shares issued and outstanding  |                   |                      |
| Common stock, \$.01 par value, 50,000 shares authorized, 23,458 shares and 23,359 shares issued and outstanding as of March 31, 2010 and December 31, 2009, respectively | 235               | 234                  |
| Additional paid-in capital   | 106,831           | 104,261              |
| Accumulated earnings   | 150,703           | 139,842              |
| Accumulated other comprehensive loss   | (603)             | (1,246)              |
| <b>Total stockholders equity</b>   | <b>257,166</b>    | <b>243,091</b>       |
| <b>Total liabilities and stockholders equity</b>   | <b>\$ 622,503</b> | <b>\$ 595,159</b>    |

*See accompanying notes to consolidated financial statements*



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

(In Thousands, Except Per Share Amounts)

(Unaudited)

|   | <b>Three Months Ended<br/>March 31,</b> |                 |
|---|---|-----------------|
|   | <b>2010</b>                             | <b>2009</b>     |
| <b>Revenue</b>  |   |                 |
| Revenue from receivable portfolios, net                                     | \$ 82,907                               | \$ 72,275       |
| Servicing fees and other related revenue                                    | 4,431                                   | 4,171           |
| <b>Total revenue</b>  | <b>87,338</b>                           | <b>76,446</b>   |
| <b>Operating expenses</b>   |   |                 |
| Salaries and employee benefits (excluding stock-based compensation expense) | 15,485                                  | 13,957          |
| Stock-based compensation expense  | 1,761                                   | 1,080           |
| Cost of legal collections   | 26,433                                  | 29,947          |
| Other operating expenses  | 9,114                                   | 5,980           |
| Collection agency commissions   | 5,296                                   | 2,891           |
| General and administrative expenses   | 6,879                                   | 5,697           |
| Depreciation and amortization   | 673                                     | 623             |
| <b>Total operating expenses</b>   | <b>65,641</b>                           | <b>60,175</b>   |
| <b>Income before other (expense) income and income taxes</b>                | <b>21,697</b>                           | <b>16,271</b>   |
| <b>Other (expense) income</b>   |   |                 |
| Interest expense  | (4,538)                                 | (4,273)         |
| Gain on repurchase of convertible notes, net                                |   | 3,053           |
| Other income (expense)  | 192                                     | (81)            |
| <b>Total other expense</b>  | <b>(4,346)</b>                          | <b>(1,301)</b>  |
| <b>Income before income taxes</b>   | <b>17,351</b>                           | <b>14,970</b>   |
| Provision for income taxes  | (6,490)                                 | (5,973)         |
| <b>Net income</b>   | <b>\$ 10,861</b>                        | <b>\$ 8,997</b> |
| <b>Weighted average shares outstanding:</b>                                 |   |                 |
| Basic   | 23,494                                  | 23,122          |
| Diluted   | 24,685                                  | 23,631          |
| <b>Earnings per share:</b>  |   |                 |
| Basic   | \$ 0.46                                 | \$ 0.39         |
| Diluted   | \$ 0.44                                 | \$ 0.38         |

*See accompanying notes to consolidated financial statements*

**Table of Contents****ENCORE CAPITAL GROUP, INC.****Condensed Consolidated Statements of Stockholders Equity and Comprehensive Income**

(Unaudited, In Thousands)

|   | Common Stock |        | Additional<br>Paid-In<br>Capital | Accumulated<br>Earnings | Accumulated<br>Other<br>Comprehensive<br>Income (loss) | Total<br>Equity | Comprehensive<br>Income |
|---|--------------|--------|----------------------------------|-------------------------|--|-----------------|-------------------------|
|   | Shares       | Par    |                                  |                         |  |                 |                         |
| <b>Balance at December 31, 2009</b>   | 23,359       | \$ 234 | \$ 104,261                       | \$ 139,842              | \$ (1,246)   | \$ 243,091      | \$                      |
| Net income  |              |        |                                  | 10,861                  |  | 10,861          | 10,861                  |
| Other comprehensive gain:   |              |        |                                  |                         |  |                 |                         |
| Unrealized gain on cash flow hedge, net of tax  |              |        |                                  |                         | 643  | 643             | 643                     |
| Exercise of stock options and issuance of<br>share-based awards, net of shares withheld for<br>employee taxes | 99           | 1      | (111)                            |                         |  | (110)           |                         |
| Stock-based compensation  |              |        | 1,761                            |                         |  | 1,761           |                         |
| Settlement of call options and warrants associated<br>with convertible notes, net                             |              |        | 524                              |                         |  | 524             |                         |
| Tax benefit related to stock-based compensation   |              |        | 396                              |                         |  | 396             |                         |
| <b>Balance at March 31, 2010</b>  | 23,458       | \$ 235 | \$ 106,831                       | \$ 150,703              | \$ (603)   | \$ 257,166      | \$ 11,504               |

*See accompanying notes to consolidated financial statements*

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

(Unaudited, In Thousands)

|   | <b>Three Months Ended<br/>March 31,</b> |             |
|---|---|-------------|
|   | <b>2010</b>                             | <b>2009</b> |
| <b>Operating activities:</b>  |   |             |
| Net income  | \$ 10,861                               | \$ 8,997    |
| Adjustments to reconcile net income to net cash provided by operating activities: |   |             |
| Depreciation and amortization   | 673                                     | 623         |
| Amortization of loan costs and debt discount                                      | 1,062                                   | 1,221       |
| Stock-based compensation expense  | 1,761                                   | 1,080       |
| Gain on repurchase of convertible notes, net                                      |   | (3,053)     |
| Deferred income tax expense   | 117                                     | 145         |
| Excess tax benefit from stock-based payment arrangements                          | (458)                                   | (21)        |
| Provision for allowances on receivable portfolios, net                            | 7,881                                   | 5,427       |
| Changes in operating assets and liabilities                                       |   |             |
| Other assets  | (822)                                   | (165)       |
| Deferred court costs  | 354                                     | (2,310)     |
| Prepaid income tax and income taxes payable                                       | 2,903                                   | 5,441       |
| Deferred revenue  | (17)                                    | 26          |
| Accounts payable, accrued liabilities and other liabilities                       | (3,787)                                 | (523)       |
| Net cash provided by operating activities   | 20,528                                  | 16,888      |
| <b>Investing activities:</b>  |   |             |
| Purchases of receivable portfolios  | (81,632)                                | (55,913)    |
| Collections applied to investment in receivable portfolios, net                   | 50,384                                  | 37,424      |
| Proceeds from put-backs of receivable portfolios                                  | 584                                     | 924         |
| Purchases of property and equipment   | (208)                                   | (469)       |
| Net cash used in investing activities   | (30,872)                                | (18,034)    |
| <b>Financing activities:</b>  |   |             |
| Payment of loan costs   | (4,660)                                 |             |
| Proceeds from notes payable and other borrowings                                  | 35,000                                  | 32,000      |
| Repayment of notes payable and other borrowings                                   | (22,000)                                | (17,000)    |
| Repurchase of convertible notes   |   | (19,834)    |
| Proceeds from net settlement of certain call options                              | 524                                     |             |
| Proceeds from exercise of stock options   | 395                                     |             |
| Excess tax benefit from stock-based payment arrangements                          | 458                                     | 21          |
| Repayment of capital lease obligations  | (186)                                   | (121)       |
| Net cash provided by financing activities   | 9,531                                   | (4,934)     |
| Net decrease in cash  | (813)                                   | (6,080)     |
| Cash and cash equivalents, beginning of period                                    | 8,388                                   | 10,341      |
| Cash and cash equivalents, end of period  | \$ 7,575                                | \$ 4,261    |

**Supplemental disclosures of cash flow information:**



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

|  |          |          |
|--|----------|----------|
| Cash paid for interest   | \$ 3,516 | \$ 3,699 |
| Cash paid for income taxes   | \$ 3,832 | \$ 499   |
| <b>Supplemental schedule of non-cash investing and financing activities:</b> |          |          |
| Fixed assets acquired through capital lease                                  | \$ 862   | \$       |

*See accompanying notes to 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 systems-driven purchaser and manager of charged-off consumer receivable portfolios and, through its wholly owned subsidiary Ascension Capital Group, Inc. ( Ascension ), a provider of bankruptcy services to the finance industry. The Company acquires its receivable portfolios at deep discounts from their face values using its proprietary valuation process that is based on the consumer attributes of the underlying accounts. Based on the Company's ongoing analysis of these accounts, it employs a dynamic mix of collection strategies to maximize its return on investment. The receivable portfolios the Company purchases consist primarily of unsecured, charged-off domestic consumer credit card, auto deficiency and telecom receivables purchased from national financial institutions, major retail credit corporations, telecom companies and resellers of such portfolios. Acquisitions of receivable portfolios are financed by operations and by borrowings from third parties. See Note 9 for further discussion of the Company's debt.

***Financial Statement Preparation***

The accompanying interim condensed consolidated financial statements have been prepared by Encore, without audit, in accordance with the instructions to Form 10-Q, and Rule 10-01 of Regulation S-X promulgated by the Securities and Exchange Commission 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.

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 results of operations, financial position 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, 2009. Operating results for interim periods are not necessarily indicative of operating results for an entire fiscal year.

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.

***Principles of Consolidation***

The Company's condensed consolidated financial statements include the assets, liabilities and operating results of its wholly-owned subsidiaries. All significant intercompany accounts and transactions have been eliminated.

***New Accounting Pronouncements***

In October 2009, the Financial Accounting Standards Board issued Accounting Standards Update No. 2009-13, *Revenue Recognition (Topic 605): Multiple-Deliverable Revenue Arrangements a consensus of the FASB Emerging Issues Task Force*, which establishes a selling price hierarchy for determining the selling price of a deliverable, and eliminates the residual method of allocation. This update requires the arrangement consideration be allocated at the inception of the arrangement to all deliverables using the relative selling price method. This update is effective prospectively for revenue arrangements entered into or materially modified in fiscal years beginning on or after June 15, 2010. The Company is currently analyzing the impact of this update, if any, to its consolidated financial statements.

**Note 2: 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.



**Table of Contents**

The components of basic and diluted earnings per share are as follows (*in thousands, except earnings per share*):

|   | <b>Three Months Ended<br/>March 31,</b> |             |
|---|---|-------------|
|   | <b>2010</b>                             | <b>2009</b> |
| Net income available for common shareholders (A)        | \$ 10,861                               | \$ 8,997    |
| Weighted average outstanding shares of common stock (B) | 23,494                                  | 23,122      |
| Dilutive effect of stock-based awards                   | 1,191                                   | 509         |
| Common stock and common stock equivalents (C)           | 24,685                                  | 23,631      |
| <b>Earnings per share:</b>                              |   |             |
| Basic (A/B)   | \$ 0.46                                 | \$ 0.39     |
| Diluted (A/C)   | \$ 0.44                                 | \$ 0.38     |

Employee stock options to purchase approximately 210,000 and 1,393,000 shares of common stock were outstanding during the three months ended March 31, 2010 and 2009, respectively, 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 3: 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 that reflect the reporting entity's own assumptions.

Assets and liabilities measured at fair value on a recurring basis at March 31, 2010 are summarized below (*in thousands*):

|                               | <b>Level 1</b> | <b>Level 2</b> | <b>Level 3</b> | <b>Total</b> |
|-------------------------------|----------------|----------------|----------------|--------------|
| <b>Assets</b>                 |                |                |                |              |
| Foreign exchange contracts    | \$             | \$ 351         | \$             | \$ 351       |
| <b>Liabilities</b>            |                |                |                |              |
| Interest rate swap agreements | \$             | \$ 1,321       | \$             | \$ 1,321     |

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 exchange rates, and forward and spot prices for currencies. As of March 31, 2010, the Company did not have any financial instruments carried at fair value that required Level 3 measurement.

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

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

Borrowings under the Company's revolving credit facility are carried at historical cost, adjusted for additional borrowings less principal repayments, which approximates fair value. The Company's Convertible Notes are carried at historical cost, adjusted for repurchases and debt discount. The fair value estimate for these notes incorporates quoted market prices at the balance sheet date, which was determined to be approximately equal to book value as of March 31, 2010 and December 31, 2009. For investment in receivable portfolios, there is no active market or observable inputs for the fair value estimation. The Company considers it not practical to attempt to estimate the fair value of such financial instruments due to the excessive costs that would be incurred in doing so.

**Table of Contents****Note 4: 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 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. In April 2007, the Company entered into two separate interest rate swap agreements. Under the swap agreements, the Company receives floating interest rate payments and makes interest payments based on fixed interest rates. The first agreement is for a notional amount of \$25.0 million, a term of three years and a fixed interest rate of 4.99%. The second agreement is for a notional amount of \$25.0 million, a term of four years and a fixed interest rate of 5.01%. 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 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. 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 Exchange Contracts**

The Company conducts business in currencies other than the U.S. dollar, primarily associated with its international subsidiary in India. As a result, India's forecasted expenditures expose the Company to foreign currency risk. 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 24 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 gain 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, 2010, the total notional amount of the forward contracts to buy Indian rupees in exchange for U.S. dollars was \$14.7 million. All outstanding contracts qualified for hedge accounting treatment as of March 31, 2010. The Company estimates that approximately \$0.2 million of net derivative gain 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, 2010.

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 consolidated statements of financial position (*in thousands*):

|  | March 31, 2010         |            | December 31, 2009      |            |
|--|------------------------|------------|------------------------|------------|
|  | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| Derivatives designated as hedging instruments: |                        |            |                        |            |
| Interest rate swaps                            | Other liabilities      | \$ (1,321) | Other liabilities      | \$ (1,791) |
| Foreign exchange contracts                     | Other assets           | \$ 351     | Other liabilities      | \$ (245)   |



**Table of Contents**

The following tables summarize the effects of derivatives in cash flow hedging relationships on the Company's statements of income for the three months ended March 31, 2010 and 2009 (*in thousands*):

|                            | Gain or (Loss) Recognized in OCI-Effective Portion |        | Location of Gain or (Loss) Reclassified from OCI into | 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 |      |
|----------------------------|--|--------|---|--|------|--|--|------|
|                            | 2010   | 2009   | Income - Effective Portion                            | 2010   | 2009 |  | 2010   | 2009 |
|                            |  |        |   |  |      |  |  |      |
| Interest rate swaps        | \$ 470   | \$ 307 | Interest expense                                      | \$   | \$   | Other (expense) income   | \$   | \$   |
| Foreign exchange contracts | \$ 494   | \$     | Salaries and employee benefits                        | \$ 3   | \$   | Other (expense) income   | \$   | \$   |
| Foreign exchange contracts | \$ 104   | \$     | General and administrative expenses                   | \$ (1)   | \$   | Other (expense) income   | \$   | \$   |

**Note 5: Stock-Based Compensation**

On March 9, 2009, the Board of Directors 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 advisors to, the Company. The amendment and restatement of the 2005 Plan increased by 2,000,000 shares the maximum number of shares of the Company's common stock that may be issued or be subject to awards under the plan, 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, plus the number of shares of stock that were available for future awards under the prior 1999 Equity Participation Plan ( 1999 Plan ). In addition, shares subject to options granted under either the 1999 Plan or the 2005 Plan that terminate or expire without being exercised will become available for grant under the 2005 Plan. The benefits provided under these plans are 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 compensation expense during the three months ended March 31, 2010 and 2009 was \$1.8 million and \$1.1 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 generally granted with an exercise price equal to the market price of the Company's stock at the date of issuance. They generally vest over three to five years of continuous service, and have ten-year contractual terms.

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.





**Table of Contents**

The fair value for options granted was estimated at the date of grant using a Black-Scholes option-pricing model with the following weighted-average assumptions:

|   | Three Months Ended<br>March 31, |         |
|---|---------------------------------|---------|
|   | 2010                            | 2009    |
| Weighted average fair value of options granted                                  | \$ 9.70                         | \$ 1.36 |
| Risk free interest rate   | 2.3%                            | 1.9%    |
| Dividend yield  | 0.0%                            | 0.0%    |
| Volatility factor of the expected market price of the Company's<br>common stock | 62.0%                           | 52.8%   |
| Weighted-average expected life of options                                       | 5 Years                         | 5 Years |

Unrecognized compensation cost related to stock options as of March 31, 2010, was \$4.9 million. The weighted-average remaining expense period, based on the unamortized value of these outstanding stock options was approximately 2.4 years.

A summary of the Company's stock option activity as of March 31, 2010, and changes during the three months then ended, is presented below:

|                                  | Number of<br>Shares | Option Price<br>Per Share |         | Weighted<br>Average<br>Exercise<br>Price | Aggregate<br>Intrinsic<br>Value<br>(in thousands) |
|----------------------------------|---------------------|---------------------------|---------|--|---|
| Outstanding at December 31, 2009 | 2,667,137           | \$ 0.35                   | \$20.09 | \$ 9.28                                  |   |
| Granted                          | 215,000             |                           | 17.90   | 17.90                                    |   |
| Cancelled/forfeited              | (10,000)            |                           | 11.30   | 11.30                                    |   |
| Exercised                        | (43,500)            | 0.35                      | 16.19   | 9.09                                     |   |
| Outstanding at March 31, 2010    | 2,828,637           | \$ 0.35                   | \$20.09 | \$ 9.93                                  | \$ 18,975   |
| Exercisable at March 31, 2010    | 1,708,625           | \$ 0.35                   | \$20.09 | \$ 8.66                                  | \$ 13,541   |

The total intrinsic value of options exercised during the three months ended March 31, 2010 and 2009 was \$0.4 million and less than \$0.1 million, respectively. As of March 31, 2010, the weighted-average remaining contractual life of options outstanding and options exercisable was 6.3 years and 4.4 years, respectively.

**Restricted Stock Units**

Under the Company's 2005 Plan, certain employees and directors are eligible to receive restricted stock units. In accordance with the authoritative guidance, the fair value of restricted stock units is equal to the closing sale price of the Company's common stock on the date of issuance. The total number of restricted stock unit awards expected to vest is adjusted by estimated forfeiture rates. As of March 31, 2010, 88,825 of the non-vested shares are expected to vest over approximately one to two years based on certain performance goals (Performance-Based Awards). The fair value of the Performance-Based Awards is expensed over the expected vesting period, net of estimated forfeitures. If performance goals are not expected to be met, the compensation expense previously recognized would be reversed. No reversals of compensation expense related to the Performance-Based Awards have been made as of March 31, 2010. The remaining 741,295 non-vested shares are not performance-based, and will vest over approximately one to five years of continuous service.

A summary of the status of the Company's restricted stock units as of March 31, 2010, and changes during the three months then ended, is presented below:

| Restricted Stock Units | Non-Vested<br>Shares | Weighted Average<br>Grant Date |
|------------------------|----------------------|--------------------------------|
|------------------------|----------------------|--------------------------------|

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

|                                 |          | <b>Fair Value</b> |
|---------------------------------|----------|-------------------|
| Non-vested at December 31, 2009 | 675,790  | \$ 9.27           |
| Awarded                         | 247,419  | \$ 17.47          |
| Vested                          | (92,423) | \$ 7.77           |
| Cancelled/forfeited             | (666)    | \$ 11.35          |
| <br>                            |          |                   |
| Non-vested at March 31, 2010    | 830,120  | \$ 11.88          |

Unrecognized compensation expense related to restricted stock units as of March 31, 2010, was \$4.8 million. The weighted-average remaining expense period, based on the unamortized value of these outstanding restricted stock units was approximately 2.7 years. The fair value of restricted stock units vested during the three months ended March 31, 2010 and 2009 was \$1.5 million and \$0.2 million, respectively.

**Table of Contents****Note 6: 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.

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 effective interest rate, or 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 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 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. As of March 31, 2010, there were three portfolios accounted for using the cost recovery method, consisting of \$0.5 million in net book value of investment in receivable portfolios.

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 current period (*in thousands*):

|                                      | Accretable<br>Yield | Estimate of<br>Zero Basis<br>Cash Flows | Total      |
|--------------------------------------|---------------------|---|------------|
| Balance at December 31, 2009         | \$ 628,439          | \$ 4,695                                | \$ 633,134 |
| Revenue recognized, net              | (80,851)            | (2,056)                                 | (82,907)   |
| Net additions to existing portfolios | 45,179              | 1,702                                   | 46,881     |
| Additions for current purchases      | 93,430              |   | 93,430     |
| Balance at March 31, 2010            | \$ 686,197          | \$ 4,341                                | \$ 690,538 |
|                                      | Accretable<br>Yield | Estimate of<br>Zero Basis<br>Cash Flows | Total      |
| Balance at December 31, 2008         | \$ 592,825          | \$ 8,337                                | \$ 601,162 |
| Revenue recognized, net              | (69,775)            | (2,500)                                 | (72,275)   |
| Net additions to existing portfolios | 5,715               | 1,032                                   | 6,747      |

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

|                                 |            |          |            |
|---------------------------------|------------|----------|------------|
| Additions for current purchases | 81,917     |          | 81,917     |
| Balance at March 31, 2009       | \$ 610,682 | \$ 6,869 | \$ 617,551 |

**Table of Contents**

During the three months ended March 31, 2010, the Company purchased receivable portfolios with a face value of \$2.1 billion for \$81.6 million, or a purchase cost of 3.8% of face value. The estimated future collections at acquisition for these portfolios amounted to \$173.3 million. During the three months ended March 31, 2009, the Company purchased receivable portfolios with a face value of \$1.3 billion for \$55.9 million, or a purchase cost of 4.2% of face value. The estimated future collections at acquisition for these portfolios amounted to \$138.4 million.

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, 2010 and 2009, approximately \$2.1 million and \$2.5 million, respectively, were recognized as revenue on portfolios for which the related cost basis has been fully recovered.

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, 2010 |                          |                       | Total      |
|---|-----------------------------------|--------------------------|-----------------------|------------|
|   | Accrual Basis Portfolios          | Cost Recovery Portfolios | Zero Basis Portfolios |            |
| Balance, beginning of period                              | \$ 526,366                        | \$ 511                   | \$                    | \$ 526,877 |
| Purchases of receivable portfolios                        | 81,632                            |                          |                       | 81,632     |
| Gross collections <sup>(1)</sup>                          | (139,084)                         | (31)                     | (2,057)               | (141,172)  |
| Put-backs and recalls <sup>(2)</sup>                      | (584)                             |                          |                       | (584)      |
| Revenue recognized <sup>(3)</sup>                         | 88,732                            |                          | 2,056                 | 90,788     |
| (Portfolio allowances) portfolio allowance reversals, net | (7,882)                           |                          | 1                     | (7,881)    |
| Balance, end of period                                    | \$ 549,180                        | \$ 480                   | \$                    | \$ 549,660 |
| Revenue as a percentage of collections <sup>(4)</sup>     | 63.8%                             | 0.0%                     | 100.0%                | 64.3%      |

|   | Three Months Ended March 31, 2009 |                          |                       | Total      |
|---|-----------------------------------|--------------------------|-----------------------|------------|
|   | Accrual Basis Portfolios          | Cost Recovery Portfolios | Zero Basis Portfolios |            |
| Balance, beginning of period                          | \$ 460,598                        | \$ 748                   | \$                    | \$ 461,346 |
| Purchases of receivable portfolios                    | 55,913                            |                          |                       | 55,913     |
| Gross collections <sup>(1)</sup>                      | (112,491)                         | (139)                    | (2,496)               | (115,126)  |
| Put-backs and recalls <sup>(2)</sup>                  | (920)                             |                          | (4)                   | (924)      |
| Revenue recognized <sup>(3)</sup>                     | 75,202                            |                          | 2,500                 | 77,702     |
| Portfolio allowances, net                             | (5,427)                           |                          |                       | (5,427)    |
| Balance, end of period                                | \$ 472,875                        | \$ 609                   | \$                    | \$ 473,484 |
| Revenue as a percentage of collections <sup>(4)</sup> | 66.9%                             | 0.0%                     | 100.0%                | 67.5%      |

(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) Includes retained interest.

(4) 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*):

|                                    | <b>Valuation Allowance</b> |                           |
|------------------------------------|----------------------------|---------------------------|
|                                    | <b>Three Months Ended</b>  | <b>Three Months Ended</b> |
|                                    | <b>March</b>               | <b>March 31, 2009</b>     |
|                                    | <b>31, 2010</b>            | <b>March 31, 2009</b>     |
| Balance at beginning of period     | \$ 76,462                  | \$ 57,152                 |
| Provision for portfolio allowances | 9,730                      | 5,580                     |
| Reversal of prior allowance        | (1,849)                    | (153)                     |
| Balance at end of period           | \$ 84,343                  | \$ 62,579                 |

**Table of Contents**

The Company currently utilizes various business channels for the collection of its receivables. The following table summarizes the collections by collection channel (*in thousands*):

|                     | Three Months Ended<br>March 31, |            |
|---------------------|---------------------------------|------------|
|                     | 2010                            | 2009       |
| Collection sites    | \$ 65,804                       | \$ 50,342  |
| Legal collections   | 57,173                          | 56,407     |
| Collection agencies | 17,752                          | 7,667      |
| Sales and other     | 538                             | 817        |
|                     | \$ 141,267                      | \$ 115,233 |

**Note 7: Deferred Court Costs**

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. Deferred Court Costs not recovered within three years of placement are fully written off. Collections received from these debtors are first applied against related court costs with the balance applied to the debtors' account.

Deferred Court Costs for the three-year deferral period consist of the following as of the dates presented (*in thousands*):

|                       | March 31,<br>2010 | December 31,<br>2009 |
|-----------------------|-------------------|----------------------|
| Court costs advanced  | \$ 174,520        | \$ 172,488           |
| Court costs recovered | (45,369)          | (44,980)             |
| Court costs reserve   | (103,548)         | (101,551)            |
|                       | \$ 25,603         | \$ 25,957            |

**Note 8: Other Assets**

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

|  | March 31,<br>2010 | December 31,<br>2009 |
|--|-------------------|----------------------|
| Debt issuance costs, net of amortization | \$ 4,829          | \$ 553               |
| Prepaid expenses                         | 3,029             | 1,728                |
| Security deposit - India building lease  | 1,042             | 1,013                |
| Deferred compensation assets             | 781               | 758                  |
| Other                                    | 513               | 200                  |
|  | \$ 10,194         | \$ 4,252             |

Deferred compensation assets represent monies held in a trust associated with the Company's deferred compensation plan.



**Note 9: Debt**

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

|                           | <b>March 31,<br/>2010</b> | <b>December 31,<br/>2009</b> |
|---------------------------|---------------------------|------------------------------|
| Convertible notes         | \$ 42,920                 | \$ 42,920                    |
| Less: Debt discount       | (1,335)                   | (2,013)                      |
| Revolving credit facility | 273,000                   | 260,000                      |
| Capital lease obligations | 3,429                     | 2,168                        |
|                           | <b>\$ 318,014</b>         | <b>\$ 303,075</b>            |

**Table of Contents****Convertible Senior Notes**

In 2005, the Company issued \$100.0 million of 3.375% Convertible Notes due September 19, 2010. Interest on the Convertible Notes is payable semi-annually, in arrears, on March 19 and September 19 of each year. The Convertible Notes rank equally with the Company's existing and future senior indebtedness and are senior to the Company's potential future subordinated indebtedness. Prior to the implementation of the net-share settlement feature discussed below, the Convertible Notes were convertible, prior to maturity, subject to certain conditions described below, into shares of the Company's common stock at an initial conversion rate of 44.7678 per \$1,000 principal amount of notes, which represented an initial conversion price of approximately \$22.34 per share, subject to adjustment.

In October 2005, the Company obtained stockholder approval of a net-share settlement feature that allows the Company to settle conversion of the Convertible Notes through a combination of cash and stock. The net-settlement feature is accounted for as convertible debt and is not subject to derivative accounting treatment. As a result of the net-settlement feature, the Company will be able to substantially reduce the number of shares issuable in the event of conversion of the Convertible Notes by repaying principal in cash instead of issuing shares of common stock for that amount. Additionally, the Company will not be required to include the underlying shares of common stock in the calculation of its diluted weighted average shares outstanding for earnings per share until the Company's common stock price exceeds \$22.34.

Effective January 1, 2009, the Company retrospectively adopted the authoritative guidance for debt with conversion and other options. The authoritative guidance 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.

In accordance with the authoritative guidance, the Company determined that the fair value of the Convertible Notes at issuance in 2005 was approximately \$73.2 million, and designated the residual value of approximately \$26.8 million as the equity component. Additionally, the Company allocated approximately \$2.5 million of the \$3.4 million original Convertible Notes issuance cost as debt issuance cost and the remaining \$0.9 million as equity issuance cost.

The balances of the liability and equity components as of each period presented are as follows (*in thousands*):

|   | March 31,<br>2010 | December 31,<br>2009 |
|---|-------------------|----------------------|
| Liability component principal amount    | \$ 42,920         | \$ 42,920            |
| Unamortized debt discount               | (1,335)           | (2,013)              |
| Liability component net carrying amount | 41,585            | 40,907               |
| Equity component                        | 25,878            | 25,878               |

The remaining debt discount is being amortized into interest expense over the remaining life of the Convertible Notes using the effective interest rate. The Convertible Notes are due on September 19, 2010. The effective interest rate on the liability component was 10.38%.

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

|  | Three Months Ended<br>March 31, |          |
|--|---------------------------------|----------|
|  | 2010                            | 2009     |
| Interest expense stated coupon rate            | \$ 362                          | \$ 540   |
| Interest expense amortization of debt discount | 678                             | 910      |
| Total interest expense convertible notes       | \$ 1,040                        | \$ 1,450 |

During the three months ended March 31, 2009, the Company repurchased \$25.6 million principal amount of its outstanding Convertible Notes for a total price of \$19.8 million plus accrued interest. These transactions resulted in a net gain of \$3.1 million. The Company wrote-off approximately \$0.2 million in debt issuance costs and \$2.5 million in debt discount in connection with the repurchase of its Convertible Notes

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

during the three months ended March 31, 2009.

As of March 31, 2010, the Company is making the required interest payments on the Convertible Notes and no other changes in the balance or structure of the Convertible Notes has occurred.

---

## **Table of Contents**

The Convertible Notes also contain a restricted convertibility feature that does not affect the conversion price of the Convertible Notes but, instead, places restrictions on a holder's ability to convert their Convertible Notes into shares of the Company's common stock. Prior to March 19, 2010, a holder of the Convertible Notes, under certain criteria defined in the agreement, had the ability to convert the Convertible Notes into shares of the Company's common stock. None of the criteria were met and therefore no such conversions took place.

Holders may surrender their Convertible Notes for conversion anytime on or after March 19, 2010, until the close of business on the trading day immediately preceding September 19, 2010.

*Convertible Notes Hedge Strategy.* Concurrent with the sale of the Convertible Notes, the Company purchased call options to purchase from the counterparties an aggregate of 4,476,780 shares of the Company's common stock at a price of \$22.34 per share. The cost of the call options totaled \$27.4 million. The Company also sold warrants to the same counterparties to purchase from the Company an aggregate of 3,984,334 shares of the Company's common stock at a price of \$29.04 per share and received net proceeds from the sale of these warrants of \$11.6 million. Taken together, the call option and warrant agreements have the effect of increasing the effective conversion price of the Convertible Notes to \$29.04 per share. The call options and warrants must be settled in net shares, except in connection with certain termination events, in which case they would be settled in cash based on the fair market value of the instruments. On the date of settlement, if the market price per share of the Company's common stock is above \$29.04 per share, the Company will be required to deliver shares of its common stock representing the value of the call options and warrants in excess of \$29.04 per share.

The warrants have a strike price of \$29.04 and are generally exercisable at any time. The Company issued and sold the warrants in a transaction exempt from the registration requirements of the Securities Act of 1933, as amended, because the offer and sale did not involve a public offering. There were no underwriting commissions or discounts in connection with the sale of the warrants. In accordance with the authoritative guidance for equity securities, the Company recorded the net call options and warrants as a reduction in additional paid in capital as of December 31, 2005, and will not recognize subsequent changes in the fair value of the call options and warrants in its consolidated financial statements.

During the three months ended March 31, 2010, the Company completed a partial net settlement of the call options and warrants associated with the Convertible Notes and received net proceeds of approximately \$0.5 million. This amount was recorded as an increase to additional paid in capital in stockholders' equity. As of March 31, 2010, the Company had outstanding call options to purchase from the counterparties an aggregate of 3,133,746 shares of the Company's common stock at a price of \$22.34 per share and outstanding warrants to the same counterparties to purchase from the Company an aggregate of 2,789,035 shares of the Company's common stock at a price of \$29.04 per share.

### ***Revolving Credit Facility***

On February 8, 2010, the Company entered into a new \$327.5 million revolving credit facility (2010 Revolving Credit Facility) to be used for the purpose of purchasing receivable portfolios and for general working capital needs. The 2010 Revolving Credit Facility expires in May 2013. The 2010 Revolving Credit Facility contains an accordion feature which allows the Company, on or subsequent to closing, at its option, and subject to customary conditions, to request an increase in the facility of up to \$100.0 million, (not to exceed a total facility of \$427.5 million) by obtaining one or more commitments from one or more lenders or other entities with the consent of the administrative agent, but without the consent of any other lenders. The 2010 Revolving Credit Facility replaces the Company's previous revolving credit facility which was due to expire in May 2010.

Provisions of the 2010 Revolving Credit Facility include:

Interest at a floating rate equal to, at the Company's option, either: (1) reserve adjusted LIBOR plus a spread that ranges from 350 to 400 basis points, depending on the Company's leverage; or (2) Alternate Base Rate (ABR) plus a spread that ranges from 250 to 300 basis points, depending on the Company's leverage. ABR, as defined in the agreement, means the highest of (i) the rate of interest publicly announced by JP Morgan Chase Bank as its prime rate in effect at its principal office in New York City, (ii) the federal funds effective rate from time to time plus 0.5% and (iii) reserved adjusted LIBOR for a one month interest period on the applicable date plus 1%;

\$10.0 million sub-limits for swingline loans and letters of credit;

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

A borrowing base equal to the lesser of (1) 30% of eligible estimated remaining collections minus, to the extent the borrowing base is being calculated on or after June 19, 2010, and so long as the Convertible Notes are outstanding, the aggregate outstanding principal amount of the Convertible Notes plus the aggregate amount of the Company's unrestricted and unencumbered cash and cash equivalent investments (not to exceed the aggregate outstanding principal amount of the Convertible Notes) and (2) the product of the net book value of all receivable portfolios acquired on or after January 1, 2005 multiplied by 95%;

**Table of Contents**

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

Repurchases of up to \$50.0 million in any combination of the Company's common stock and Convertible Notes, subject to compliance with certain covenants and available borrowing capacity;

A change of control definition which excludes acquisitions of stock by Red Mountain, JCF FPK and their respective affiliates;

Events of default which, upon occurrence, may permit the lenders to terminate the 2010 Revolving Credit Facility and declare all amounts outstanding to be immediately due and payable;

An annual capital expenditure maximum of \$12.5 million;

An annual rental expense maximum of \$12.5 million;

An outstanding capital lease maximum of \$12.5 million;

An acquisition limit of \$100.0 million; and

Collateralization by all assets of the Company.

In conjunction with the 2010 Revolving Credit Facility, the Company incurred loan fees and other loan costs of approximately \$4.7 million. These costs will be amortized over the term of the agreement.

As of March 31, 2010, the outstanding balance on the 2010 Revolving Credit Facility was \$273.0 million, which bore a weighted average interest rate of 4.55%. The aggregate borrowing base was \$327.5 million, of which \$54.5 million was available for future borrowings. The Company is in compliance with all covenants under its financing agreements.

***Capital Lease Obligations***

The Company has capital lease obligations for certain computer equipment. As of March 31, 2010, the Company's combined obligation was approximately \$2.5 million. These lease obligations require monthly payments that range from approximately \$1,000 to \$20,000 through June 2013 and have implicit interest rates that range from approximately 5.9% to 7.7%.

The Company has financed certain leasehold improvement projects with its lessors in its Phoenix and St. Cloud facilities. As of March 31, 2010, the Company's combined obligation was approximately \$1.0 million. These financing agreements require monthly principal and interest payments, accrue interest at 8% to 9% per annum and will mature in June and September 2013.

**Note 10: Income Taxes**

The Company recorded an income tax provision of \$6.5 million, reflecting an effective rate of 37.4% of pretax income during the three months ended March 31, 2010. The effective tax rate for the three months ended March 31, 2010, consists primarily of a provision for Federal income taxes of 32.4% (which is net of a benefit for state taxes of 2.6%), a provision for state taxes of 7.3% and the benefit of permanent book versus tax differences of 2.3%. The Company recorded an income tax provision of \$6.0 million, reflecting an effective rate of 39.9% of pretax income during the three months ended March 31, 2009. The effective tax rate for the three months ended March 31, 2009, consists primarily of a provision for Federal income taxes of 32.3% (which is net of a benefit for state taxes of 2.7%), a provision for state taxes of 7.8% and the benefit of permanent book versus tax differences of 0.2%.

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

As of March 31, 2010, the Company had a gross unrecognized tax benefit of \$0.9 million that, if recognized, would result in a net tax benefit of approximately \$0.7 million and would have a positive effect on the Company's effective tax rate. During the three months ended March 31, 2010, there were no material changes to the unrecognized tax benefit.

For the three months ended March 31, 2010, the Company has not provided for the United States income taxes or foreign withholding taxes on the quarterly undistributed earnings from continuing operations of its subsidiary operating outside of the United States. Undistributed earnings of the subsidiary for the three months ended March 31, 2010, were approximately \$1.8 million. Such undistributed earnings are considered permanently reinvested.

The Company's subsidiary operating outside of the United States is currently operating under a tax holiday in India. The tax holiday is due to expire on March 31, 2011. The impact of the tax holiday on the Company's consolidated financial statements is not material.

**Table of Contents****Note 11: Purchase Concentrations**

The following table summarizes the concentration of initial purchase cost by seller sorted by total aggregate costs (*in thousands, except percentages*):

|                            | <b>Three Months Ended</b> |               |
|----------------------------|---------------------------|---------------|
|                            | <b>March 31, 2010</b>     |               |
|                            | <b>Cost</b>               | <b>%</b>      |
| Seller 1                   | \$ 19,213                 | 23.5%         |
| Seller 2                   | 15,273                    | 18.7%         |
| Seller 3                   | 14,406                    | 17.7%         |
| Seller 4                   | 13,562                    | 16.6%         |
| Seller 5                   | 10,260                    | 12.6%         |
| Other sellers              | 8,918                     | 10.9%         |
|                            | <b>\$ 81,632</b>          | <b>100.0%</b> |
| Adjustments <sup>(1)</sup> | (10)                      |               |
| Purchases, net             | <b>\$ 81,622</b>          |               |

<sup>(1)</sup> Adjusted for Put-backs and Recalls.

**Note 12: Commitments and Contingencies****Litigation**

On October 18, 2004, Timothy W. Moser, one of the Company's former officers, filed an action in the United States District Court for the Southern District of California against it, and certain individuals, including several of the Company's officers and directors. On February 14, 2005, the Company was served with an amended complaint in this action alleging defamation, intentional interference with contractual relations, breach of contract, breach of the covenant of good faith and fair dealing, intentional and negligent infliction of emotional distress and civil conspiracy arising out of certain statements in its Registration Statement on Form S-1, originally filed in September 2003, and alleged to be included in its Registration Statement on Form S-3, originally filed in May 2004. The amended complaint sought injunctive relief, economic and punitive damages in an unspecified amount plus an award of profits allegedly earned by the defendants and alleged co-conspirators as a result of the alleged conduct, in addition to attorney's fees and costs. On June 1, 2006, the plaintiff filed a second amended complaint in which he amended his claim for negligent infliction of emotional distress. On January 19, 2010, the District Court issued an order granting defendants summary judgment motions, dismissed all causes of action against all of the defendants and entered judgment in favor of the defendants. On February 12, 2010, Mr. Moser filed a notice of appeal of the judgment.

On September 7, 2005, Mr. Moser filed a related action in the United States District Court for the Southern District of California against Triarc Companies, Inc. (Triarc), which at the time was a significant stockholder of the Company, alleging intentional interference with contractual relations and intentional infliction of emotional distress. The case arose out of the same statements made or alleged to have been made in the Company's Registration Statements mentioned above. The amended complaint sought injunctive relief, an order directing Triarc to issue a statement of retraction or correction of the allegedly false statements, economic and punitive damages in an unspecified amount and attorney's fees and costs. Triarc tendered the defense of this action to the Company, and it accepted the defense and will indemnify Triarc, pursuant to the indemnification provisions of the Registration Rights Agreements dated as of October 31, 2000 and February 21, 2002, and the Underwriting Agreements dated September 25, 2004 and January 20, 2005 to which Triarc is a party. This action was also dismissed by the District Court on January 19, 2010. Mr. Moser's February 12, 2010 notice of appeal also challenges this judgment.

The Company, along with others in its industry, is subject to legal actions based on the Fair Debt Collection Practices Act, or FDCPA, and comparable state statutes, which could have a material adverse effect on it due to the remedies available under these statutes, including punitive damages. 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, and has made inaccurate assertions of fact in support of its collection



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

actions. A number of these cases are styled as class actions and a class has been certified in several of these cases. Many of these cases present novel issues on which there is no clear legal precedent. As a result, the Company is unable to predict the range of possible outcomes.

In one such action, captioned *Brent v. Midland Credit Management, Inc et. al*, filed on May 19, 2008, in the United States District Court for the Northern District of Ohio [Western Division], the plaintiff has filed a class action counter-claim against Midland Credit Management, Inc. and Midland Funding LLC (the Midland Defendants ). The complaint alleges that the Midland Defendants

## **Table of Contents**

business practices violated consumers' rights under the FDCPA and the Ohio Consumer Sales Practices Act. The plaintiff is seeking actual and statutory damages for the class of Ohio residents, plus attorney's fees and costs of class notice and class administration. On August 11, 2009, the court issued an order partially granting plaintiff's motion for summary judgment and entering findings adverse to the Midland Defendants on certain of plaintiff's claims. The Midland Defendants subsequently moved the court to reconsider the order and were partially successful. However, because the court did not completely reverse the August 11 order, certain portions of the order remain subject to reversal only on appeal. On February 22, 2010, the District Court denied Plaintiff's attempts to enlarge the case to include a national class of consumers, and ordered the parties to brief issues relating to whether a statewide class should be certified. No class has been certified to date.

There are a number of other lawsuits, claims and counterclaims pending or threatened against the Company. In general, these lawsuits, claims or counterclaims have arisen in the ordinary course of business and involve claims for damages arising from a variety of alleged misconduct or improper reporting of credit information by the Company or its employees or agents. In addition, from time to time, the Company is subject to various regulatory investigations, inquiries and other actions, relating to its collection activities.

On January 6, 2010, the Office of the Attorney General of the State of California (the California Attorney General) issued a subpoena to the Company to answer interrogatories and to produce documents in a proceeding entitled *In the Matter of the Investigation of Encore Capital Group, Inc., Midland Credit Management, Inc. and Affiliated Persons and Entities* concerning its debt collection practices and related topics. The Company intends to cooperate fully with the California Attorney General in response to this subpoena, subject to applicable law.

On December 16, 2009, the Federal Trade Commission (the FTC) issued an order directing the Company to submit information about its practices in buying and collecting consumer debt, which the FTC intends to use for a study of the debt-buying industry. The Company is one of nine companies that received such an order from the FTC requesting the production of information for use in the FTC's study of the industry. The nine companies were described by the FTC as the nation's largest consumer debt buyers. The order was publicly announced by the FTC on January 5, 2010. The Company intends to cooperate fully with the FTC in connection with its study, subject to applicable law.

The Company has established loss provisions only for matters in which losses are probable and can be reasonably estimated. Some of the matters pending against the Company involve potential compensatory, punitive damage claims, fines or sanctions that, if granted, could require it to pay damages or make other expenditures in amounts that could have a material adverse effect on its financial position or results of operations. Although litigation is inherently uncertain, at this time, based on past experience, the information currently available and the possible availability of insurance and/or indemnification in some cases, the Company does not believe that the resolution of these matters will have a material adverse effect on its consolidated financial position or its results of operations.

### ***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, 2010, the Company has entered into agreements to purchase receivable portfolios with a face value of approximately \$1.7 billion for a purchase price of approximately \$96.8 million. Certain of these agreements allow the Company to terminate the commitment with 60 days notice or by paying a one-time cancellation fee. The Company does not anticipate cancelling any of these commitments at this time. The Company has no purchase commitments extending past one year.

### **Note 13: Securities Repurchase Program**

On February 8, 2010, the Company's board of directors approved a new \$50.0 million securities repurchase program to replace the remaining available repurchase authority allowed under the prior program. Under the 2010 Revolving Credit Facility, the Company has the renewed ability to repurchase up to \$50.0 million in any combination of the Company's common stock and Convertible Notes, subject to compliance with certain covenants and available borrowing capacity. The board's approval authorizes the Company to repurchase an aggregate of up to \$50.0 million of any combination of its common stock and Convertible Notes.

---

## **Table of Contents**

### **Item 2 Management's Discussion and Analysis of Financial Condition and Results of Operations**

#### **Introduction**

We are a systems-driven purchaser and manager of charged-off consumer receivable portfolios and a provider of bankruptcy services to the finance industry. We acquire receivable portfolios at deep discounts from their face values using our proprietary valuation process that is based on the consumer attributes of the underlying accounts. Based upon the ongoing analysis of these accounts, we employ a dynamic mix of collection strategies to maximize our return on investment.

#### **Market Overview**

Although the broader economy resumed growth in the second half of 2009, the consequences of the recent recession continue to impact consumer liquidity and credit. In the U.S., consumer credit availability continues to be limited and the unemployment rate remains at levels not seen since the early 1980s. Credit card delinquency rates have moderated in the first quarter of 2010, but net charge-off rates remain near their historical highs. Other indicators of consumer financial distress, personal bankruptcies and home foreclosure filings remain relatively high; the latter increasing by 16% from the first quarter of 2009 and is expected to remain at record levels through 2011. These conditions present us with both opportunities and challenges.

On the opportunities side, the increase in credit card charge-offs and delinquencies (which contribute to an increase in supply), combined with the challenges some of our competitors are facing in (i) generating sufficient returns on receivables they purchased in 2005–2007, when prices were high and (ii) obtaining sufficient capital to fund future purchases (which contributes to a decrease in demand) have resulted in a significant reduction in the market price for portfolios of charged-off receivables. For example, prices for fresh charge-offs (receivables that are sold immediately after charge-off) have declined from 8%–13% of face value in 2008 to 4%–8% of face value in 2009 and the first quarter of 2010. We have seen similar pricing declines across all ages of charge-offs and the decline is more pronounced in the resale market. Recently, however, pricing has begun to increase slightly from the low levels experienced during most of 2009, although pricing is still favorable when compared to 2005–2008. Additionally, as a result of the price decline, some sellers of portfolios have chosen not to sell as much of their charge-offs as they previously had and, as an alternative to selling all of their charge-offs, have collected on accounts internally or placed accounts with third-party collection agencies. As such, the full impact the price reduction will have on our purchasing volumes is presently unclear.

On the challenges side, increases in unemployment, high foreclosure rates and the difficulties consumers are experiencing in obtaining credit may, for a period of time, negatively impact collections on receivables that we currently own or that we purchase during these challenging economic times. Despite these market conditions, during the first quarter of 2010, most of the collection metrics we track have remained relatively consistent, as compared to 2008 and 2009. For example, payer rates and average payment size, adjusted for the change in settlement-in-full/payment plan mix, have remained relatively constant. One change we have noted is that more consumers are settling their debts through payment plans rather than in one-time settlements. Payments made over longer periods of time impact our business in two ways: First, when payments are extended over longer periods of time rather than received up front, the delay in cash flows could result in a provision for portfolio allowances. This is because discounting a long-term payment stream using a pool group's internal rate of return, or IRR, rather than discounting a one-time settlement payment using the same IRR, will result in a lower net present value. As a result, even if the total amount of cash received through long-term payment plans is the same as the cash received through one-time settlements, accounting for the stream of payments in the former may result in a provision for portfolio allowances. Second, when debts are settled through payment plans, there is a possibility that consumers will not make all of the payments required by those plans. We refer to consumers who do not make all of their payments as "broken payers." When this happens, we are often successful in getting the consumer back on plan but this is not always the case and, in those instances where we are unable to get the consumer back on plan, we experience a shortfall in collections. Despite the current economic environment, we have not experienced an increase in the broken payer rate in the first quarter of 2010 as compared to the same period in 2009. Please refer to Management's Discussion and Analysis Revenue below for a more detailed explanation of the provision for portfolio allowances for the three months ended March 31, 2010.

In light of the uncertainties presented by the current economic environment, we believe we are applying conservative assumptions when valuing portfolios for purchase and when establishing our forecasted collections. Additionally, while we believe that consumers who are currently charging off their debt (when economic conditions are bad) are more likely to recover faster than consumers who charged off their debt historically (when economic times were good), we have not factored any such recovery into our forecasts.

When evaluating the overall long-term returns of our business, we believe that the benefits resulting from the current lower portfolio pricing will outweigh the negative impacts from the collection shortfalls we may experience from a more distressed consumer. However, if the lower pricing environment re-attracts significant capital to our industry and prices are bid up as a result of increased demand, or if the ability of consumers to repay their debt deteriorates further, our returns would be negatively impacted.



**Table of Contents****Purchases and Collections*****Purchases***

During the three months ended March 31, 2010, we invested \$81.6 million primarily for charged-off credit card portfolios with face values aggregating \$2.1 billion, for an average purchase price of 3.8% of face value. This is a \$25.7 million increase, or 46.0%, in the amount invested, compared with the \$55.9 million invested during the three months ended March 31, 2009, to acquire primarily charged-off credit card portfolios with a face value aggregating \$1.3 billion for an average purchase price of 4.2% 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.

***Collections by Channel***

During the three months ended March 31, 2010 and 2009, 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 thousands*):

|                     | <b>Three Months Ended</b> |                   |
|---------------------|---------------------------|-------------------|
|                     | <b>March 31,</b>          |                   |
|                     | <b>2010</b>               | <b>2009</b>       |
| Collection sites    | \$ 65,804                 | \$ 50,342         |
| Legal collections   | 57,173                    | 56,407            |
| Collection agencies | 17,752                    | 7,667             |
| Sales and other     | 538                       | 817               |
|                     | <b>\$ 141,267</b>         | <b>\$ 115,233</b> |

Gross collections increased \$26.1 million, or 22.6%, to \$141.3 million during the three months ended March 31, 2010, from \$115.2 million during the three months ended March 31, 2009. A portion of our collections come from the weekly remittances we receive from our law firm and agency partners. Typically there are 13 remittances in each quarter, however, there were only 12 remittances during the three months ended March 31, 2010. As our average weekly remittances have grown to approximately \$8.0 million, our collections for the three months ended March 31, 2010 were negatively affected by the one fewer weekly remittance. There were 13 remittances during the three months ended March 31, 2009. The second and fourth quarters of 2010 will have the typical 13 weekly remittances and the third quarter will have 14 remittances.

**Table of Contents****Results of Operations**

Results of operations in dollars and as a percentage of total revenue were as follows (*in thousands, except percentages*):

|  | <b>Three Months Ended March 31,</b> |               |                 |               |
|--|-------------------------------------|---------------|-----------------|---------------|
|  | <b>2010</b>                         |               | <b>2009</b>     |               |
| <b>Revenue</b>   |                                     |               |                 |               |
| Revenue from receivable portfolios, net                      | \$ 82,907                           | 94.9%         | \$ 72,275       | 94.5%         |
| Servicing fees and related revenue                           | 4,431                               | 5.1%          | 4,171           | 5.5%          |
| <b>Total revenue</b>   | <b>87,338</b>                       | <b>100.0%</b> | <b>76,446</b>   | <b>100.0%</b> |
| <b>Operating expenses</b>                                    |                                     |               |                 |               |
| Salaries and employee benefits                               | 15,485                              | 17.7%         | 13,957          | 18.3%         |
| Stock-based compensation expense                             | 1,761                               | 2.0%          | 1,080           | 1.4%          |
| Cost of legal collections                                    | 26,433                              | 30.3%         | 29,947          | 39.2%         |
| Other operating expenses                                     | 9,114                               | 10.4%         | 5,980           | 7.8%          |
| Collection agency commissions                                | 5,296                               | 6.1%          | 2,891           | 3.8%          |
| General and administrative expenses                          | 6,879                               | 7.9%          | 5,697           | 7.4%          |
| Depreciation and amortization                                | 673                                 | 0.8%          | 623             | 0.8%          |
| <b>Total operating expenses</b>                              | <b>65,641</b>                       | <b>75.2%</b>  | <b>60,175</b>   | <b>78.7%</b>  |
| <b>Income before other (expense) income and income taxes</b> | <b>21,697</b>                       | <b>24.8%</b>  | <b>16,271</b>   | <b>21.3%</b>  |
| <b>Other (expense) income</b>                                |                                     |               |                 |               |
| Interest expense   | (4,538)                             | (5.2)%        | (4,273)         | (5.6)%        |
| Gain on repurchase of convertible notes, net                 |                                     | 0.0%          | 3,053           | 4.0%          |
| Other income (expense)                                       | 192                                 | 0.2%          | (81)            | (0.1)%        |
| <b>Total other expense</b>                                   | <b>(4,346)</b>                      | <b>(5.0)%</b> | <b>(1,301)</b>  | <b>(1.7)%</b> |
| <b>Income before income taxes</b>                            | <b>17,351</b>                       | <b>19.8%</b>  | <b>14,970</b>   | <b>19.6%</b>  |
| Provision for income taxes                                   | (6,490)                             | (7.4)%        | (5,973)         | (7.8)%        |
| <b>Net income</b>  | <b>\$ 10,861</b>                    | <b>12.4%</b>  | <b>\$ 8,997</b> | <b>11.8%</b>  |

**Comparison of Results of Operations****Revenue**

Our revenue consists primarily of portfolio revenue and bankruptcy servicing revenue. 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 internal rate of return 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. Servicing fee revenue is revenue primarily associated with bankruptcy servicing fees earned from our Ascension subsidiary, a provider of bankruptcy services to the finance industry.



**Table of Contents**

The following tables summarize collections, revenue, end of period receivable balance and other related supplemental data, by year of purchase (in thousands, except percentages):

|       | Three Months Ended March 31, 2010 |                              |   |                                    |                            | As of<br>March 31, 2010 |             |
|-------|-----------------------------------|------------------------------|---|------------------------------------|----------------------------|-------------------------|-------------|
|       | Collections <sup>(1)</sup>        | Gross Revenue <sup>(2)</sup> | Revenue Recognition Rate <sup>(3)</sup> | Net (Portfolio Allowance) Reversal | Revenue % of Total Revenue | Unamortized Balances    | Monthly IRR |
| ZBA   | \$ 2,056                          | \$ 2,056                     | 100.0%                                  | \$ 1                               | 2.3%                       | \$                      |             |
| 2002  | 254                               |                              | 0.0%                                    | 254                                | 0.0%                       |                         |             |
| 2003  | 1,477                             | 533                          | 36.1%                                   | 703                                | 0.6%                       | 388                     | 31.0%       |
| 2004  | 2,140                             | 1,079                        | 50.4%                                   | 167                                | 1.2%                       | 3,704                   | 8.0%        |
| 2005  | 7,663                             | 4,944                        | 64.5%                                   | (771)                              | 5.4%                       | 27,314                  | 5.6%        |
| 2006  | 7,425                             | 6,263                        | 84.4%                                   | (4,322)                            | 6.9%                       | 38,543                  | 5.1%        |
| 2007  | 20,888                            | 12,543                       | 60.0%                                   | (892)                              | 13.8%                      | 59,493                  | 6.2%        |
| 2008  | 35,141                            | 23,071                       | 65.7%                                   | (3,021)                            | 25.4%                      | 142,690                 | 5.0%        |
| 2009  | 55,787                            | 37,001                       | 66.3%                                   |                                    | 40.8%                      | 200,951                 | 5.7%        |
| 2010  | 8,341                             | 3,298                        | 39.5%                                   |                                    | 3.6%                       | 76,577                  | 3.8%        |
| Total | \$ 141,172                        | \$ 90,788                    | 64.3%                                   | \$ (7,881)                         | 100.0%                     | \$ 549,660              | 5.3%        |

|       | Three Months Ended March 31, 2009 |                              |   |                                    |                            | As of<br>March 31, 2009 |             |
|-------|-----------------------------------|------------------------------|---|------------------------------------|----------------------------|-------------------------|-------------|
|       | Collections <sup>(1)</sup>        | Gross Revenue <sup>(2)</sup> | Revenue Recognition Rate <sup>(3)</sup> | Net (Portfolio Allowance) Reversal | Revenue % of Total Revenue | Unamortized Balances    | Monthly IRR |
| ZBA   | \$ 2,500                          | \$ 2,500                     | 100.0%                                  | \$                                 | 3.2%                       | \$                      |             |
| 2002  | 909                               | 570                          | 62.7%                                   | 153                                | 0.7%                       | 491                     | 29.8%       |
| 2003  | 2,349                             | 2,185                        | 93.0%                                   | (409)                              | 2.8%                       | 2,090                   | 30.7%       |
| 2004  | 3,375                             | 2,211                        | 65.5%                                   | (437)                              | 2.9%                       | 8,073                   | 8.1%        |
| 2005  | 12,034                            | 7,782                        | 64.7%                                   | (1,257)                            | 10.0%                      | 43,103                  | 5.6%        |
| 2006  | 12,784                            | 9,049                        | 70.8%                                   | (990)                              | 11.7%                      | 56,642                  | 5.1%        |
| 2007  | 33,221                            | 19,085                       | 57.4%                                   | (848)                              | 24.6%                      | 107,220                 | 5.4%        |
| 2008  | 44,944                            | 31,807                       | 70.8%                                   | (1,639)                            | 40.9%                      | 200,820                 | 5.0%        |
| 2009  | 3,010                             | 2,513                        | 83.5%                                   |                                    | 3.2%                       | 55,045                  | 4.2%        |
| Total | \$ 115,126                        | \$ 77,702                    | 67.5%                                   | \$ (5,427)                         | 100.0%                     | \$ 473,484              | 5.3%        |

(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.

Total revenue was \$87.3 million for the three months ended March 31, 2010, an increase of \$10.9 million, or 14.2%, compared to total revenue of \$76.4 million for the three months ended March 31, 2009. Portfolio revenue was \$82.9 million for the three months ended March 31, 2010, an increase of \$10.6 million, or 14.7%, compared to portfolio revenue of \$72.3 million for the three months ended March 31, 2009. The increase in portfolio revenue for the three months ended March 31, 2010, was primarily the result of additional accretion revenue associated with a higher portfolio balance during the three months ended March 31, 2010 compared to the three months ended March 31, 2009. During the three months ended March 31, 2010, we recorded a net portfolio allowance provision of \$7.9 million, compared to a net portfolio allowance provision of \$5.4 million in the same period of the prior year. The net provision for portfolio allowances for the three months ended March 31, 2010 and 2009 was



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

largely due to a shortfall in collections in certain pool groups against our forecast. While our total collections exceeded our forecast, there is often variability at the pool group level between our actual collections and our forecasts, primarily our 2006 through 2008 vintage portfolios. This is the result of several factors, including pressure on the consumer due to a weak economy, changes in internal operating strategy, shifts in consumer payment patterns and the inherent challenge of forecasting collections at the pool group level.

Revenue associated with bankruptcy servicing fees earned from Ascension was \$4.4 million for the three months ended March 31, 2010, an increase of \$0.3 million, or 6.3%, compared to revenue of \$4.1 million for the three months ended March 31, 2009. The increase in Ascension revenue was due to a higher volume of bankruptcy placements in 2010.

**Table of Contents****Operating Expenses**

Total operating expenses were \$65.6 million for the three months ended March 31, 2010, an increase of \$5.4 million, or 9.1%, compared to total operating expenses of \$60.2 million for the three months ended March 31, 2009.

Operating expenses are explained in more detail as follows:

**Salaries and employee benefits**

Total salaries and employee benefits increased \$1.5 million, or 10.9%, to \$15.5 million during the three months ended March 31, 2010, from \$14.0 million during the three months ended March 31, 2009. The increase was primarily the result of increases in headcount and related compensation expenses to support our growth.

**Stock-based compensation expenses**

Stock-based compensation increased \$0.7 million, or 63.1%, to \$1.8 million during the three months ended March 31, 2010, from \$1.1 million during the three months ended March 31, 2009. This increase was primarily attributable to awards granted to our senior management team in the three months ended March 31, 2010 and higher fair value of equity awards granted in recent periods due to an increase in our stock price.

**Cost of legal collections**

The cost of legal collections decreased \$3.5 million, or 11.7%, to \$26.4 million during the three months ended March 31, 2010, compared to \$29.9 million during the three months ended March 31, 2009. These costs represent contingent fees paid to our nationwide network of attorneys and costs of litigation. The decrease in the cost of legal collections was primarily the result of a decrease in upfront court cost expenses due to more targeted placement volumes as part of an initiative to primarily sue higher quality accounts. Court costs advanced for the three months ended March 31, 2010 decreased to \$13.3 million, compared to \$20.5 million for the three months ended March 31, 2009. As a result, court cost expense decreased to 8.5 million, or 14.9% as a percent of collections, for the three months ended March 31, 2010, compared to \$13.3 million, or 23.6% of collections, for the three months ended March 31, 2009. This decrease was partially offset by an increase in commissions paid on increased collections through our legal channel. For the three months ended March 31, 2010, we paid commissions of \$17.3 million, or 30.2%, on legal collections of \$57.2 million, compared to commissions of \$16.1 million, or 28.5%, on legal collections of \$56.4 million for the three months ended March 31, 2009. In addition to a fixed-rate commission, we incent certain third-party law firms by paying bonus commissions when a law firm exceeds specific targets. Total bonus commissions, included in the amounts above, were \$1.5 million, or 2.7% of legal collections during the three months ended March 31, 2010, compared to bonus commissions of \$0.4 million, or 0.7% of legal collections during the same period of the prior year. The increase in bonus commissions in the three months ended March 31, 2010 was related to certain firms exceeding their targets due to a one-time change in placement volumes at these firms. As a result of the factors discussed above, the cost of legal collections, as a percent of gross collections through this channel, decreased to 46.2% for the three months ended March 31, 2010 from 53.1% for the three months ended March 31, 2009.

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

|                                   | Three Months Ended March 31, |        |           |         |
|-----------------------------------|------------------------------|--------|-----------|---------|
|                                   | 2010                         |        | 2009      |         |
| Collections                       | \$ 57,173                    | 100.0% | \$ 56,407 | 100.0%  |
| Court costs advanced              | \$ 13,321                    | 23.3%  | \$ 20,544 | 36.4%   |
| Court costs deferred              | (4,789)                      | (8.4)% | (7,241)   | (12.8)% |
| Court cost expense <sup>(1)</sup> | 8,532                        | 14.9%  | 13,303    | 23.6%   |
| Other <sup>(2)</sup>              | 621                          | 1.1%   | 544       | 1.0%    |
| Commissions                       | 17,280                       | 30.2%  | 16,100    | 28.5%   |
| Total Costs                       | \$ 26,433                    | 46.2%  | \$ 29,947 | 53.1%   |

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

- (1) In connection with our agreement with contracted attorneys, we advance certain out-of-pocket court costs. We 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.

**Table of Contents****Other operating expenses**

Other operating expenses increased \$3.1 million, or 52.4%, to \$9.1 million during the three months ended March 31, 2010, from \$6.0 million during the three months ended March 31, 2009. The increase was primarily the result of an increase of \$0.7 million in telephone expenses, an increase of \$0.6 million in skip tracing expenses, an increase of \$0.7 million in direct mail campaign expenses, an increase of \$0.7 million in media-related expenses and a net increase in various other operating expenses of \$0.4 million.

**Collection agency commissions**

During the three months ended March 31, 2010, we incurred \$5.3 million in commissions to third party collection agencies, or 29.8%, of the related gross collections of \$17.8 million, compared to \$2.9 million in commissions, or 37.7%, of the related gross collections of \$7.7 million during the three months ended March 31, 2009. The increase in commissions was due to the increase in collections through this channel, offset by a lower net commission rate. The decrease in the net commission rate as a percentage of the related gross collections was primarily due to the mix of accounts placed with the agencies. Commissions, as a percentage of collections through this channel, vary from period to period depending on, among other things, the time from charge-off of the accounts placed with an agency. Generally, freshly charged-off accounts have a lower commission rate than accounts that have been charged off for a longer period of time. During the three months ended March 31, 2010, we placed more freshly charged-off accounts with our agencies as compared to the same period in the prior year.

**General and administrative expenses**

General and administrative expenses increased \$1.2 million, or 20.7%, to \$6.9 million during the three months ended March 31, 2010, from \$5.7 million during the three months ended March 31, 2009. The increase was primarily the result of an increase of \$0.4 million in building rent related to our India expansion, an increase of \$0.4 million in corporate settlements, an increase of \$0.4 million in system maintenance costs, and a net increase in other general and administrative expenses of \$0.7 million. The increase was offset by a decrease of \$0.7 million in corporate legal expenses.

**Cost per Dollar Collected**

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

|                                     | Three Months Ended March 31, |                          |                                   |                                 |             |                          |                                   |                                 |
|-------------------------------------|------------------------------|--------------------------|-----------------------------------|---------------------------------|-------------|--------------------------|-----------------------------------|---------------------------------|
|                                     | 2010                         |                          |                                   |                                 | 2009        |                          |                                   |                                 |
|                                     | 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                    | \$ 65,804                    | \$ 6,022 <sup>(1)</sup>  | 9.2%                              | 4.3%                            | \$ 50,342   | \$ 5,805 <sup>(1)</sup>  | 11.5%                             | 5.0%                            |
| Legal networks                      | 57,173                       | 26,433                   | 46.2%                             | 18.7%                           | 56,407      | 29,947                   | 53.1%                             | 26.0%                           |
| Collection agency outsourcing       | 17,752                       | 5,296                    | 29.8%                             | 3.7%                            | 7,667       | 2,891                    | 37.7%                             | 2.5%                            |
| Sales and other                     | 538                          |                          |                                   |                                 | 817         |                          |                                   |                                 |
| Other indirect costs <sup>(2)</sup> |                              | 22,818                   |                                   | 16.2%                           |             | 17,066                   |                                   | 14.8%                           |
| Total                               | \$ 141,267                   | \$ 60,569 <sup>(3)</sup> |                                   | 42.9%                           | \$ 115,233  | \$ 55,709 <sup>(3)</sup> |                                   | 48.3%                           |

(1) Represents only account manager salaries, variable compensation and employee benefits.

(2) Other indirect costs represent non collection salaries and employee benefits, general and administrative expenses, other operating expenses, and depreciation and amortization.

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

(3) Represents all operating expenses excluding stock-based compensation expense and bankruptcy servicing operating 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 reconciliation of operating expenses, excluding stock-based compensation expense and bankruptcy servicing operating expenses to GAAP total operating expenses in the table below.

The following table provides a reconciliation of operating expenses, excluding stock-based compensation expense and bankruptcy servicing operating expenses to GAAP total operating expenses, *(in thousands)*:

|  | <b>Three Months Ended March 31,</b> |             |
|--|-------------------------------------|-------------|
|  | <b>2010</b>                         | <b>2009</b> |
| GAAP total operating expenses, as reported   | \$ 65,641                           | \$ 60,175   |
| Stock-based compensation expense   | (1,761)                             | (1,080)     |
| Bankruptcy servicing operating expenses  | (3,311)                             | (3,386)     |
| Operating expenses, excluding stock-based compensation expense and bankruptcy servicing operating expenses | \$ 60,569                           | \$ 55,709   |

**Table of Contents**

During the three months ended March 31, 2010, cost per dollar collected decreased by 540 basis points to 42.9% of gross collections from 48.3% of gross collections during the three months ended March 31, 2009. This decrease was primarily due to several factors, including:

The cost of legal collections as a percent of total collections decreased to 18.7% from 26.0% and, as a percentage of legal collections, decreased to 46.2% from 53.1%. The decrease was primarily due to fewer placements, resulting in less upfront court costs expensed in this channel, as discussed in the cost of legal collections section above.

The cost from our collection sites, account manager salaries, variable compensation and employee benefits, as a percentage of total collections, decreased to 4.3% from 5.0% and, as a percentage of our site collections, decreased to 9.2% from 11.5%. The decrease was primarily due to a shift in our collection workforce from the United States to India and a change in our compensation plan structure in the United States.

The decrease was offset by:

An increase in collection agency commissions, as a percentage of total collections, to 3.7% from 2.5%. The increase in the percentage of commissions to total collections is due to collection agency commissions growing at a rate faster than total collections, offset by a decline in our commission rate, resulting in a decline in cost per dollar collected in this channel from 37.7% to 29.8%. This was the result of a change in the mix of accounts placed into this channel, primarily freshly charged off accounts. Freshly charged-off accounts have a lower commission rate than accounts that have been charged off for a longer period of time.

Other costs not directly attributable to specific channel collections, including non collection salaries and employee benefits, general and administrative expenses, other operating expenses, and depreciation and amortization, increased as a percentage of total collection to 16.5% from 14.8%. This increase is primarily the result of increased other operating expenses as a percentage of total collections related to increased telephone, skip tracing, direct mail campaign, and media-related expenses as discussed above.

**Interest Expense**

Interest expense increased \$0.2 million, or 6.2%, to \$4.5 million during the three months ended March 31, 2010, from \$4.3 million during the three months ended March 31, 2009.

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

|   | Three Months Ended March 31, |          |           |          |
|---|------------------------------|----------|-----------|----------|
|   | 2010                         | 2009     | \$ Change | % Change |
| Stated interest on debt obligations             | \$ 3,476                     | \$ 3,053 | \$ 423    | 13.9%    |
| Amortization of loan fees and other loan costs  | 384                          | 310      | 74        | 23.9%    |
| Amortization of debt discount convertible notes | 678                          | 910      | (232)     | (25.5)%  |
| Total interest expense                          | \$ 4,538                     | \$ 4,273 | \$ 265    | 6.2%     |

Stated interest on debt obligations increased \$0.4 million during the three months ended March 31, 2010, compared to the same period of the prior year, primarily due to an increase in our outstanding loan balances and an increase in the credit spread required under our new 2010 Revolving Credit Facility. Amortization of debt discount decreased \$0.2 million during the three months ended March 31, 2010, compared to the same period of the prior year, primarily due to buybacks of a portion of our convertible senior notes and the related write-off of the debt discount.

**Provision for Income Taxes**

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

During the three months ended March 31, 2010, we recorded an income tax provision of \$6.5 million, reflecting an effective rate of 37.4% of pretax income. The effective tax rate for the three months ended March 31, 2010 consists primarily of a provision for federal income taxes of 32.4% (which is net of a benefit for state taxes of 2.6%), a blended provision for state taxes of 7.3%, and a benefit for the effect of permanent book versus tax differences of 2.3%.

During the three months ended March 31, 2009, we recorded an income tax provision of \$6.0 million, reflecting an effective rate of 39.9% of pretax income. Our effective tax rate for the three months ended March 31, 2009, differed from the Federal statutory rate, primarily due to the net effect of state taxes and the effect of permanent book versus tax differences.

The decline in the effective rate from 39.9% during the three months ended March 31, 2009 to 37.4% during the three months ended March 31, 2010 was primarily due to a one-time benefit resulting from a change in our transfer pricing with India, following a recently updated transfer pricing analysis.

**Table of Contents****Supplemental Performance Data****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 December 31, 2009 |                   |                   |                   |                   |                   |                   |                   |                      | CCM <sup>(3)</sup> |
|------------------|-------------------------------|--|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|----------------------|--------------------|
|                  |                               | <2004  | 2004              | 2005              | 2006              | 2007              | 2008              | 2009              | 2010              | Total <sup>(2)</sup> |                    |
| <2004            | \$ 284,164 <sup>(4)</sup>     | \$ 517,451                                       | \$ 192,940        | \$ 144,775        | \$ 109,379        | \$ 50,708         | \$ 26,777         | \$ 16,345         | \$ 3,139          | \$ 1,061,514         | 3.7                |
| 2004             | 101,329                       |  | 39,400            | 79,845            | 54,832            | 34,625            | 19,116            | 11,363            | 2,140             | 241,321              | 2.4                |
| 2005             | 192,591                       |  |                   | 66,491            | 129,809           | 109,078           | 67,346            | 42,387            | 7,721             | 422,832              | 2.2                |
| 2006             | 141,969                       |  |                   |                   | 42,354            | 92,265            | 70,743            | 44,553            | 7,425             | 257,340              | 1.8                |
| 2007             | 204,298                       |  |                   |                   |                   | 68,048            | 145,272           | 111,117           | 20,888            | 345,325              | 1.7                |
| 2008             | 227,935                       |  |                   |                   |                   |                   | 69,049            | 165,164           | 35,578            | 269,791              | 1.2                |
| 2009             | 254,127                       |  |                   |                   |                   |                   |                   | 96,529            | 55,927            | 152,456              | 0.6                |
| 2010             | 81,621                        |  |                   |                   |                   |                   |                   |                   | 8,354             | 8,354                | 0.1                |
| <b>Total</b>     | <b>\$ 1,488,034</b>           | <b>\$ 517,451</b>                                | <b>\$ 232,340</b> | <b>\$ 291,111</b> | <b>\$ 336,374</b> | <b>\$ 354,724</b> | <b>\$ 398,303</b> | <b>\$ 487,458</b> | <b>\$ 141,172</b> | <b>\$ 2,758,933</b>  | <b>1.9</b>         |

(1) Adjusted for put-backs, account recalls, purchase price rescissions, and the impact of an acquisition in 2000. Put-backs represent accounts that are returned to the seller in accordance with the respective purchase agreement ( Put-Backs ). Recalls represents accounts that are recalled by the seller in accordance with the respective purchase agreement ( Recalls ).

(2) Cumulative collections from inception through March 31, 2010, excluding collections on behalf of others.

(3) Cumulative Collections Multiple ( CCM ) through March 31, 2010 collections as a multiple of purchase price.

(4) From inception through December 31, 2002.

**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 |
|-------|-------------------------------|---------------------------------------|--|-----------------------------------|---|
| <2004 | \$ 284,164 <sup>(4)</sup>     | \$ 1,061,514                          | \$ 1,060                                       | \$ 1,062,574                      | 3.7   |
| 2004  | 101,329                       | 241,321                               | 6,158  | 247,479                           | 2.4   |
| 2005  | 192,591                       | 422,832                               | 48,854   | 471,686                           | 2.4   |
| 2006  | 141,969                       | 257,340                               | 80,045   | 337,385                           | 2.4   |
| 2007  | 204,298                       | 345,325                               | 128,648  | 473,973                           | 2.3   |
| 2008  | 227,935                       | 269,791                               | 305,698  | 575,489                           | 2.5   |
| 2009  | 254,127                       | 152,456                               | 503,048  | 655,504                           | 2.6   |
| 2010  | 81,621                        | 8,354                                 | 166,687  | 175,041                           | 2.1   |



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

|       |              |              |              |              |     |
|-------|--------------|--------------|--------------|--------------|-----|
| Total | \$ 1,488,034 | \$ 2,758,933 | \$ 1,240,198 | \$ 3,999,131 | 2.7 |
|-------|--------------|--------------|--------------|--------------|-----|

- (1) Adjusted for Put-Backs, Recalls, purchase price rescissions, and the impact of an acquisition in 2000.
- (2) Cumulative collections from inception through March 31, 2010, excluding collections on behalf of others.
- (3) Includes \$0.5 million in expected collections for the healthcare portfolios on cost recovery.
- (4) From inception through December 31, 2002.

**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 |                   |                   |                   |                  |                  |                 |               |                     |
|----------------------|---|-------------------|-------------------|-------------------|------------------|------------------|-----------------|---------------|---------------------|
|                      | 2010  | 2011              | 2012              | 2013              | 2014             | 2015             | 2016            | 2017          | Total               |
| <2004 <sup>(1)</sup> | \$ 1,060  | \$                | \$                | \$                | \$               | \$               | \$              | \$            | \$ 1,060            |
| 2004                 | 4,110   | 2,048             |                   |                   |                  |                  |                 |               | 6,158               |
| 2005                 | 21,359  | 20,424            | 7,054             | 17                |                  |                  |                 |               | 48,854              |
| 2006                 | 24,252  | 27,102            | 19,355            | 9,336             |                  |                  |                 |               | 80,045              |
| 2007                 | 46,055  | 39,506            | 25,175            | 14,169            | 3,743            |                  |                 |               | 128,648             |
| 2008                 | 97,306  | 89,566            | 56,269            | 35,697            | 19,980           | 6,880            |                 |               | 305,698             |
| 2009                 | 154,925   | 149,399           | 94,476            | 54,657            | 29,960           | 14,512           | 5,119           |               | 503,048             |
| 2010                 | 35,897  | 51,650            | 35,317            | 20,416            | 12,019           | 6,634            | 4,213           | 541           | 166,687             |
| <b>Total</b>         | <b>\$ 384,964</b>   | <b>\$ 379,695</b> | <b>\$ 237,646</b> | <b>\$ 134,292</b> | <b>\$ 65,702</b> | <b>\$ 28,026</b> | <b>\$ 9,332</b> | <b>\$ 541</b> | <b>\$ 1,240,198</b> |

(1) Estimated remaining collections for Zero Basis Portfolios can extend beyond the 84-month accrual basis collection forecast.

**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 Balance<br>as of<br>March 31,<br>2010 <sup>(1)</sup> | Purchase Price <sup>(2)</sup> | Unamortized Balance<br>as a Percentage of<br>Purchase Price | Unamortized Balance<br>as a Percentage of<br>Total |
|--------------|--|-------------------------------|---|--|
| 2003         | \$ 388   | \$ 88,503                     | 0.4%  | 0.1%   |
| 2004         | 3,704  | 101,329                       | 3.7%  | 0.7%   |
| 2005         | 27,314   | 192,591                       | 14.2%   | 5.0%   |
| 2006         | 38,543   | 141,969                       | 27.1%   | 7.0%   |
| 2007         | 59,493   | 204,298                       | 29.1%   | 10.7%  |
| 2008         | 142,690  | 227,935                       | 62.6%   | 26.0%  |
| 2009         | 200,951  | 254,127                       | 79.1%   | 36.6%  |
| 2010         | 76,577   | 81,621                        | 93.8%   | 13.9%  |
| <b>Total</b> | <b>\$ 549,660</b>  | <b>\$ 1,292,373</b>           | <b>42.5%</b>  | <b>100.0%</b>                                      |

(1) Includes \$0.5 million for healthcare portfolios being accounted for on the cost recovery method.

(2) 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.

**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

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

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.

**Table of Contents**

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*):

|  | Accrual Basis<br>Portfolios | Three Months Ended March 31, 2010 |                          | Total             |
|--|-----------------------------|-----------------------------------|--------------------------|-------------------|
|  |                             | Cost Recovery<br>Portfolios       | Zero Basis<br>Portfolios |                   |
| Balance, beginning of period                             | \$ 526,366                  | \$ 511                            | \$                       | \$ 526,877        |
| Purchases of receivable portfolios                       | 81,632                      |                                   |                          | 81,632            |
| Gross collections <sup>(1)</sup>                         | (139,084)                   | (31)                              | (2,057)                  | (141,172)         |
| Put-backs and recalls                                    | (584)                       |                                   |                          | (584)             |
| Revenue recognized <sup>(2)</sup>                        | 88,732                      |                                   | 2,056                    | 90,788            |
| (Portfolio allowances) portfolio allowance reversal, net | (7,882)                     |                                   | 1                        | (7,881)           |
| <b>Balance, end of period</b>                            | <b>\$ 549,180</b>           | <b>\$ 480</b>                     | <b>\$</b>                | <b>\$ 549,660</b> |
| Revenue as a percentage of collections <sup>(3)</sup>    | 63.8%                       | 0.0%                              | 100.0%                   | 64.3%             |

|   | Accrual Basis<br>Portfolios | Three Months Ended March 31, 2009 |                          | Total             |
|---|-----------------------------|-----------------------------------|--------------------------|-------------------|
|   |                             | Cost Recovery<br>Portfolios       | Zero Basis<br>Portfolios |                   |
| Balance, beginning of period                          | \$ 460,598                  | \$ 748                            | \$                       | \$ 461,346        |
| Purchases of receivable portfolios                    | 55,913                      |                                   |                          | 55,913            |
| Gross collections <sup>(1)</sup>                      | (112,491)                   | (139)                             | (2,496)                  | (115,126)         |
| Put-backs and recalls                                 | (920)                       |                                   | (4)                      | (924)             |
| Revenue recognized <sup>(2)</sup>                     | 75,202                      |                                   | 2,500                    | 77,702            |
| Portfolio allowances, net                             | (5,427)                     |                                   |                          | (5,427)           |
| <b>Balance, end of period</b>                         | <b>\$ 472,875</b>           | <b>\$ 609</b>                     | <b>\$</b>                | <b>\$ 473,484</b> |
| Revenue as a percentage of collections <sup>(3)</sup> | 66.9%                       | 0.0%                              | 100.0%                   | 67.5%             |

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

(2) Includes retained interest.

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

As of March 31, 2010, we had \$549.7 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 portfolio balance is as follows (*in thousands*):

| Year Ended December 31, | Amortization |
|-------------------------|--------------|
| 2010 <sup>(1)</sup>     | \$ 121,355   |
| 2011                    | 162,512      |
| 2012                    | 121,974      |
| 2013                    | 75,353       |
| 2014                    | 40,707       |

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

|              |                   |
|--------------|-------------------|
| 2015         | 19,103            |
| 2016         | 8,118             |
| 2017         | 538               |
| <b>Total</b> | <b>\$ 549,660</b> |

<sup>(1)</sup> 2010 amount consists of nine months data from April 1, 2010 to December 31, 2010.

**Table of Contents****Analysis of Changes in Revenue**

The following table analyzes the components of the change in revenue from our receivable portfolios for the three months ended March 31, 2010, compared to the three months ended March 31, 2009 (*in thousands, except percentages*):

| Variance Component                                      | Three Months Ended March 31, |            |           | Revenue Variance |
|---|------------------------------|------------|-----------|------------------|
|   | 2010                         | 2009       | Change    |                  |
| Average portfolio balance                               | \$ 522,139                   | \$ 449,569 | \$ 72,570 | \$ 12,139        |
| Weighted average effective interest rate <sup>(1)</sup> | 68.0%                        | 66.9%      | (1.1)%    | \$ 1,391         |
| Zero basis revenue                                      | \$ 2,056                     | \$ 2,500   |           | \$ (444)         |
| Net portfolio allowances                                | \$ (7,881)                   | \$ (5,427) |           | \$ (2,454)       |
| <b>Total variance</b>                                   |                              |            |           | <b>\$ 10,632</b> |

<sup>(1)</sup> For accrual basis portfolios, the weighted average annualized effective interest rate is the accrual rate utilized in recognizing revenue on our accrual basis portfolios. This rate represents the monthly internal rate of return, which has been annualized utilizing the simple interest method. The monthly internal rate of return is determined based on the timing and amounts of actual cash received to date and the anticipated future cash flow projections for each pool.

**Collections by Channel**

We utilize numerous business channels for the collection of charged-off credit cards and other receivables. The following table summarizes the gross collections by collection channel (*in thousands*):

|                     | Three Months Ended March 31, |                   |
|---------------------|------------------------------|-------------------|
|                     | 2010                         | 2009              |
| Collection sites    | \$ 65,804                    | \$ 50,342         |
| Legal collections   | 57,173                       | 56,407            |
| Collection agencies | 17,752                       | 7,667             |
| Sales and other     | 538                          | 817               |
|                     | <b>\$ 141,267</b>            | <b>\$ 115,233</b> |

**External Collection Channels and Related Direct Costs**

The following tables summarize our external collection channel performance and related direct costs (*in thousands, except percentages*):

| Collections                       | Legal Collections                 |              |                                   |              | Collection Agencies               |              |                                   |              |
|-----------------------------------|-----------------------------------|--------------|-----------------------------------|--------------|-----------------------------------|--------------|-----------------------------------|--------------|
|                                   | Three Months Ended March 31, 2010 |              | Three Months Ended March 31, 2009 |              | Three Months Ended March 31, 2010 |              | Three Months Ended March 31, 2009 |              |
| Collections                       | \$ 57,173                         | 100.0%       | \$ 56,407                         | 100.0%       | \$ 17,752                         | 100.0%       | \$ 7,667                          | 100.0%       |
| Commissions                       | \$ 17,280                         | 30.2%        | \$ 16,100                         | 28.5%        | \$ 5,296                          | 29.8%        | \$ 2,891                          | 37.7%        |
| Court cost expense <sup>(1)</sup> | 8,532                             | 14.9%        | 13,303                            | 23.6%        |                                   |              |                                   |              |
| Other <sup>(2)</sup>              | 621                               | 1.1%         | 544                               | 1.0%         |                                   |              |                                   |              |
| <b>Total Costs</b>                | <b>\$ 26,433</b>                  | <b>46.2%</b> | <b>\$ 29,947</b>                  | <b>53.1%</b> | <b>\$ 5,296</b>                   | <b>29.8%</b> | <b>\$ 2,891</b>                   | <b>37.7%</b> |

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

- (1) In connection with our agreement with contracted attorneys, we advance certain out-of-pocket court costs. We 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 primarily of costs related to counter claims and legal network subscription fees.

**Table of Contents****Legal Outsourcing Collections and Related Costs**

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

| Placement Year | Gross Collections by Year of Collection <sup>(1)</sup> |           |           |           |           |           |            |           | Total Collections |
|----------------|--|-----------|-----------|-----------|-----------|-----------|------------|-----------|-------------------|
|                | 2003   | 2004      | 2005      | 2006      | 2007      | 2008      | 2009       | 2010      |                   |
| 2003           | \$ 10,750  | \$ 27,192 | \$ 17,212 | \$ 9,566  | \$ 5,561  | \$ 3,050  | \$ 2,014   | \$ 423    | \$ 75,768         |
| 2004           |  | \$ 23,455 | \$ 37,674 | \$ 21,676 | \$ 12,029 | \$ 5,840  | \$ 3,665   | \$ 677    | \$ 105,016        |
| 2005           |  |           | \$ 21,694 | \$ 40,762 | \$ 22,152 | \$ 10,582 | \$ 6,226   | \$ 1,152  | \$ 102,568        |
| 2006           |  |           |           | \$ 39,395 | \$ 82,740 | \$ 43,303 | \$ 22,527  | \$ 3,729  | \$ 191,694        |
| 2007           |  |           |           |           | \$ 41,958 | \$ 80,211 | \$ 44,321  | \$ 6,678  | \$ 173,168        |
| 2008           |  |           |           |           |           | \$ 47,320 | \$ 110,868 | \$ 18,209 | \$ 176,397        |
| 2009           |  |           |           |           |           |           | \$ 40,856  | \$ 23,769 | \$ 64,625         |
| 2010           |  |           |           |           |           |           |            | \$ 1,993  | \$ 1,993          |

<sup>(1)</sup> Includes collections for accounts placed in our legal channel beginning January 1, 2003. We continue to collect on accounts placed in this channel prior to that date.

| Placement Year | Court Costs by Year of Collection <sup>(1)</sup> |          |          |           |           |           |           |          | Total Court Costs |
|----------------|--|----------|----------|-----------|-----------|-----------|-----------|----------|-------------------|
|                | 2003   | 2004     | 2005     | 2006      | 2007      | 2008      | 2009      | 2010     |                   |
| 2003           | \$ 908   | \$ 2,046 | \$ 571   | \$ 300    | \$ 147    | \$ 103    | \$ 86     | \$ 16    | \$ 4,177          |
| 2004           |  | \$ 2,509 | \$ 2,937 | \$ 1,087  | \$ 406    | \$ 223    | \$ 153    | \$ 29    | \$ 7,344          |
| 2005           |  |          | \$ 3,271 | \$ 4,426  | \$ 859    | \$ 356    | \$ 218    | \$ 43    | \$ 9,173          |
| 2006           |  |          |          | \$ 10,158 | \$ 10,291 | \$ 1,829  | \$ 407    | \$ 137   | \$ 22,822         |
| 2007           |  |          |          |           | \$ 15,357 | \$ 11,952 | \$ 1,178  | \$ 80    | \$ 28,567         |
| 2008           |  |          |          |           |           | \$ 19,322 | \$ 15,842 | \$ 753   | \$ 35,917         |
| 2009           |  |          |          |           |           |           | \$ 17,009 | \$ 5,585 | \$ 22,594         |
| 2010           |  |          |          |           |           |           |           | \$ 1,252 | \$ 1,252          |

<sup>(1)</sup> Includes court cost expense for accounts placed in our legal channel beginning January 1, 2003. We continue to incur court cost expense on accounts placed in this channel prior to that date. Court cost expense in this table is calculated based on our blended court cost expense rate.

| Placement Year | Commissions by Year of Collection <sup>(1)</sup> |          |           |           |           |           |           |          | Total Commissions |
|----------------|--|----------|-----------|-----------|-----------|-----------|-----------|----------|-------------------|
|                | 2003   | 2004     | 2005      | 2006      | 2007      | 2008      | 2009      | 2010     |                   |
| 2003           | \$ 3,574   | \$ 8,606 | \$ 5,496  | \$ 2,898  | \$ 1,574  | \$ 872    | \$ 577    | \$ 125   | \$ 23,722         |
| 2004           |  | \$ 7,273 | \$ 12,060 | \$ 6,653  | \$ 3,498  | \$ 1,690  | \$ 1,063  | \$ 202   | \$ 32,439         |
| 2005           |  |          | \$ 6,725  | \$ 12,108 | \$ 6,364  | \$ 3,036  | \$ 1,792  | \$ 343   | \$ 30,368         |
| 2006           |  |          |           | \$ 11,451 | \$ 23,659 | \$ 12,370 | \$ 6,464  | \$ 1,108 | \$ 55,052         |
| 2007           |  |          |           |           | \$ 11,845 | \$ 22,927 | \$ 12,697 | \$ 1,990 | \$ 49,459         |
| 2008           |  |          |           |           |           | \$ 13,678 | \$ 31,794 | \$ 5,402 | \$ 50,874         |
| 2009           |  |          |           |           |           |           | \$ 11,476 | \$ 6,889 | \$ 18,365         |
| 2010           |  |          |           |           |           |           |           | \$ 536   | \$ 536            |

<sup>(1)</sup> Includes commissions for accounts placed in our legal channel beginning January 1, 2003. We continue to incur commissions on collections for accounts placed in this channel prior to that date.





**Table of Contents****Court Cost Expense and Commissions as a % of Gross Collections  
by Year of Collection**

| Placement Year | 2003  | 2004  | 2005  | 2006  | 2007  | 2008  | 2009  | 2010  | Cumulative<br>Average |
|----------------|-------|-------|-------|-------|-------|-------|-------|-------|-----------------------|
| 2003           | 41.7% |       |       |       |       |       |       |       |                       |
| 2004           |       | 41.7% |       |       |       |       |       |       |                       |
| 2005           |       |       | 46.1% |       |       |       |       |       |                       |
| 2006           |       |       |       | 54.9% |       |       |       |       |                       |
| 2007           |       |       |       |       | 64.8% |       |       |       |                       |
| 2008           |       |       |       |       |       | 69.7% |       |       |                       |
| 2009           |       |       |       |       |       |       | 69.7% |       |                       |
| 2010           |       |       |       |       |       |       |       | 89.7% |                       |

| Placement Year <sup>(2)</sup> | Lawsuits Filed by Year <sup>(1)</sup> |      |      |      |      |      |      |      |       |  |
|-------------------------------|---------------------------------------|------|------|------|------|------|------|------|-------|--|
|                               | 2003                                  | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | Total |  |
| 2003                          | 23                                    | 29   | 5    | 2    |      |      |      |      | 59    |  |
| 2004                          |                                       | 59   | 39   | 11   | 2    |      |      |      | 111   |  |
| 2005                          |                                       |      | 76   | 46   | 3    |      |      |      | 125   |  |
| 2006                          |                                       |      |      | 205  | 105  | 4    |      |      | 314   |  |
| 2007                          |                                       |      |      |      | 269  | 106  | 4    |      | 379   |  |
| 2008                          |                                       |      |      |      |      | 338  | 136  | 1    | 475   |  |
| 2009                          |                                       |      |      |      |      |      | 245  | 59   | 304   |  |
| 2010                          |                                       |      |      |      |      |      |      | 42   | 42    |  |

(1) Represents the year the account was placed into litigation.

(2) Represents the year the account was placed into our legal channel.

**Headcount by Function by Site**

The following table summarizes our headcount by function by site:

|                          | Headcount as of March 31, |       |      |       |
|--------------------------|---------------------------|-------|------|-------|
|                          | 2010                      |       | 2009 |       |
|                          | U.S.                      | India | U.S. | India |
| General & Administrative | 342                       | 200   | 317  | 98    |
| Account Manager          | 216                       | 757   | 270  | 350   |
| Bankruptcy Specialist    | 63                        | 60    | 62   | 37    |
|                          | 621                       | 1,017 | 649  | 485   |

**Gross Collections by Account Manager**

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

|  | Three Months Ended March 31, |           |
|--|------------------------------|-----------|
|  | 2010                         | 2009      |
| Gross collections - collection sites           | \$ 65,804                    | \$ 50,342 |
| Average active account managers                | 938                          | 587       |
| Collections per average active account manager | \$ 70.2                      | \$ 85.8   |



**Table of Contents****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*):

|                                      | Three Months Ended March 31, |           |
|--------------------------------------|------------------------------|-----------|
|                                      | 2010                         | 2009      |
| Gross collections - collection sites | \$ 65,804                    | \$ 50,342 |
| Total hours paid                     | 439                          | 265       |
| Collections per hour paid            | \$ 149.9                     | \$ 190.0  |

**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*):

|                                      | Three Months Ended March 31, |           |
|--------------------------------------|------------------------------|-----------|
|                                      | 2010                         | 2009      |
| Gross collections - collection sites | \$ 65,804                    | \$ 50,342 |
| Direct cost <sup>(1)</sup>           | \$ 6,022                     | \$ 5,805  |
| Cost per dollar collected            | 9.2%                         | 11.5%     |

<sup>(1)</sup> Represents 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*):

|  | Three Months Ended March 31, |           |
|--|------------------------------|-----------|
|  | 2010                         | 2009      |
| Portfolio Purchasing and Collecting Activities |                              |           |
| Collections related                            | \$ 6,022                     | \$ 5,805  |
| General & administrative                       | 7,586                        | 6,106     |
| Subtotal                                       | 13,608                       | 11,911    |
| Bankruptcy Services                            | 1,877                        | 2,046     |
|  | \$ 15,485                    | \$ 13,957 |

**Purchases by Quarter**

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

| Quarter | # of<br>Accounts | Face<br>Value | Purchase<br>Price | Forward<br>Flow<br>Allocation <sup>(1)</sup> |
|---------|------------------|---------------|-------------------|--|
| Q1 2007 | 1,434            | 2,510,347     | 45,386            | 3,539  |
| Q2 2007 | 1,042            | 1,341,148     | 41,137            | 2,949  |
| Q3 2007 | 659              | 1,281,468     | 47,869            | 2,680  |
| Q4 2007 | 1,204            | 1,768,111     | 74,561            | 2,536  |

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

|         |       |           |        |        |
|---------|-------|-----------|--------|--------|
| Q1 2008 | 647   | 1,199,703 | 47,902 | 2,926  |
| Q2 2008 | 676   | 1,801,902 | 52,492 | 2,635  |
| Q3 2008 | 795   | 1,830,292 | 66,107 |        |
| Q4 2008 | 1,084 | 1,729,568 | 63,777 |        |
| Q1 2009 | 505   | 1,341,660 | 55,913 |        |
| Q2 2009 | 719   | 1,944,158 | 82,033 |        |
| Q3 2009 | 1,515 | 2,173,562 | 77,734 | 10,302 |
| Q4 2009 | 519   | 1,017,998 | 40,952 |        |
| Q1 2010 | 839   | 2,112,332 | 81,632 |        |

- (1) Allocation of the forward flow asset to the cost basis of receivable portfolio purchases. In July 2008, we ceased forward flow purchases from Jefferson Capital due to an alleged breach by Jefferson Capital and its parent, CompuCredit Corporation, of certain agreements. In September 2009, we settled our dispute with Jefferson Capital. As part of the settlement, we purchased a receivable portfolio and applied the remaining forward flow asset to that purchase.

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

Historically, we have met our cash requirements by utilizing our cash flows from operations, bank borrowings and equity offerings. Our primary cash requirements have included the purchase of receivable portfolios, operational 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<br/>March 31,</b> |             |
|---|---|-------------|
|   | <b>2010</b>                             | <b>2009</b> |
| Net cash provided by operating activities           | \$ 20,528                               | \$ 16,888   |
| Net cash used in investing activities               | \$ (30,872)                             | \$ (18,034) |
| Net cash provided by (used in) financing activities | \$ 9,531                                | \$ (4,934)  |

On February 8, 2010, we entered into a new \$327.5 million, revolving credit facility, or 2010 Revolving Credit Facility. This new facility replaces the previous revolving credit facility and is due to expire in May 2013. All of our portfolio purchases are funded with cash or financed under the 2010 Revolving Credit Facility. See Note 9 to our consolidated financial statements for a further discussion on our 2010 Revolving Credit Facility.

On February 8, 2010, our board of directors approved a new \$50.0 million securities repurchase program to replace the remaining available repurchase authority allowed under our prior program. Under the 2010 Revolving Credit Facility, we have the renewed ability to repurchase up to \$50.0 million in any combination of our common stock and Convertible Notes, subject to compliance with certain covenants and available borrowing capacity. The board's approval authorizes us to repurchase an aggregate of up to \$50.0 million of any combination of our common stock and Convertible Notes. See Note 9 to our consolidated financial statements for a further discussion of our Convertible Notes.

***Operating Cash Flows***

Net cash provided by operating activities was \$20.5 million and \$16.9 million for the three months ended March 31, 2010 and 2009, respectively.

Cash provided by operating activities for the three months ended March 31, 2010, is primarily related to net income of \$10.9 million and \$7.9 million in a non-cash add back related to the net provision for allowance on our receivable portfolios. Cash provided by operating activities for the three months ended March 31, 2009, was primarily attributable to net income of \$9.0 million, \$5.4 million in a non-cash add back related to the net provision for allowance on our receivable portfolios and a net increase of \$2.5 million due to changes in other operating assets and liabilities, offset by a non-cash gain of \$3.1 million related to a repurchase of our Convertible Notes.

***Investing Cash Flows***

Net cash used in investing activities was \$30.9 million and \$18.0 million for the three months ended March 31, 2010 and 2009, respectively.

The cash flows used in investing activities for the three months ended March 31, 2010, are primarily related to receivable portfolio purchases of \$81.3 million, offset by gross collection proceeds applied to the principal of our receivable portfolios in the amount of \$50.4 million. The cash flows used in investing activities for the three months ended March 31, 2009, are primarily related to receivable portfolio purchases of \$55.9 million, offset by gross collection proceeds applied to the principal of our receivable portfolios in the amount of \$37.4 million.

Capital expenditures for fixed assets acquired with internal cash flow were \$0.2 million and \$0.5 million for three months ended March 31, 2010 and 2009, respectively.

***Financing Cash Flows***

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

Net cash provided by financing activities was \$9.5 million for the three months ended March 31, 2010 and net cash used in financing activities was \$4.9 million for the three months ended March 31, 2009.

## **Table of Contents**

The cash provided by financing activities during the three months ended March 31, 2010, reflects \$22.0 million in repayments of amounts outstanding under our line of credit, offset by \$35.0 million in borrowings under our line of credit agreement. The cash used in financing activities during the three months ended March 31, 2009, reflects \$17.0 million in repayments of amounts outstanding under our line of credit and \$19.8 million used for the repurchase of Convertible Notes with face value of \$23.1 million, offset by \$32.0 million in borrowings under our line of credit agreement.

We are in compliance with all covenants under our financing arrangements and, excluding the effects of the one-time payment of \$16.9 million to eliminate all future Contingent Interest payments in the second quarter of 2007 (this payment, less amounts accrued on our balance sheet, resulted in a charge in our statement of operations of \$6.9 million after the effect of income taxes) and the effects of the adoption of a new accounting principal related to our Convertible Notes, we have achieved 33 consecutive quarters of positive net income. 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 \$7.6 million as of March 31, 2010, and availability under our new \$327.5 million 2010 Revolving Credit Facility which expires in May 2013.

### ***Off Balance Sheet Arrangements***

We do not have any off balance sheet arrangements as defined by Item 303(a)(4) of Regulation S-K.

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

For quantitative and qualitative disclosures about market risk affecting Encore, see Item 7A, Quantitative and Qualitative Disclosures About Market Risk, of our Annual Report on Form 10-K for the fiscal year ended December 31, 2009, which is incorporated herein by reference. Our exposure to market risk has not changed materially since December 31, 2009.

### **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 with the Securities and Exchange Commission ( SEC ) is recorded, processed, summarized and reported within the time periods specified in the rules and forms of the SEC and that such information is accumulated and communicated to our management 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 management accordingly 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 Securities Exchange Act of 1934 ( Exchange Act ), as amended, 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**

On October 18, 2004, Timothy W. Moser, one of our former officers, filed an action in the United States District Court for the Southern District of California against us, and certain individuals, including several of our officers and directors. On February 14, 2005, we were served with an amended complaint in this action alleging defamation, intentional interference with contractual relations, breach of contract, breach of the covenant of good faith and fair dealing, intentional and negligent infliction of emotional distress and civil conspiracy arising out of certain statements in our Registration Statement on Form S-1, originally filed in September 2003, and alleged to be included in our Registration Statement on Form S-3, originally filed in May 2004. The amended complaint sought injunctive relief, economic and punitive damages in an unspecified amount plus an award of profits allegedly earned by the defendants and alleged co-conspirators as a result of the alleged conduct, in addition to attorney's fees and costs. On June 1, 2006, the plaintiff filed a second amended complaint in which he amended his claim for negligent infliction of emotional distress. On January 19, 2010, the District Court issued an order granting defendants' summary judgment motions, dismissed all causes of action against all of the defendants and entered judgment in favor of the defendants. On February 12, 2010, Mr. Moser filed a notice of appeal of the judgment.

On September 7, 2005, Mr. Moser filed a related action in the United States District Court for the Southern District of California against Triarc Companies, Inc. (Triarc), which at the time, was a significant stockholder of ours, alleging intentional interference with contractual relations and intentional infliction of emotional distress. The case arose out of the same statements made or alleged to have been made in our Registration Statements mentioned above. The amended complaint sought injunctive relief, an order directing Triarc to issue a statement of retraction or correction of the allegedly false statements, economic and punitive damages in an unspecified amount and attorney's fees and costs. Triarc tendered the defense of this action to us, and we accepted the defense and will indemnify Triarc, pursuant to the indemnification provisions of the Registration Rights Agreements dated as of October 31, 2000 and February 21, 2002, and the Underwriting Agreements dated September 25, 2004 and January 20, 2005 to which Triarc is a party. This action was also dismissed by the District Court on January 19, 2010. Mr. Moser's February 12, 2010 notice of appeal also challenges this judgment.

We, along with others in our industry, are subject to legal actions based on the Fair Debt Collection Practices Act, or FDCPA, and comparable state statutes, which could have a material adverse effect on us due to the remedies available under these statutes, including punitive damages. 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, and have made inaccurate assertions of fact in support of our collection actions. A number of these cases are styled as class actions and a class has been certified in several of these cases. Many of these cases present novel issues on which there is no clear legal precedent. As a result, we are unable to predict the range of possible outcomes.

In one such action, captioned *Brent v. Midland Credit Management, Inc et. al*, filed on May 19, 2008, in the United States District Court for the Northern District of Ohio [Western Division], the plaintiff has filed a class action counter-claim against Midland Credit Management, Inc. and Midland Funding LLC, or the Midland Defendants. The complaint alleges that the Midland Defendants' business practices violated consumers rights under the FDCPA and the Ohio Consumer Sales Practices Act. The plaintiff is seeking actual and statutory damages for the class of Ohio residents, plus attorney's fees and costs of class notice and class administration. On August 11, 2009, the court issued an order partially granting plaintiff's motion for summary judgment and entering findings adverse to the Midland Defendants on certain of plaintiff's claims. The Midland Defendants subsequently moved the court to reconsider the order and were partially successful. However, because the court did not completely reverse the August 11 order, certain portions of the order remain subject to reversal only on appeal. On February 22, 2010, the District Court denied Plaintiff's attempts to enlarge the case to include a national class of consumers, and ordered the parties to brief issues relating to whether a statewide class should be certified. No class has been certified to date.

There are a number of other lawsuits, claims and counterclaims pending or threatened against us. In general, these lawsuits, claims or counterclaims have arisen in the ordinary course of business and involve claims for damages arising from a variety of alleged misconduct or improper reporting of credit information by us or our employees or agents. In addition, from time to time, we are subject to various regulatory investigations, inquiries and other actions, relating to our collection activities.

On January 6, 2010, the Office of the Attorney General of the State of California, the California Attorney General, issued a subpoena to us to answer interrogatories and to produce documents in a proceeding entitled *In the Matter of the Investigation of Encore Capital Group, Inc., Midland Credit Management, Inc. and Affiliated Persons and Entities* concerning our debt collection practices and related topics. We intend to cooperate fully with the California Attorney General in response to this subpoena, subject to applicable law.

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

On December 16, 2009, the Federal Trade Commission, or FTC, issued an order directing us to submit information about our practices in buying and collecting consumer debt, which the FTC intends to use for a study of the debt-buying industry. We are one of

## **Table of Contents**

nine companies that received such an order from the FTC requesting the production of information for use in the FTC's study of the industry. The nine companies were described by the FTC as the nation's largest consumer debt buyers. The order was publicly announced by the FTC on January 5, 2010. We intend to cooperate fully with the FTC in connection with its study, subject to applicable law.

We have established loss provisions only for matters in which losses are probable and can be reasonably estimated. Some of the matters pending against us involve potential compensatory, punitive damage claims, fines or sanctions that, if granted, could require us to pay damages or make other expenditures in amounts that could have a material adverse effect on our financial position or results of operations. Although litigation is inherently uncertain, at this time, based on past experience, the information currently available and the possible availability of insurance and/or indemnification in some cases, we do not believe that the resolution of these matters will have a material adverse effect on our consolidated financial position or results of operations.

### **Item 1A Risk Factors**

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of Section 27A of the Securities Act of 1933, as amended (the Securities Act), and Section 21E of the Securities Exchange Act of 1934, as amended (the Exchange Act), which we believe are subject to certain safe harbors. Many statements, other than statements of historical facts, included or incorporated into this Quarterly Report on Form 10-Q are forward-looking statements. The words believe, expect, anticipate, estimate, project, intend, plan, will, may, and expressions often characterize forward-looking statements. These statements may include 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. In particular, these statements may be found, under the Management's Discussion and Analysis of Financial Condition and Results of Operations and Risk Factors sections, among other places.

Although we believe that the expectations reflected in these forward-looking statements are reasonable, we caution you 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 those set forth below, could cause our actual results, performance, achievements, or industry results to be very different from the results, performance or achievements 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. This section highlights some specific risks affecting our business, operating results and financial condition. The list of risks is not intended to be exhaustive and the order in which the risks appear is not intended as an indication of their relative weight or importance. These factors include the following:

Recent instability in the financial markets and global economy may affect our access to capital, our ability to purchase accounts, and the success of our collection efforts;

Our quarterly operating results may fluctuate due to a variety of factors;

Fluctuations in our operating results may lead to decreases in the trading prices of our common stock and convertible notes;

We may not be able to purchase receivables at sufficiently favorable prices or terms, or at all;

We may not be successful in acquiring and collecting on portfolios consisting of new types of receivables;

We may purchase receivable portfolios that contain unprofitable accounts and we may not be able to collect sufficient amounts to recover our costs and to fund our operations;

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

We may purchase portfolios that contain accounts which do not meet our account collection criteria;

We may not be able to use our sales channel to sell unprofitable accounts;

We may not be successful in recovering the level of court costs we anticipate recovering;

Our industry is highly competitive, and we may be unable to compete successfully with businesses that may have greater resources than we have;

Our failure to purchase sufficient quantities of receivable portfolios may necessitate workforce reductions, which may harm our business;

A significant portion of our portfolio purchases during any period may be concentrated with a small number of sellers;

**Table of Contents**

We may be unable to meet our future short- or long-term liquidity requirements;

Volatility in U.S. credit markets could affect our ability to refinance and/or retire existing debt, obtain financing to fund acquisitions, investments, or other significant operating or capital expenditures;

We may not be able to continue to satisfy the restrictive covenants in our debt agreements;

The statistical models we use to project remaining cash flows from our receivable portfolios may prove to be inaccurate;

If we do not meet our projected collection levels for particular account portfolios, our earnings will be reduced through provisions for portfolio allowances;

If our goodwill or amortizable intangible assets become impaired we may be required to record a significant charge to earnings. We carry approximately \$16.0 million in goodwill and approximately \$1.0 million in amortizable intangible assets on our balance sheet. Under generally accepted accounting principles, we review our goodwill for potential impairment at least annually, and review our amortizable intangible assets for impairment whenever events or changes in circumstances indicate the carrying value may not be recoverable. Factors that may indicate that the carrying value of our goodwill or amortizable intangible assets may not be recoverable include adverse changes in estimated future cash flows, growth rates and discount rates. We may be required to record a significant charge in our financial statements during the period in which any impairment of our goodwill or amortizable intangible assets is determined, negatively impacting our results of operations;

Negative news regarding the debt collection industry and individual debt collectors may have a negative impact on a debtor's willingness to pay the debt we acquire;

Present and future government regulation, legislation or enforcement actions may limit our ability to recover and enforce the collection of receivables;

Failure to comply with government regulation by us or third parties acting for or in our behalf could result in the suspension or termination of our ability to conduct business, may require the payment of significant fines and penalties, or require other significant expenditures;

We are dependent upon third parties to service a substantial portion of our consumer receivable portfolios;

A significant portion of our collections relies upon our success in individual lawsuits brought against consumers and our ability to collect on judgments in our favor;

An inability to obtain relevant supporting documentation related to our consumer receivable portfolios, or the cost of obtaining such documentation, may limit our ability to recover and enforce collection of receivables or increase our costs of collection;

Increases in court costs and attorneys' fees can materially raise our costs associated with our collection strategies and the individual lawsuits brought against consumers to collect on judgments in our favor;

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

We are subject to ongoing risks of litigation, including individual and class actions under consumer credit, collections, employment, securities and other laws, and may be subject to awards of substantial damages;

We may make acquisitions that prove unsuccessful or strain or divert our resources;

We are dependent on our management team for the adoption and implementation of our strategies and the loss of their services could have a material adverse effect on our business;

We may not be able to hire and retain enough sufficiently trained employees to support our operations, and/or we may experience high rates of personnel turnover;

Exposure to regulatory, political and economic conditions in India exposes us to risks or loss of business;

We may not be able to manage our growth effectively, including the expansion of our operations in India;

The failure of our technology and telecommunications systems could have an adverse effect on our operations;

We may not be able to successfully anticipate, invest in or adopt technological advances within our industry;

We may not be able to adequately protect the intellectual property rights upon which we rely;

Our results of operations may be materially adversely affected if bankruptcy filings increase or if bankruptcy or other debt collection laws change; and

We are subject to examinations and challenges by tax authorities.

**Table of Contents**

For more information about these risks, see the discussion under Part I, Item 1A Risk Factors of our Annual Report on Form 10-K for the fiscal year ended December 31, 2009, filed with the Securities and Exchange Commission, which is incorporated herein by reference.

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 our policy generally 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.

**Table of Contents**

**Item 5. Exhibits**

- 10.1 Credit Agreement dated as of February 8, 2010 by and among Encore Capital Group, Inc., the Lenders from time to time parties thereto, and JPMorgan Chase Bank, N.A., as administrative agent (the 2010 Credit Agreement ) (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on February 8, 2010).
- 10.2 Pledge and Security Agreement dated as of February 8, 2010 with respect to the 2010 Credit Agreement (incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed on February 8, 2010).
- 10.3 Guaranty dated as of February 8, 2010 with respect to the 2010 Credit Agreement (incorporated by reference to Exhibit 10.3 to the Company's Current Report on Form 8-K filed on February 8, 2010).
- 31.1 Certification of the Principal Executive Officer pursuant to rule 13-14(a) under the Securities Exchange Act of 1934 (filed herewith).
- 31.2 Certification of the Principal Financial Officer pursuant to rule 13-14(a) under the Securities Exchange Act of 1934 (filed herewith).
- 32.1 Certification 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 (filed herewith).



**Table of Contents**

**ENCORE CAPITAL GROUP, INC.**

**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: April 27, 2010

**Table of Contents**

**EXHIBIT INDEX**

- 10.1 Credit Agreement dated as of February 8, 2010 by and among Encore Capital Group, Inc., the Lenders from time to time parties thereto, and JPMorgan Chase Bank, N.A., as administrative agent (the "2010 Credit Agreement") (incorporated by reference to Exhibit 10.1 to the Company's Current Report on Form 8-K filed on February 8, 2010).
- 10.2 Pledge and Security Agreement dated as of February 8, 2010 with respect to the 2010 Credit Agreement (incorporated by reference to Exhibit 10.2 to the Company's Current Report on Form 8-K filed on February 8, 2010).
- 10.3 Guaranty dated as of February 8, 2010 with respect to the 2010 Credit Agreement (incorporated by reference to Exhibit 10.3 to the Company's Current Report on Form 8-K filed on February 8, 2010).
- 31.1 Certification of the Principal Executive Officer pursuant to rule 13-14(a) under the Securities Exchange Act of 1934 (filed herewith).
- 31.2 Certification of the Principal Financial Officer pursuant to rule 13-14(a) under the Securities Exchange Act of 1934 (filed herewith).
- 32.1 Certification 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 (filed herewith).