

ENCORE CAPITAL GROUP INC

Form 10-Q

August 01, 2011

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 June 30, 2011

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)

3111 Camino Del Rio North, Suite 1300

San Diego, California
(Address of principal executive offices)

48-1090909
(IRS Employer

Identification No.)

92108
(Zip code)

(877) 445 - 4581

(Registrant's telephone number, including area code)

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

8875 Aero Drive, Suite 200, San Diego, California 92123

(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 July 18, 2011 |
|--------------------------------|------------------------------|
| Common Stock, \$0.01 par value | 24,452,519 shares |

Table of Contents

ENCORE CAPITAL GROUP, INC.

INDEX TO FORM 10-Q

| | Page |
|---|-------------|
| <u>PART I FINANCIAL INFORMATION</u> | 1 |
| <u>Item 1 Condensed Consolidated Financial Statements (Unaudited)</u> | 1 |
| <u>Condensed Consolidated Statements of Financial Condition</u> | 1 |
| <u>Condensed Consolidated Statements of 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>Item 3 Quantitative and Qualitative Disclosures About Market Risk</u> | 37 |
| <u>Item 4 Controls and Procedures</u> | 37 |
| <u>PART II OTHER INFORMATION</u> | 38 |
| <u>Item 1 Legal Proceedings</u> | 38 |
| <u>Item 1A Risk Factors</u> | 39 |
| <u>Item 2 Unregistered Sales of Equity Securities and Use of Proceeds</u> | 45 |
| <u>Item 6 Exhibits</u> | 46 |
| <u>SIGNATURES</u> | 47 |

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)

| | June 30, 2011 | December 31, 2010 |
|---|-------------------|----------------------|
| Assets | | |
| Cash and cash equivalents | \$ 14,660 | \$ 10,905 |
| Accounts receivable, net | 2,998 | 3,331 |
| Investment in receivable portfolios, net | 657,783 | 644,753 |
| Deferred court costs, net | 36,068 | 32,158 |
| Property and equipment, net | 14,830 | 13,658 |
| Prepaid income tax | 6,324 | 1,629 |
| Other assets | 13,727 | 13,301 |
| Goodwill | 15,985 | 15,985 |
| Identifiable intangible assets, net | 605 | 748 |
| Total assets | \$ 762,980 | \$ 736,468 |
| Liabilities and stockholders' equity | | |
| Liabilities: | | |
| Accounts payable and accrued liabilities | \$ 25,942 | \$ 26,539 |
| Deferred tax liabilities, net | 17,464 | 17,626 |
| Debt | 378,172 | 385,264 |
| Other liabilities | 4,128 | 4,342 |
| Total liabilities | 425,706 | 433,771 |
| 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, 24,448 shares and 24,011 shares issued and outstanding as of June 30, 2011 and December 31, 2010, respectively | 244 | 240 |
| Additional paid-in capital | 119,560 | 113,412 |
| Accumulated earnings | 217,348 | 188,894 |
| Accumulated other comprehensive income | 122 | 151 |
| Total stockholders' equity | 337,274 | 302,697 |
| Total liabilities and stockholders' equity | \$ 762,980 | \$ 736,468 |

See accompanying notes to condensed consolidated financial statements

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

(In Thousands, Except Per Share Amounts)

(Unaudited)

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|------------------|------------------------------|------------------|
| | 2011 | 2010 | 2011 | 2010 |
| Revenue | | | | |
| Revenue from receivable portfolios, net | \$ 111,093 | \$ 91,845 | \$ 216,419 | \$ 174,752 |
| Servicing fees and other related revenue | 4,737 | 4,386 | 9,714 | 8,817 |
| Total revenue | 115,830 | 96,231 | 226,133 | 183,569 |
| Operating expenses | | | | |
| Salaries and employee benefits (excluding stock-based compensation expense) | 20,212 | 16,484 | 39,252 | 31,969 |
| Stock-based compensation expense | 1,810 | 1,446 | 3,575 | 3,207 |
| Cost of legal collections | 40,686 | 31,235 | 77,195 | 57,668 |
| Other operating expenses | 9,191 | 9,027 | 19,287 | 18,141 |
| Collection agency commissions | 3,596 | 6,413 | 7,510 | 11,709 |
| General and administrative expenses | 9,623 | 7,425 | 19,792 | 14,304 |
| Depreciation and amortization | 1,105 | 752 | 2,158 | 1,425 |
| Total operating expenses | 86,223 | 72,782 | 168,769 | 138,423 |
| Income from operations | 29,607 | 23,449 | 57,364 | 45,146 |
| Other (expense) income | | | | |
| Interest expense | (5,369) | (4,880) | (10,962) | (9,418) |
| Other income (expense) | 23 | (90) | 139 | 102 |
| Total other expense | (5,346) | (4,970) | (10,823) | (9,316) |
| Income before income taxes | 24,261 | 18,479 | 46,541 | 35,830 |
| Provision for income taxes | (9,486) | (6,749) | (18,087) | (13,239) |
| Net income | \$ 14,775 | \$ 11,730 | \$ 28,454 | \$ 22,591 |
| Weighted average shares outstanding: | | | | |
| Basic | 24,433 | 23,713 | 24,384 | 23,673 |
| Diluted | 25,610 | 24,958 | 25,594 | 24,897 |
| Earnings per share: | | | | |
| Basic | \$ 0.60 | \$ 0.49 | \$ 1.17 | \$ 0.95 |
| Diluted | \$ 0.58 | \$ 0.47 | \$ 1.11 | \$ 0.91 |

See accompanying notes to condensed 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 | Accumulated | Accumulated | Total | Comprehensive |
|---|--------------|--------|------------|-------------|---------------|------------|---------------|
| | Shares | Par | Paid-In | Earnings | Other | Equity | Income |
| | | | Capital | | Comprehensive | | Income |
| | | | | | Income | | |
| | | | | | (Loss) | | |
| Balance at December 31, 2010 | 24,011 | \$ 240 | \$ 113,412 | \$ 188,894 | \$ 151 | \$ 302,697 | \$ |
| Net income | | | | 28,454 | | 28,454 | 28,454 |
| Other comprehensive gain: | | | | | | | |
| Unrealized loss on cash flow hedge, net of tax | | | | | (29) | (29) | (29) |
| Exercise of stock options and issuance of share-based awards, net of shares withheld for employee taxes | 437 | 4 | (2,146) | | | (2,142) | |
| Stock-based compensation | | | 3,575 | | | 3,575 | |
| Tax benefit related to stock-based compensation | | | 4,719 | | | 4,719 | |
| Balance at June 30, 2011 | 24,448 | \$ 244 | \$ 119,560 | \$ 217,348 | \$ 122 | \$ 337,274 | \$ 28,425 |

See accompanying notes to condensed consolidated financial statements

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

(Unaudited, In Thousands)

| | Six Months Ended June 30, | |
|---|--------------------------------------|------------------|
| | 2011 | 2010 |
| Operating activities: | | |
| Net income | \$ 28,454 | \$ 22,591 |
| Adjustments to reconcile net income to net cash provided by operating activities: | | |
| Depreciation and amortization | 2,158 | 1,425 |
| Amortization of loan costs and debt discount | 901 | 2,194 |
| Stock-based compensation expense | 3,575 | 3,207 |
| Deferred income tax benefit | (162) | (22) |
| Excess tax benefit from stock-based payment arrangements | (4,727) | (1,813) |
| Provision for allowances on receivable portfolios, net | 6,504 | 10,720 |
| Changes in operating assets and liabilities | | |
| Other assets | (233) | 39 |
| Deferred court costs | (3,910) | 3 |
| Prepaid income tax and income taxes payable | 24 | (3,027) |
| Accounts payable, accrued liabilities and other liabilities | (841) | (494) |
| Net cash provided by operating activities | 31,743 | 34,823 |
| Investing activities: | | |
| Purchases of receivable portfolios | (184,376) | (164,968) |
| Collections applied to investment in receivable portfolios, net | 163,144 | 112,446 |
| Proceeds from put-backs of receivable portfolios | 1,698 | 1,864 |
| Purchases of property and equipment | (1,461) | (1,647) |
| Net cash used in investing activities | (20,995) | (52,305) |
| Financing activities: | | |
| Payment of loan costs | (814) | (4,660) |
| Proceeds from senior secured notes | 25,000 | |
| Proceeds from notes payable and other borrowings | 55,000 | 53,000 |
| Repayment of notes payable and other borrowings | (87,000) | (31,000) |
| Proceeds from net settlement of certain call options | | 524 |
| Proceeds from exercise of stock options | 1,248 | 1,688 |
| Taxes paid related to net share settlement of equity awards | (3,388) | (1,251) |
| Excess tax benefit from stock-based payment arrangements | 4,727 | 1,813 |
| Repayment of capital lease obligations | (1,766) | (618) |
| Net cash (used in) provided by financing activities | (6,993) | 19,496 |
| Net increase in cash and cash equivalents | 3,755 | 2,014 |
| Cash and cash equivalents, beginning of period | 10,905 | 8,388 |
| Cash and cash equivalents, end of period | \$ 14,660 | \$ 10,402 |

Supplemental disclosures of cash flow information:

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

| | | |
|--|-----------|-----------|
| Cash paid for interest | \$ 9,718 | \$ 6,994 |
| Cash paid for income taxes | \$ 17,814 | \$ 16,544 |
| Supplemental schedule of non-cash investing and financing activities: | | |
| Fixed assets acquired through capital lease | \$ 1,726 | \$ 1,389 |

See accompanying notes to condensed consolidated financial statements

Table of Contents

ENCORE CAPITAL GROUP, INC.

NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

(Unaudited)

Note 1: Ownership, Description of Business and Summary of Significant Accounting Policies

Encore Capital Group, Inc. (Encore), through its subsidiaries (collectively, the Company), is a leader in consumer debt buying and recovery. The Company purchases portfolios of defaulted consumer receivables and manages them by partnering with individuals as they repay their obligations and work toward financial recovery. Defaulted receivables are consumers' unpaid financial commitments to credit originators, including banks, credit unions, consumer finance companies, commercial retailers, auto finance companies and telecommunication companies, which the Company purchases at deep discounts. Defaulted receivables also include receivables subject to bankruptcy proceedings or consumer bankruptcy receivables.

The Company purchases receivables based on robust, account-level valuation methods and employs a suite of proprietary statistical and behavioral models across the full extent of its operations. These investments allow the Company to value portfolios accurately (and limit the risk of overpaying), avoid buying portfolios that are incompatible with its methods or goals and precisely align the accounts it purchases with its operational channels to maximize future collections. As a result, the Company has been able to realize significant returns from the receivables it acquires. The Company maintains strong relationships with many of the largest credit providers in the United States, and possesses one of the industry's best collection staff retention rates.

The Company expands upon the insights created during its purchasing process when building account collection strategies. The Company's proprietary consumer-level collectability analysis is the primary determinant of whether an account is actively serviced post-purchase. Throughout the Company's ownership period, it continuously refines this analysis to determine the most effective collection strategy to pursue for each account. After the Company's preliminary analysis, it seeks to collect on only a fraction of the accounts it purchases, through one or more of its collection channels. The channel identification process is analogous to a funneling system where the Company first differentiates those consumers who are not able to pay, from those who are able to pay. Consumers who the Company believes are financially incapable of making any payments, are facing extenuating circumstances or hardships (such as medical issues), are serving in the military, or are currently receiving social security as their only means of financial sustenance are excluded from the next step of its collection process and are designated as inactive. The remaining pool of accounts in the funnel then receives further evaluation. At that point, the Company analyzes and determines a consumer's willingness to pay. Based on that analysis, the Company will pursue collections through letters and / or phone calls to its consumers. Despite its efforts to reach consumers and work out a settlement option, only a small number of consumers who are contacted choose to engage with the Company. Those who do are often offered deep discounts on their obligations, or are presented with payment plans which are better suited to meet their daily cash flow needs. The majority of contacted consumers, however, ignore both the Company's calls and letters, and therefore the Company must then make the difficult decision to pursue collections through legal means.

In addition, the Company provides bankruptcy support services to some of the largest companies in the financial services industry through its wholly owned subsidiary, Ascension Capital Group, Inc. (Ascension). Leveraging a proprietary software platform dedicated to bankruptcy servicing, Ascension's operational platform integrates lenders, trustees, and consumers across the bankruptcy lifecycle.

Financial Statement Preparation

The accompanying interim condensed consolidated financial statements have been prepared by Encore, without audit, in accordance with the instructions to the Quarterly Report on Form 10-Q, and Rule 10-01 of Regulation S-X promulgated by the 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 financial position, results of operations and cash flows. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2010. 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.

Table of Contents**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.

Reclassification

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

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.

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---|--------------------------------|-----------|------------------------------|-----------|
| | 2011 | 2010 | 2011 | 2010 |
| Net income available for common stockholders (A) | \$ 14,775 | \$ 11,730 | \$ 28,454 | \$ 22,591 |
| Weighted average outstanding shares of common stock (B) | 24,433 | 23,713 | 24,384 | 23,673 |
| Dilutive effect of stock-based awards | 1,177 | 1,245 | 1,210 | 1,224 |
| Common stock and common stock equivalents (C) | 25,610 | 24,958 | 25,594 | 24,897 |
| Earnings per share: | | | | |
| Basic (A/B) | \$ 0.60 | \$ 0.49 | \$ 1.17 | \$ 0.95 |
| Diluted (A/C) | \$ 0.58 | \$ 0.47 | \$ 1.11 | \$ 0.91 |

Employee stock options to purchase approximately 209,000 and 125,000 shares of common stock during the three and six months ended June 30, 2011, respectively, and employee stock options to purchase approximately 259,000 and 264,000 shares of common stock during the three and six months ended June 30, 2010, were outstanding but not included in the computation of diluted earnings per share because the effect on diluted earnings per share would be anti-dilutive.

Note 3: Fair Value Measurements

The Company accounts for certain assets and liabilities at fair value. The authoritative guidance for fair value measurements defines fair value as the price that would be received upon the 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.

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

Level 3: Unobservable inputs that reflect the reporting entity's own assumptions.

The Company's assets and liabilities measured at fair value on a recurring basis at June 30, 2011 are summarized below (*in thousands*):

| | Level 1 | Level 2 | Level 3 | Total |
|-------------------------------|---------|----------|---------|----------|
| Assets | | | | |
| Interest rate swap agreements | \$ | \$ 68 | \$ | \$ 68 |
| Foreign exchange contracts | \$ | \$ 723 | \$ | \$ 723 |
| Liabilities | | | | |
| Interest rate swap agreements | \$ | \$ (577) | \$ | \$ (577) |

Table of Contents

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 June 30, 2011, 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

Borrowings under the Company's revolving credit facility are carried at historical cost, adjusted for additional borrowings less principal repayments, which approximates fair value. For investment in receivable portfolios, there is no active market or observable inputs for the fair value estimation. The Company does not consider it practical to attempt to estimate the fair value of such financial instruments due to the excessive costs that would be incurred in doing so.

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. As of June 30, 2011, the Company had six interest rate swap agreements outstanding with a total notional amount of \$150.0 million. Under the swap agreements, the Company receives floating interest rate payments based on one-month reserve-adjusted LIBOR and makes interest payments based on fixed interest rates. The Company intends to continue electing the one-month reserve-adjusted LIBOR as the benchmark interest rate on the debt being hedged through its term. No credit spread was hedged. The Company designates its interest rate swap instruments as cash flow hedges.

The authoritative guidance requires companies to recognize derivative instruments as either an asset or liability measured at fair value in the statement of financial position. The effective portion of the change in fair value of the derivative instrument is recorded in other comprehensive income (OCI). The ineffective portion of the change in fair value of the derivative instrument, if any, is recognized in interest expense in the period of change. From the inception of the hedging program, the Company has determined that the hedging instruments are highly effective.

Foreign Exchange Contracts

The Company has operations in India, which exposes the Company to foreign currency exchange rate fluctuations due to transactions denominated in Indian Rupees, such as employee salaries and rent expenditures. To mitigate this risk, the Company enters into derivative financial instruments, principally forward contracts, which are designated as cash flow hedges to mitigate fluctuations in the cash payments of future forecasted transactions in Indian Rupees for up to 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 other comprehensive income or loss on the derivative into earnings. If all or a portion of the forecasted transaction was cancelled, this would render all or a portion of the cash flow hedge ineffective and the Company would reclassify the ineffective portion of the hedge into earnings. The Company generally does not experience ineffectiveness of the hedge relationship and the accompanying consolidated financial statements do not include any such gains or losses.

As of June 30, 2011, the total notional amount of the forward contracts to buy Indian rupees in exchange for U.S. dollars was \$20.5 million. All outstanding contracts qualified for hedge accounting treatment as of June 30, 2011. The Company estimates that approximately \$0.4 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 since the inception of the hedge.

The Company does not enter into derivative instruments for trading or speculative purposes.

Table of Contents

The following table summarizes the fair value of derivative instruments as recorded in the Company's consolidated statements of financial position (*in thousands*):

| | June 30, 2011 | | December 31, 2010 | |
|--|------------------------|------------|------------------------|------------|
| | Balance Sheet Location | Fair Value | Balance Sheet Location | Fair Value |
| Derivatives designated as hedging instruments: | | | | |
| Interest rate swaps | Other assets | \$ 68 | Other assets | \$ 542 |
| Interest rate swaps | Other liabilities | (577) | Other liabilities | (485) |
| Foreign exchange contracts | Other assets | 723 | Other assets | 209 |

The following tables summarize the effects of derivatives in cash flow hedging relationships on the Company's statements of income during the three and six months ended June 30, 2011 and 2010 (*in thousands*):

| | Gain or (Loss) Recognized in OCI - Effective Portion | | Location of Gain or (Loss) Reclassified from OCI into Income - Effective Portion | Gain or (Loss) Reclassified from OCI into Income - Effective Portion | | Location of Gain or (Loss) Recognized - Ineffective Portion and Amount Excluded from Effectiveness Testing | Amount of Gain or (Loss) Recognized - Ineffective Portion and Amount Excluded from Effectiveness Testing | |
|----------------------------|--|----------------------------------|--|--|----------------------------------|--|--|----------------------------------|
| | Three Months Ended June 30, 2011 | Three Months Ended June 30, 2010 | | Three Months Ended June 30, 2011 | Three Months Ended June 30, 2010 | | Three Months Ended June 30, 2011 | Three Months Ended June 30, 2010 |
| Interest rate swaps | \$ (1,072) | \$ 374 | Interest expense | \$ | \$ | Other (expense) income | \$ | \$ |
| Foreign exchange contracts | \$ 242 | \$ (381) | Salaries and employee benefits | \$ 94 | \$ 9 | Other (expense) income | \$ | \$ |
| Foreign exchange contracts | \$ 57 | \$ (78) | General and administrative expenses | \$ 20 | \$ 3 | Other (expense) income | \$ | \$ |

| | Gain or (Loss) Recognized in OCI - Effective Portion | | Location of Gain or (Loss) Reclassified from OCI into Income - Effective Portion | Gain or (Loss) Reclassified from OCI into Income - Effective Portion | | Location of Gain or (Loss) Recognized - Ineffective Portion and Amount Excluded from Effectiveness Testing | Amount of Gain or (Loss) Recognized - Ineffective Portion and Amount Excluded from Effectiveness Testing | |
|----------------------------|--|--------------------------------|--|--|--------------------------------|--|--|--------------------------------|
| | Six Months Ended June 30, 2011 | Six Months Ended June 30, 2010 | | Six Months Ended June 30, 2011 | Six Months Ended June 30, 2010 | | Six Months Ended June 30, 2011 | Six Months Ended June 30, 2010 |
| Interest rate swaps | \$ (566) | \$ 845 | Interest expense | \$ | \$ | Other (expense) income | \$ | \$ |
| Foreign exchange contracts | \$ 597 | \$ 113 | Salaries and employee benefits | \$ 167 | \$ 12 | Other (expense) income | \$ | \$ |
| Foreign exchange contracts | \$ 122 | \$ 26 | General and administrative expenses | \$ 38 | \$ 2 | Other (expense) income | \$ | \$ |

Note 5: Stock-Based Compensation

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

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,

Table of Contents

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 benefit provided under these plans is compensation subject to authoritative guidance for stock-based compensation.

In accordance with authoritative guidance for stock-based compensation, compensation expense is recognized only for those shares expected to vest, based on the Company's historical experience and future expectations. Total compensation expense during the three months ended June 30, 2011 and 2010 was \$1.8 million and \$1.4 million, respectively. Total compensation expense during the six months ended June 30, 2011 and 2010 was \$3.6 million and \$3.2 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.

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:

| | Six Months Ended June 30, | |
|---|------------------------------|---------|
| | 2011 | 2010 |
| Weighted average fair value of options granted | \$ 13.26 | \$ 9.70 |
| Risk free interest rate | 2.0% | 2.3% |
| Dividend yield | 0.0% | 0.0% |
| Volatility factor of the expected market price of the Company's common stock | 61.0% | 62.0% |
| Weighted-average expected life of options | 5 Years | 5 Years |

Unrecognized compensation cost related to stock options as of June 30, 2011, was \$4.1 million. The weighted-average remaining expense period, based on the unamortized value of these outstanding stock options, was approximately 2.1 years.

A summary of the Company's stock option activity as of June 30, 2011, and changes during the six months ended, is presented below:

| | Number of Shares | Option Price Per Share | Weighted Average Exercise Price | Aggregate Intrinsic Value (in thousands) |
|----------------------------------|---------------------|---------------------------|--|---|
| Outstanding at December 31, 2010 | 2,437,062 | \$ 0.51 | \$20.09 | \$ 10.74 |
| Granted | 209,000 | | 24.65 | 24.65 |
| Cancelled/forfeited | (21,498) | 2.89 | 17.90 | 10.34 |
| Exercised | (396,716) | 0.51 | 17.90 | 5.76 |
| Outstanding at June 30, 2011 | 2,227,848 | \$ 0.51 | \$24.65 | \$ 12.94 |
| Exercisable at June 30, 2011 | 1,240,853 | \$ 0.51 | \$24.65 | \$ 11.28 |

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

The total intrinsic value of options exercised during the six months ended June 30, 2011 and 2010 was \$9.9 million and \$3.2 million, respectively. As of June 30, 2011, the weighted-average remaining contractual life of options outstanding and options exercisable was 6.3 years and 4.7 years, respectively.

Table of Contents***Non-Vested Shares***

Under the Company's 2005 Plan, employees, officers, executives and directors of, and consultants and advisors to, the Company are eligible to receive restricted stock units and restricted stock awards. In accordance with the authoritative guidance, the fair value of these non-vested shares is equal to the closing sale price of the Company's common stock on the date of issuance. The total number of these awards expected to vest is adjusted by estimated forfeiture rates. As of June 30, 2011, 37,662 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 June 30, 2011. The remaining 616,239 non-vested shares are not performance-based, and will vest over approximately one to three years of continuous service.

A summary of the status of the Company's restricted stock units as of June 30, 2011, and changes during the six months ended, is presented below:

| | Non-Vested Shares | Weighted Average Grant Date Fair Value |
|---------------------------------|----------------------|--|
| Non-vested at December 31, 2010 | 614,370 | \$ 13.08 |
| Awarded | 281,290 | \$ 25.11 |
| Vested | (211,171) | \$ 12.87 |
| Cancelled/forfeited | (30,588) | \$ 16.56 |
| Non-vested at June 30, 2011 | 653,901 | \$ 18.16 |

Unrecognized compensation expense related to non-vested shares as of June 30, 2011, was \$8.0 million. The weighted-average remaining expense period, based on the unamortized value of these outstanding non-vested shares, was approximately 2.3 years. The fair value of restricted stock units and restricted stock awards vested during the six months ended June 30, 2011 and 2010 was \$5.6 million and \$3.5 million, respectively.

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 internal rate of return (IRR) to the cost basis of the pool, which remains unchanged throughout the life of the pool, unless there is an increase in subsequent expected cash flows. Subsequent increases in expected cash flows are generally recognized prospectively through an upward adjustment of the pool's IRR over its remaining life. Subsequent decreases in expected cash flows do not change the IRR, but are recognized as an allowance to the cost basis of the pool, and are reflected in the consolidated statements of 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

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

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.

Table of Contents

Accretable yield represents the amount of revenue the Company expects to generate over the remaining life of its existing investment in receivable portfolios based on estimated future cash flows. Total accretable yield is the difference between future estimated collections and the current carrying value of a portfolio. All estimated cash flows on portfolios where the cost basis has been fully recovered are classified as zero basis cash flows.

The following table summarizes the Company's accretable yield and an estimate of zero basis future cash flows at the beginning and end of the period presented (*in thousands*):

| | Accretable Yield | Estimate of Zero Basis Cash Flows | Total |
|--------------------------------------|-----------------------------|--|-------------------|
| Balance at December 31, 2010 | \$ 739,785 | \$ 4,274 | \$ 744,059 |
| Revenue recognized, net | (101,709) | (3,617) | (105,326) |
| Net additions to existing portfolios | 18,715 | 2,948 | 21,663 |
| Additions for current purchases | 93,098 | | 93,098 |
| Balance at March 31, 2011 | \$ 749,889 | \$ 3,605 | \$ 753,494 |
| Revenue recognized, net | (106,961) | (4,132) | (111,093) |
| Net additions to existing portfolios | 15,575 | 3,900 | 19,475 |
| Additions for current purchases | 95,532 | | 95,532 |
| Balance at June 30, 2011 | \$ 754,035 | \$ 3,373 | \$ 757,408 |

| | Accretable Yield | Estimate of Zero Basis 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 |
| Revenue recognized, net | (89,490) | (2,355) | (91,845) |
| Additions to existing portfolios | 16,481 | 1,960 | 18,441 |
| Additions for current purchases | 95,862 | | 95,862 |
| Balance at June 30, 2010 | \$ 709,050 | \$ 3,946 | \$ 712,996 |

During the three months ended June 30, 2011, the Company purchased receivable portfolios with a face value of \$3.0 billion for \$93.7 million, or a purchase cost of 3.1% of face value. The estimated future collections at acquisition for these portfolios amounted to \$185.9 million. During the six months ended June 30, 2011, the Company purchased receivable portfolios with a face value of \$5.9 billion for \$184.4 million, or a purchase cost of 3.1% of face value. The estimated future collections at acquisition for these portfolios amounted to \$364.3 million.

All collections realized after the net book value of a portfolio has been fully recovered are recorded as revenue (Zero Basis Revenue). During the three months ended June 30, 2011 and 2010, Zero Basis Revenue was approximately \$2.9 million and \$2.4 million, respectively. During the six months ended June 30, 2011 and 2010, approximately \$5.9 million and \$4.4 million were recognized as Zero Basis Revenue, respectively.

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

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

| | Three Months Ended June 30, 2011 | | | Total |
|---|----------------------------------|--------------------------|-----------------------|-------------------|
| | Accrual Basis Portfolios | Cost Recovery Portfolios | Zero Basis Portfolios | |
| Balance, beginning of period | \$ 648,820 | \$ | \$ | \$ 648,820 |
| Purchases of receivable portfolios | 93,701 | | | 93,701 |
| Gross collections ⁽¹⁾ | (190,901) | | (4,132) | (195,033) |
| Put-backs and recalls ⁽²⁾ | (798) | | | (798) |
| Revenue recognized ⁽³⁾ | 109,185 | | 2,914 | 112,099 |
| (Portfolio allowances) portfolio allowance reversals, net | (2,224) | | 1,218 | (1,006) |
| Balance, end of period | \$ 657,783 | \$ | \$ | \$ 657,783 |
| Revenue as a percentage of collections ⁽⁴⁾ | 57.2% | 0.0% | 70.5% | 57.5% |

Table of Contents

| | Three Months Ended June 30, 2010 | | | |
|---|---|-------------------------------------|----------------------------------|-------------------|
| | Accrual Basis Portfolios | Cost Recovery Portfolios | Zero Basis Portfolios | Total |
| Balance, beginning of period | \$ 549,180 | \$ 480 | \$ | \$ 549,660 |
| Purchases of receivable portfolios | 83,336 | | | 83,336 |
| Gross collections ⁽¹⁾ | (154,367) | (24) | (2,355) | (156,746) |
| Put-backs and recalls ⁽²⁾ | (1,280) | | | (1,280) |
| Revenue recognized ⁽³⁾ | 92,329 | | 2,355 | 94,684 |
| (Portfolio allowances) portfolio allowance reversals, net | (2,383) | (456) | | (2,839) |
| Balance, end of period | \$ 566,815 | \$ | \$ | \$ 566,815 |
| Revenue as a percentage of collections ⁽⁴⁾ | 59.8% | 0.0% | 100.0% | 60.4% |

| | Six Months Ended June 30, 2011 | | | |
|---|---------------------------------------|-------------------------------------|----------------------------------|-------------------|
| | Accrual Basis Portfolios | Cost Recovery Portfolios | Zero Basis Portfolios | Total |
| Balance, beginning of period | \$ 644,753 | \$ | \$ | \$ 644,753 |
| Purchases of receivable portfolios | 184,376 | | | 184,376 |
| Gross collections ⁽¹⁾ | (378,318) | | (7,749) | (386,067) |
| Put-backs and recalls ⁽²⁾ | (1,698) | | | (1,698) |
| Revenue recognized ⁽³⁾ | 216,989 | | 5,934 | 222,923 |
| (Portfolio allowances) portfolio allowance reversals, net | (8,319) | | 1,815 | (6,504) |
| Balance, end of period | \$ 657,783 | \$ | \$ | \$ 657,783 |
| Revenue as a percentage of collections ⁽⁴⁾ | 57.4% | 0.0% | 76.6% | 57.7% |

| | Six Months Ended June 30, 2010 | | | |
|---|---------------------------------------|-------------------------------------|----------------------------------|-------------------|
| | Accrual Basis Portfolios | Cost Recovery Portfolios | Zero Basis Portfolios | Total |
| Balance, beginning of period | \$ 526,366 | \$ 511 | \$ | \$ 526,877 |
| Purchases of receivable portfolios | 164,968 | | | 164,968 |
| Gross collections ⁽¹⁾ | (293,451) | (55) | (4,412) | (297,918) |
| Put-backs and recalls ⁽²⁾ | (1,864) | | | (1,864) |
| Revenue recognized ⁽³⁾ | 181,061 | | 4,411 | 185,472 |
| (Portfolio allowances) portfolio allowance reversals, net | (10,265) | (456) | 1 | (10,720) |
| Balance, end of period | \$ 566,815 | \$ | \$ | \$ 566,815 |
| Revenue as a percentage of collections ⁽⁴⁾ | 61.7% | 0.0% | 100.0% | 62.3% |

(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 portfolio purchase agreement (Put-Backs). Recalls represent accounts that are recalled by the seller in accordance with the respective portfolio purchase agreement (Recalls).

(3) Includes retained interest.

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

⁽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*):

| | Valuation Allowance | | | |
|------------------------------------|----------------------------|-------------|-------------------------|-------------|
| | Three Months Ended | | Six Months Ended | |
| | June 30, | | June 30, | |
| | 2011 | 2010 | 2011 | 2010 |
| Balance at beginning of period | \$ 104,169 | \$ 84,343 | \$ 98,671 | \$ 76,462 |
| Provision for portfolio allowances | 2,553 | 4,659 | 8,648 | 14,389 |
| Reversal of prior allowance | (1,547) | (1,820) | (2,144) | (3,669) |
| Balance at end of period | \$ 105,175 | \$ 87,182 | \$ 105,175 | \$ 87,182 |

Table of Contents

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---------------------|--------------------------------|------------|------------------------------|------------|
| | 2011 | 2010 | 2011 | 2010 |
| Legal collections | \$ 98,084 | \$ 68,049 | \$ 186,572 | \$ 125,222 |
| Collection sites | 84,576 | 66,619 | 173,117 | 132,424 |
| Collection agencies | 12,421 | 21,960 | 26,411 | 39,712 |
| Other | | 161 | 54 | 698 |
| | \$ 195,081 | \$ 156,789 | \$ 386,154 | \$ 298,056 |

Note 7: Deferred Court Costs, Net

The Company contracts with a nationwide network of attorneys that specialize in collection matters. The Company generally refers charged-off accounts to its contracted attorneys when it believes the related debtor has sufficient assets to repay the indebtedness and has, to date, been unwilling to pay. In connection with the Company's agreement with the contracted attorneys, it advances certain out-of-pocket court costs (Deferred Court Costs). The Company capitalizes Deferred Court Costs in its consolidated financial statements and provides a reserve for those costs that it believes will ultimately be uncollectible. The Company determines the reserve based on its analysis of court costs that have been advanced and those that have been recovered. 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*):

| | June 30, 2011 | December 31, 2010 |
|-----------------------|------------------|----------------------|
| Court costs advanced | \$ 213,997 | \$ 194,612 |
| Court costs recovered | (55,009) | (49,215) |
| Court costs reserve | (122,920) | (113,239) |
| | \$ 36,068 | \$ 32,158 |

Note 8: Other Assets

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

| | June 30, 2011 | December 31, 2010 |
|--|------------------|----------------------|
| Debt issuance costs, net of amortization | \$ 5,198 | \$ 5,286 |
| Prepaid expenses | 5,299 | 5,052 |
| Security deposit - building lease | 1,459 | 1,370 |
| Deferred compensation assets | 781 | 776 |
| Other | 990 | 817 |
| | \$ 13,727 | \$ 13,301 |

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*):

| | June 30, 2011 | December 31, 2010 |
|-------------------------------------|--------------------------|------------------------------|
| Revolving credit facility | \$ 295,000 | \$ 327,000 |
| Senior secured notes | 75,000 | 50,000 |
| Capital lease obligations and other | 8,172 | 8,264 |
| | \$ 378,172 | \$ 385,264 |

Table of Contents

Revolving Credit Facility

On February 11, 2011, the Company obtained an additional \$50.0 million in commitments from lenders and exercised a portion of its \$100.0 million accordion feature, thereby increasing its revolving credit facility to \$410.5 million from \$360.5 million.

Loan fees and other loan costs associated with the above transactions amounted to approximately \$0.5 million during the six months ended June 30, 2011. These costs are included in other assets in the Company's consolidated statements of financial condition and are being amortized over the term of the agreement.

Provisions of the 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;

A borrowing base equal to (1) the lesser of (i) 30% of eligible estimated remaining collections and (ii) the product of the net book value of all receivable portfolios acquired on or after January 1, 2005 multiplied by 95%, minus (2) the aggregate principal amount outstanding in respect of the senior secured notes;

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 of the Company's common stock, subject to compliance with certain covenants and available borrowing capacity;

A change of control definition which excludes acquisitions of stock by Red Mountain Capital Partners LLC, JCF FPK I LP and their respective affiliates of up to 50% of the outstanding shares of the Company's voting stock;

Events of default which, upon occurrence, may permit the lenders to terminate the revolving credit facility and declare all amounts outstanding to be immediately due and payable;

An annual capital expenditure maximum of \$12.5 million;

An annual rental expense maximum of \$12.5 million;

An outstanding capital lease maximum of \$12.5 million;

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

An acquisition limit of \$100.0 million; and

Collateralization by all assets of the Company.

At June 30, 2011, of the \$410.5 million borrowing capacity, the outstanding balance on the revolving credit facility was \$295.0 million, which bore a weighted average interest rate of 4.47% and 4.54% for the three and six months ended June 30, 2011, respectively. The aggregate borrowing base was \$349.6 million, of which \$54.6 million was available for future borrowings.

Subject to compliance with the revolving credit facility, the Company is authorized by its Board of Directors to repurchase up to \$50.0 million of its common stock.

Senior Secured Notes

On February 10, 2011, the Company issued an additional \$25.0 million in senior secured notes (2011 Senior Secured Notes) to certain affiliates of Prudential Capital Group through an amended and restated note purchase agreement. These 2011 Senior Secured Notes bear an annual interest rate of 7.375% and mature in 2018 with principal amortization beginning in May 2013. Interest on the 2011 Senior Secured Notes is payable quarterly on February 10, May 10, August 10 and November 10 of each year. Principal payments of \$1.25 million are payable on May 10, 2013 and on each August 10, November 10, February 10 and May 10 thereafter. Loan fees and other loan costs associated with the above transactions were approximately \$0.4 million during the six months ended June 30, 2011. These costs are included in other assets in the Company's consolidated statements of financial condition and are being amortized over the term of the agreement.

Table of Contents

In addition to the above 2011 Senior Secured Notes, the Company had \$50.0 million outstanding in senior secured notes (the 2010 Senior Secured Notes) payable to certain affiliates of Prudential Capital Group. The 2010 Senior Secured Notes bear an annual interest rate of 7.75% and mature in 2017 with principal amortization beginning in December 2012. Interest on the 2010 Senior Secured Notes is payable quarterly on March 17, June 17, September 17 and December 17 of each year. Principal payments of \$2.5 million are payable on December 17, 2012 and on each March 17, June 17, September 17 and December 17 thereafter.

The 2010 and 2011 Senior Secured Notes are guaranteed in full by certain of the Company's subsidiaries and are collateralized by all assets of the Company. The 2010 and 2011 Senior Secured Notes may be accelerated and become automatically and immediately due and payable upon certain events of default, including certain events related to insolvency, bankruptcy or liquidation. Additionally, the 2010 and 2011 Senior Secured Notes may be accelerated at the election of the holder or holders of a majority in principal amount of the 2010 and 2011 Senior Secured Notes upon certain events of default by the Company, including breach of affirmative covenants regarding guarantors, collateral, most favored lender treatment or minimum revolving credit facility commitment or the breach of any negative covenant. If the Company prepays the 2010 or 2011 Senior Secured Notes at any time for any reason, payment will be at the higher of par or the present value of the remaining scheduled payments of principal and interest on the portion being prepaid. The discount rate used to determine the present value will be 50 basis points over the then current Treasury Rate corresponding to the remaining average life. The covenants are substantially similar to those in the revolving credit facility. Prudential Capital Group and the administrative agent for the lenders of the revolving credit facility have an inter-creditor agreement related to collateral, actionable default, powers and duties and remedies, among other topics.

Pursuant to Securities and Exchange Commission rules, the Company has concluded that separate financial statements or condensed consolidating financial information are not required, as the guarantees related to the senior secured notes are full and unconditional and joint and severable, and the subsidiary of the parent company other than the subsidiary guarantors is minor.

Capital Lease Obligations

The Company has capital lease obligations primarily for certain computer equipment. As of June 30, 2011, the Company's combined obligations for these computer equipment leases were approximately \$7.4 million. These lease obligations require monthly or quarterly payments through June 2016 and have implicit interest rates that range from zero to approximately 7.7%.

Note 10: Income Taxes

The Company recorded an income tax provision of \$9.5 million, reflecting an effective rate of 39.1% of pretax income during the three months ended June 30, 2011. The effective tax rate for the three months ended June 30, 2011 primarily consisted of a provision for federal income taxes of 32.5% (which is net of a benefit for state taxes of 2.5%), a blended provision for state taxes of 7.0%, and a net benefit for permanent book versus tax differences of 0.4%. The Company recorded an income tax provision of \$6.7 million, reflecting an effective rate of 36.5% of pretax income during the three months ended June 30, 2010. The effective tax rate for the three months ended June 30, 2010, primarily consisted 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%, a benefit for permanent book versus tax differences of 1.5%, and a benefit for an Internal Revenue Service (IRS) refund of 1.7%.

The Company recorded an income tax provision of \$18.1 million, reflecting an effective rate of 38.9% of pretax income during the six months ended June 30, 2011. The effective tax rate for the six months ended June 30, 2011, primarily consisted of a provision for federal income taxes of 32.5% (which is net of a benefit for state taxes of 2.5%), a provision for state taxes of 7.0% and a benefit for permanent book versus tax differences of 0.6%. The Company recorded an income tax provision of \$13.2 million, reflecting an effective rate of 36.9% of pretax income during the six months ended June 30, 2010. The effective tax rate for the six months ended June 30, 2010, primarily consisted 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%, a benefit for permanent book versus tax differences of 1.9%, and a benefit for an IRS refund of 0.9%.

The increase in the overall effective tax rates from three and six months ended June 30, 2010 to June 30, 2011 was primarily attributable to an increase in the effective tax rate in India. The Company's operations in India benefited from a tax holiday, which expired on March 31, 2011. Accounting guidance requires the impact of the expiration of the tax holiday to be spread throughout the year ended December 31, 2011. Accordingly, the impact of the expiration was reflected in the effective tax rates for three and six months ended June 30, 2011.

Table of Contents

As of June 30, 2011, the Company had a gross unrecognized tax benefit of \$1.2 million that, if recognized, would result in a net tax benefit of approximately \$0.8 million and would have a positive effect on the Company's effective tax rate. During the three and six months ended June 30, 2011, there were no material changes to the unrecognized tax benefit.

For the three and six months ended June 30, 2011, 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 and six months ended June 30, 2011, were approximately \$0.8 million and \$2.8 million, respectively. Such undistributed earnings are considered permanently reinvested.

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*):

| | Six Months Ended June 30, 2011 | |
|----------------------------|---|----------|
| | Cost | % |
| Seller 1 | \$ 46,545 | 25.2% |
| Seller 2 | 44,424 | 24.1% |
| Seller 3 | 18,428 | 10.0% |
| Seller 4 | 13,199 | 7.2% |
| Seller 5 | 10,006 | 5.4% |
| Other sellers | 51,774 | 28.1% |
| | \$ 184,376 | 100.0% |
| Adjustments ⁽¹⁾ | (206) | |
| Purchases, net | \$ 184,170 | |

⁽¹⁾ Adjusted for Put-backs and Recalls.

Note 12: Commitments and Contingencies**Litigation**

The Company is involved in disputes and legal actions from time to time in the ordinary course of business. The Company, along with others in its industry, is routinely subject to legal actions based on the Fair Debt Collection Practices Act, or FDCPA, comparable state statutes, the Telephone Consumer Protection Act, state and federal unfair competition statutes, and common law causes of action. The violations of law alleged in these actions often include claims that the Company lacks specified licenses to conduct its business, attempts to collect debts on which the statute of limitations has run, has made inaccurate assertions of fact in support of its collection actions, and / or has acted improperly in connection with its efforts to contact consumers. These cases are frequently styled as putative class actions.

On May 19, 2008, an action captioned *Brent v. Midland Credit Management, Inc et. al* was filed in the United States District Court for the Northern District of Ohio Western Division, in which the plaintiff, Andrea Brent, has filed a class action counter-claim against the Company's subsidiaries Midland Credit Management, Inc. and Midland Funding LLC (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. On November 4, 2010, the court granted in part,

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

and denied in part, plaintiff's motion for class certification of a statewide class. On February 10, 2011, the parties reached an agreement in principal to settle this lawsuit, as well as two other pending lawsuits in the Northern District of Ohio - *Franklin v. Midland Funding LLC* and *Vassalle v. Midland Funding LLC*, on a national class basis, subject to entering into a definitive settlement agreement and obtaining court approval after notice to the class. On March 9, 2011, the parties entered into a final settlement agreement, which was preliminarily approved by the court on March 11, 2011. On July 11, 2011, the court held a final approval hearing with respect to the settlement, and the parties are awaiting the court's decision.

Table of Contents

In addition, from time to time, the Company is subject to various governmental litigation, investigations, inquiries and other actions relating to its collection activities.

On March 28, 2011, the Office of the Attorney General of the State of Minnesota filed a motion in the United States District Court for the Northern District of Ohio, seeking clarification of an order granting preliminary injunction against parallel litigation (the Order) issued by that court in connection with the case captioned *Brent v. Midland Credit Management, Inc et. al.* The Minnesota Attorney General sought a ruling clarifying that the Order did not prevent it from filing a complaint against the Company in Minnesota state court concerning its debt collection practices and related topics. On May 17, 2011, the District Court in Ohio ruled that the Order did not apply to the State of Minnesota. On May 19, 2011, the State of Minnesota filed a complaint against the Company in Hennepin County District Court alleging, among other things, contempt of court and violations of Minnesota's Collection Agencies Act based on the Company's debt collection and related practices in the State of Minnesota. The complaint seeks civil penalties, disgorgement of profits, injunctive relief, and attorney's fees. The Company intends to vigorously defend the allegations set forth in the complaint.

On January 12, 2011, the Office of the Attorney General of the State of Texas issued a civil investigative demand to the Company to produce documents in an investigation of its methods of collecting consumer debts in the State of Texas and related topics. On July 8, 2011, the Texas Attorney General filed a petition in the District Court of Harris County, Texas against the Company alleging violations of the Texas Deceptive Trade Practices Act and the Texas Debt Collection Act, based on the Company's debt collection and related practices in the State of Texas. The complaint seeks civil penalties, disgorgement of profits, injunctive relief and attorney's fees. The Company intends to vigorously defend the allegations set forth in the complaint. On May 2, 2011, the Department of Justice of the State of Oregon issued an investigative demand to the Company to produce documents and answer interrogatories concerning the Company's debt collection practices in the State of Oregon and related topics. The Company has and intends to continue to cooperate fully with the State of Oregon in response to this subpoena, subject to applicable law. In addition, on June 28, 2011, the Office of the Attorney General of the State of New York issued a subpoena to the Company to produce documents concerning the Company's debt collection practices in the State of New York and related topics. The Company intends to cooperate fully with the State of New York in response to this subpoena, subject to applicable law.

In certain legal proceedings, the Company may have recourse to insurance or third party contractual indemnities to cover all or portions of its litigation expenses, judgments or settlements. In accordance with authoritative guidance, the Company has recorded loss contingencies in its financial statements only for matters in which losses are probable and can be reasonably estimated.

Purchase Commitments

In the normal course of business, the Company enters into forward flow purchase agreements and other purchase commitment agreements. As of June 30, 2011, the Company has entered into agreements to purchase receivable portfolios with a face value of approximately \$2.6 billion for a purchase price of approximately \$70.0 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.

Table of Contents

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

This Quarterly Report on Form 10-Q contains forward-looking statements within the meaning of the securities laws. The words believe, expect, anticipate, estimate, project, intend, plan, will, may and similar expressions often characterize forward-looking statements. These statements may include, but are not limited to, projections of collections, revenues, income or loss, estimates of capital expenditures, plans for future operations, products or services and financing needs or plans, as well as assumptions relating to these matters. Although we believe that the expectations reflected in these forward-looking statements are reasonable, we caution that these expectations or predictions may not prove to be correct or we may not achieve the financial results, savings or other benefits anticipated in the forward-looking statements. These forward-looking statements are necessarily estimates reflecting the best judgment of our senior management and involve a number of risks and uncertainties, some of which may be beyond our control or cannot be predicted or quantified, that could cause actual results to differ materially from those suggested by the forward-looking statements. Many factors, including but not limited to those set forth in this Quarterly Report on Form 10-Q under Part II, Item 1A. Risk Factors, could cause our actual results, performance, achievements or industry results to be very different from the results, performance, achievements or industry results expressed or implied by these forward-looking statements. Our business, financial condition or results of operations could also be materially and adversely affected by other factors besides those listed. Forward-looking statements speak only as of the date the statements were made. We do not undertake any obligation to update or revise any forward-looking statements to reflect new information or future events, or for any other reason, even if experience or future events make it clear that any expected results expressed or implied by these forward-looking statements will not be realized. In addition, it is generally our policy not to make any specific projections as to future earnings, and we do not endorse projections regarding future performance that may be made by third parties.

Introduction

We are a leader in consumer debt buying and recovery. We purchase portfolios of defaulted consumer receivables at deep discounts to face value based on robust, account-level valuation methods, and employ a suite of proprietary statistical and behavioral models when building account collection strategies. We use a variety of operational channels to maximize our collections from the portfolios that we purchase, including seeking to partner with individuals as they repay their obligations and work toward financial recovery. In addition, we provide bankruptcy support services to some of the largest companies in the financial services industry through our wholly owned subsidiary, Ascension Capital Group, Inc. (Ascension).

While seasonality does not have a material impact on our business, collections are generally strongest in our first calendar quarter, slower in the second and third calendar quarters, and slowest in the fourth calendar quarter. Relatively higher collections in the first quarter could result in a lower cost-to-collect ratio compared to the other quarters, as our fixed costs would be constant and applied against a larger collection base. The seasonal impact on our business may be influenced by our purchasing levels, the types of portfolios we purchase, and our operating strategies.

Collection seasonality can also impact our revenue recognition rate. Generally, revenue for each pool group declines steadily over time, whereas collections can fluctuate from quarter to quarter based on seasonality, as described above. In quarters with lower collections (like the fourth calendar quarter), revenue as a percentage of collections can be higher than in quarters with higher collections (like the first calendar quarter).

In addition, seasonality could have an impact on the relative level of quarterly earnings. In quarters with stronger collections, total costs are higher, as a result of the additional efforts required to generate those collections. Since revenue for each pool group declines steadily over time, in quarters with stronger collections and higher costs (like the first calendar quarter), all else being equal, earnings could be lower than in quarters with slower collections and lower costs (like the fourth calendar quarter). Additionally, in quarters where a greater percentage of collections come from our legal and agency outsourcing channels, cost to collect will be higher than if there were more collections from our internal collection sites.

Market Overview

While there has been some improvement in macroeconomic indicators during the last six months, including stronger manufacturing and corporate profit metrics, a broad economic recovery has yet to fully materialize for the U.S. consumer. Minimal job growth, uncertainty over state and federal taxes and limited credit availability continue to challenge U.S. consumers, as demonstrated by weak consumer spending and volatile but rising consumer confidence levels. Within the credit card space, we continue to see mixed signals. Although charge-off rates remain high, delinquency levels have improved at a rate that may indicate a fundamental improvement in consumer financial strength. However, related measures, like personal bankruptcies and home foreclosures, remain elevated and indicate continued near-term pressure on the average consumer.

Table of Contents

Despite this macroeconomic uncertainty through the second quarter of 2011, most of our internal collection metrics were consistent with, or better than, what we observed during the same period in 2009 and 2010. To illustrate, payer rates and average payment size, adjusted for changes in the mix of settlements-in-full versus payment plans, remained constant. However, more of our consumers are opting to settle their debt obligations through payment plans as opposed to one-time settlements. Settlements made through payment plans impact our recoveries in two ways. First, the delay in cash flows from payments received over extended time periods may result in a provision for portfolio allowance. When a long-term payment stream (as compared to a one-time payment of the same amount) is discounted using a pool group's internal rate of return, or IRR, the net present value is lower. In other words, despite the absolute value of total cash received being identical in both scenarios, accounting for the timing of cash flows in a payment plan yields a lower net present value which, in turn, can result in a provision for portfolio allowance. Second, payment plans inherently contain the possibility of consumers failing to complete all scheduled payments, which we term a broken payer.

The rate at which consumers are honoring their obligations and completing their payment plans has continued to increase over the last twelve months. We believe this is the result of two factors: our commitment to partner effectively with consumers during their recovery process and the strength of our analytic platform, which allows us to make accurate and timely decisions about how best to maximize our portfolio returns. Nevertheless, payment plans may still produce broken payers that fail to fulfill all scheduled payments. 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 do so, we experience a shortfall in recoveries as compared to our initial forecasts. Please refer to Management's Discussion and Analysis Revenue below for a more detailed explanation of the provision for portfolio allowances.

Throughout the credit crisis, we strategically invested in receivable portfolio as credit card charge-offs increased to historic levels and we believe that some of our competitors were (i) caught owning receivables with low yields as a result of purchasing certain portfolios at elevated pricing levels between 2005 and 2008 and (ii) faced with constrained access to capital to fund portfolio purchases due to depressed capital markets. These dynamics resulted in a supply-demand gap that dramatically reduced pricing of available portfolios, beginning in early 2009. For example, prices for freshly charged-off assets (i.e., receivables sold within thirty days of charge-off by the credit issuers) declined from a range of 8% - 13% in 2008 to a range of 5% - 9% in 2009 and early 2010. Similar price reductions were apparent across a broad range of defaulted consumer receivable asset classes (including credit cards and other consumer loans), balance ranges and ages. After such a dramatic decline, pricing has started to increase, but remains favorable when compared to 2005 through 2008 levels. In response to the price declines in 2009 and early 2010, some issuers opted not to sell all of their receivable portfolio and instead, pursued internal liquidation strategies or partnered with third party agencies. We believe that as pricing increases, these issuers will sell a greater percentage of their charged-off portfolios.

Purchases and Collections**Purchases by Type**

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|----------|------------------------------|-----------|
| | 2011 | 2010 | 2011 | 2010 |
| Credit card | \$88,257 | \$79,911 | \$176,248 | \$161,542 |
| Telecom | 5,248 | 3,426 | 6,484 | 3,426 |
| Consumer bankruptcy receivables ⁽¹⁾ | 196 | | 1,644 | |
| | \$93,701 | \$83,337 | \$184,376 | \$164,968 |

⁽¹⁾ Represents portfolio receivables subject to Chapter 13 and Chapter 7 bankruptcy proceedings acquired from issuers.

During the three months ended June 30, 2011, we invested \$93.7 million in receivable portfolios, primarily for charged-off credit card portfolios with face values aggregating \$3.0 billion, for an average purchase price of 3.1% of the face value of the purchased receivables. This is a \$10.4 million increase, or 12.5%, in the amount invested, compared to the \$83.3 million invested during the three months ended June 30, 2010, to acquire receivable portfolios, primarily consisting of charged-off credit card portfolios, with a face value aggregating \$2.2 billion for an average purchase price of 3.7% of the face value of the purchased receivables.

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

During the six months ended June 30, 2011, we invested \$184.4 million in receivable portfolios, primarily for charged-off credit card portfolios with face values aggregating \$5.9 billion, for an average purchase price of 3.1% of the face value of the purchased receivables. This is a \$19.4 million increase, or 11.8%, in the amount invested, compared to the \$165.0 million invested during the six months ended June 30, 2010, to acquire receivable portfolios, primarily consisting of charged-off credit card portfolios, with a face value aggregating \$4.4 billion for an average purchase price of 3.8% of the face value of the purchased receivables.

Table of Contents

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

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|---------------------|--------------------------------|------------|------------------------------|------------|
| | 2011 | 2010 | 2011 | 2010 |
| Legal collections | \$ 98,084 | \$ 68,049 | \$ 186,572 | \$ 125,222 |
| Collection sites | 84,576 | 66,619 | 173,117 | 132,424 |
| Collection agencies | 12,421 | 21,960 | 26,411 | 39,712 |
| Other | | 161 | 54 | 698 |
| | \$ 195,081 | \$ 156,789 | \$ 386,154 | \$ 298,056 |

Gross collections increased \$38.3 million, or 24.4%, to \$195.1 million during the three months ended June 30, 2011, from \$156.8 million during the three months ended June 30, 2010. Gross collections increased \$88.1 million, or 29.6%, to \$386.2 million during the six months ended June 30, 2011, from \$298.1 million during the six months ended June 30, 2010.

Results of Operations

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

| | Three Months Ended June 30, | | 2010 | |
|---|-----------------------------|---------------|---------------|---------------|
| | 2011 | | 2010 | |
| Revenue | | | | |
| Revenue from receivable portfolios, net | \$ 111,093 | 95.9% | \$ 91,845 | 95.4% |
| Servicing fees and related revenue | 4,737 | 4.1% | 4,386 | 4.6% |
| Total revenue | 115,830 | 100.0% | 96,231 | 100.0% |
| Operating expenses | | | | |
| Salaries and employee benefits | 20,212 | 17.4% | 16,484 | 17.1% |
| Stock-based compensation expense | 1,810 | 1.6% | 1,446 | 1.5% |
| Cost of legal collections | 40,686 | 35.1% | 31,235 | 32.4% |
| Other operating expenses | 9,191 | 7.9% | 9,027 | 9.4% |
| Collection agency commissions | 3,596 | 3.1% | 6,413 | 6.7% |
| General and administrative expenses | 9,623 | 8.3% | 7,425 | 7.7% |
| Depreciation and amortization | 1,105 | 1.0% | 752 | 0.8% |
| Total operating expenses | 86,223 | 74.4% | 72,782 | 75.6% |
| Income from operations | 29,607 | 25.6% | 23,449 | 24.4% |
| Other (expense) income | | | | |
| Interest expense | (5,369) | (4.6)% | (4,880) | (5.1)% |
| Other income (expense) | 23 | 0.0% | (90) | (0.1)% |

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

| | | | | |
|-----------------------------------|------------------|--------------|------------------|--------------|
| Total other expense | (5,346) | (4.6)% | (4,970) | (5.2)% |
| Income before income taxes | 24,261 | 21.0% | 18,479 | 19.2% |
| Provision for income taxes | (9,486) | (8.2)% | (6,749) | (7.0)% |
| Net income | \$ 14,775 | 12.8% | \$ 11,730 | 12.2% |

Table of Contents

| | Six Months Ended June 30, | | | |
|---|---------------------------|---------------|------------------|---------------|
| | 2011 | | 2010 | |
| Revenue | | | | |
| Revenue from receivable portfolios, net | \$ 216,419 | 95.7% | \$ 174,752 | 95.2% |
| Servicing fees and related revenue | 9,714 | 4.3% | 8,817 | 4.8% |
| Total revenue | 226,133 | 100.0% | 183,569 | 100.0% |
| Operating expenses | | | | |
| Salaries and employee benefits | 39,252 | 17.4% | 31,969 | 17.4% |
| Stock-based compensation expense | 3,575 | 1.6% | 3,207 | 1.7% |
| Cost of legal collections | 77,195 | 34.1% | 57,668 | 31.4% |
| Other operating expenses | 19,287 | 8.5% | 18,141 | 9.9% |
| Collection agency commissions | 7,510 | 3.3% | 11,709 | 6.4% |
| General and administrative expenses | 19,792 | 8.7% | 14,304 | 7.8% |
| Depreciation and amortization | 2,158 | 1.0% | 1,425 | 0.8% |
| Total operating expenses | 168,769 | 74.6% | 138,423 | 75.4% |
| Income from operations | 57,364 | 25.4% | 45,146 | 24.6% |
| Other (expense) income | | | | |
| Interest expense | (10,962) | (4.9)% | (9,418) | (5.2)% |
| Other income | 139 | 0.1% | 102 | 0.1% |
| Total other expense | (10,823) | (4.8)% | (9,316) | (5.1)% |
| Income before income taxes | 46,541 | 20.6% | 35,830 | 19.5% |
| Provision for income taxes | (18,087) | (8.0)% | (13,239) | (7.2)% |
| Net income | \$ 28,454 | 12.6% | \$ 22,591 | 12.3% |

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 June 30, 2011 | | | | | As of June 30, 2011 | |
|--------------------|----------------------------------|---------------------------------|---|---|-------------------------------------|-------------------------|----------------|
| | Collections ⁽¹⁾ | Gross Revenue ⁽²⁾ | Revenue Recognition Rate ⁽³⁾ | Net (Portfolio Allowance) Reversal | Revenue % of Total Revenue | Unamortized Balances | Monthly IRR |
| ZBA ⁽⁴⁾ | \$ 4,132 | \$ 2,914 | 70.5% | \$ 1,218 | 2.6% | \$ | |
| 2004 | 359 | 16 | 4.5% | 102 | 0.0% | | 0.0% |
| 2005 | 5,080 | 2,201 | 43.3% | (54) | 2.0% | 11,050 | 5.6% |
| 2006 | 5,048 | 3,674 | 72.8% | (1,205) | 3.3% | 22,661 | 5.1% |
| 2007 | 12,170 | 7,333 | 60.3% | (381) | 6.5% | 26,710 | 6.9% |
| 2008 | 23,760 | 13,132 | 55.3% | (686) | 11.7% | 75,471 | 5.3% |
| 2009 | 44,107 | 27,426 | 62.2% | | 24.5% | 110,723 | 7.5% |
| 2010 | 78,271 | 42,872 | 54.8% | | 38.2% | 240,543 | 5.4% |
| 2011 | 22,106 | 12,531 | 56.7% | | 11.2% | 170,625 | 3.7% |
| Total | \$ 195,033 | \$ 112,099 | 57.5% | \$ (1,006) | 100.0% | \$ 657,783 | 5.3% |

| | Three Months Ended June 30, 2010 | | | | | As of June 30, 2010 | |
|--------------------|----------------------------------|---------------------------------|---|---|-------------------------------------|-------------------------|----------------|
| | Collections ⁽¹⁾ | Gross Revenue ⁽²⁾ | Revenue Recognition Rate ⁽³⁾ | Net (Portfolio Allowance) Reversal | Revenue % of Total Revenue | Unamortized Balances | Monthly IRR |
| ZBA ⁽⁴⁾ | \$ 2,355 | \$ 2,355 | 100.0% | \$ | 2.5% | \$ | |
| 2002 | 164 | | 0.0% | 164 | 0.0% | | |
| 2003 | 1,247 | 218 | 17.5% | 668 | 0.2% | 26 | 30.3% |
| 2004 | 2,209 | 826 | 37.4% | 469 | 0.9% | 2,787 | 7.5% |
| 2005 | 7,364 | 4,324 | 58.7% | (411) | 4.6% | 23,863 | 5.6% |
| 2006 | 7,122 | 5,691 | 79.9% | (942) | 6.0% | 35,243 | 5.1% |
| 2007 | 19,390 | 11,617 | 59.9% | (977) | 12.3% | 50,741 | 6.8% |
| 2008 | 34,324 | 20,770 | 60.5% | (1,810) | 21.9% | 127,313 | 5.1% |
| 2009 | 53,321 | 33,887 | 63.6% | | 35.8% | 181,270 | 5.8% |
| 2010 | 29,250 | 14,996 | 51.3% | | 15.8% | 145,572 | 4.3% |
| Total | \$ 156,746 | \$ 94,684 | 60.4% | \$ (2,839) | 100.0% | \$ 566,815 | 6.0% |

| | Six Months Ended June 30, 2011 | | | | | As of June 30, 2011 | |
|--------------------|--------------------------------|---------------------------------|---|---|-------------------------------------|-------------------------|----------------|
| | Collections ⁽¹⁾ | Gross Revenue ⁽²⁾ | Revenue Recognition Rate ⁽³⁾ | Net (Portfolio Allowance) Reversal | Revenue % of Total Revenue | Unamortized Balances | Monthly IRR |
| ZBA ⁽⁴⁾ | \$ 7,749 | \$ 5,934 | 76.6% | \$ 1,815 | 2.7% | \$ | |
| 2004 | 1,462 | 196 | 13.4% | 102 | 0.0% | | 0.0% |
| 2005 | 10,551 | 4,942 | 46.8% | (657) | 2.2% | 11,050 | 5.6% |
| 2006 | 10,361 | 7,819 | 75.5% | (3,686) | 3.5% | 22,661 | 5.1% |
| 2007 | 25,628 | 16,051 | 62.6% | (1,844) | 7.2% | 26,710 | 6.9% |
| 2008 | 50,185 | 28,113 | 56.0% | (2,234) | 12.6% | 75,471 | 5.3% |
| 2009 | 93,773 | 56,736 | 60.5% | | 25.5% | 110,723 | 7.5% |

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

| | | | | | | | |
|-------|------------|------------|-------|------------|--------|------------|------|
| 2010 | 155,990 | 85,991 | 55.1% | | 38.6% | 240,543 | 5.4% |
| 2011 | 30,368 | 17,141 | 56.4% | | 7.7% | 170,625 | 3.7% |
| Total | \$ 386,067 | \$ 222,923 | 57.7% | \$ (6,504) | 100.0% | \$ 657,783 | 5.3% |

Table of Contents

| | Collections(1) | Collections(1) | Collections(1) | Collections(1) | Collections(1) | Collections(1) | Collections(1) |
|--------------------|--------------------------------|---------------------|-----------------------------------|---|-------------------------------------|-------------------------|------------------------|
| | Six Months Ended June 30, 2010 | | | | | | As of June 30, 2010 |
| | Collections(1) | Gross Revenue(2) | Revenue Recognition Rate(3) | Net Reversal (Portfolio Allowance) | Revenue % of Total Revenue | Unamortized Balances | Monthly IRR |
| ZBA ⁽⁴⁾ | \$ 4,412 | \$ 4,411 | 100.0% | \$ 1 | 2.4% | \$ | |
| 2002 | 417 | | 0.0% | 418 | 0.0% | | |
| 2003 | 2,724 | 751 | 27.6% | 1,371 | 0.5% | 26 | 30.3% |
| 2004 | 4,349 | 1,905 | 43.8% | 636 | 1.0% | 2,787 | 7.5% |
| 2005 | 15,027 | 9,268 | 61.7% | (1,182) | 5.0% | 23,863 | 5.6% |
| 2006 | 14,547 | 11,954 | 82.2% | (5,264) | 6.4% | 35,243 | 5.1% |
| 2007 | 40,278 | 24,160 | 60.0% | (1,869) | 13.0% | 50,741 | 6.8% |
| 2008 | 69,465 | 43,841 | 63.1% | (4,831) | 23.6% | 127,313 | 5.1% |
| 2009 | 109,108 | 70,888 | 65.0% | | 38.2% | 181,270 | 5.8% |
| 2010 | 37,591 | 18,294 | 48.7% | | 9.9% | 145,572 | 4.3% |
| Total | \$ 297,918 | \$ 185,472 | 62.3% | \$ (10,720) | 100.0% | \$ 566,815 | 6.0% |

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

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

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

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

Total revenue was \$115.8 million for the three months ended June 30, 2011, an increase of \$19.6 million, or 20.4%, compared to total revenue of \$96.2 million for the three months ended June 30, 2010. Portfolio revenue was \$111.1 million for the three months ended June 30, 2011, an increase of \$19.3 million, or 21.0%, compared to portfolio revenue of \$91.8 million for the three months ended June 30, 2010.

Total revenue was \$226.1 million for the six months ended June 30, 2011, an increase of \$42.6 million, or 23.2%, compared to total revenue of \$183.6 million for the six months ended June 30, 2010. Portfolio revenue was \$216.4 million for the six months ended June 30, 2011, an increase of \$41.7 million, or 23.8%, compared to portfolio revenue of \$174.7 million for the three months ended June 30, 2010.

The increase in portfolio revenue during the three and six months ended June 30, 2011, was primarily the result of additional accretion revenue associated with a higher portfolio balance during the three and six months ended June 30, 2011 compared to the three and six months ended June 30, 2010. During the three months ended June 30, 2011, we recorded a net portfolio allowance provision of \$1.0 million, compared to a net portfolio allowance provision of \$2.8 million in the same period of the prior year. During the six months ended June 30, 2011, we recorded a net portfolio allowance provision of \$6.5 million, compared to a net portfolio allowance provision of \$10.7 million in the same period of the prior year. The net provision for portfolio allowances for the three and six months ended June 30, 2011 and 2010 was 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 2005 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 \$4.5 million for the three months ended June 30, 2011, slightly higher than the revenue of \$4.4 million for the three months ended June 30, 2010. Revenue associated with bankruptcy servicing fees earned from Ascension was \$9.4 million for the six months ended June 30, 2011, an increase of \$0.6 million, or 6.6%, compared to revenue of \$8.8

million for the three months ended June 30, 2010.

Operating Expenses

Total operating expenses were \$86.2 million for the three months ended June 30, 2011, an increase of \$13.4 million, or 18.5%, compared to total operating expenses of \$72.8 million for the three months ended June 30, 2010.

Total operating expenses were \$168.8 million for the six months ended June 30, 2011, an increase of \$30.4 million, or 21.9%, compared to total operating expenses of \$138.4 million for the six months ended June 30, 2010.

Operating expenses are explained in more detail as follows:

Table of Contents**Salaries and employee benefits**

Total salaries and employee benefits increased \$3.7 million, or 22.6%, to \$20.2 million during the three months ended June 30, 2011, from \$16.5 million during the three months ended June 30, 2010. Total salaries and employee benefits increased \$7.3 million, or 22.8%, to \$39.3 million during the six months ended June 30, 2011, from \$32.0 million during the six months ended June 30, 2010. The increase was primarily the result of increases in headcount and related compensation expenses to support our growth, including growth in our internal legal channel. Salaries and employee benefits related to our internal legal channel were approximately \$0.6 million and \$0.8 million for the three and six months ended June 30, 2011, respectively.

Stock-based compensation expenses

Stock-based compensation increased \$0.4 million, or 25.2%, to \$1.8 million during the three months ended June 30, 2011, from \$1.4 million during the three months ended June 30, 2010. This increase was primarily attributable to higher fair value of equity awards granted in recent periods due to an increase in our stock price.

Stock-based compensation increased \$0.4 million, or 11.5%, to \$3.6 million during the six months ended June 30, 2011, from \$3.2 million during the six months ended June 30, 2010. This increase was primarily attributable to 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 increased \$9.5 million, or 30.3%, to \$40.7 million during the three months ended June 30, 2011, compared to \$31.2 million during the three months ended June 30, 2010. These costs represent contingent fees paid to our nationwide network of attorneys and costs of litigation. The increase in the cost of legal collections was primarily the result of an increase of \$7.7 million in contingent fees paid to our network of attorneys related to an increase of \$30.1 million, or 44.1%, in gross collections through our legal channel in addition to an increase of \$1.9 million in upfront litigation costs expensed during the period. Gross legal collections amounted to \$98.1 million during the three months ended June 30, 2011, up from \$68.0 million collected during the three months ended June 30, 2010. The cost of legal collections decreased as a percent of gross collections through this channel to 41.5% during the three months ended June 30, 2011, from 45.9% during the three months ended June 30, 2010, primarily due to a more targeted placement volume as part of an initiative to primarily focus our legal collections on higher quality accounts.

The cost of legal collections increased \$19.5 million, or 33.9%, to \$77.2 million during the six months ended June 30, 2011, compared to \$57.7 million during the six months ended June 30, 2010. These costs represent contingent fees paid to our nationwide network of attorneys and costs of litigation. The increase in the cost of legal collections was primarily the result of an increase of \$14.8 million in contingent fees paid to our network of attorneys related to an increase of \$61.4 million, or 49.0%, in gross collections through our legal channel in addition to an increase of \$5.1 million in upfront litigation costs expensed during the period. Gross legal collections amounted to \$186.6 million during the six months ended June 30, 2011, up from \$125.2 million collected during the six months ended June 30, 2010. The cost of legal collections decreased as a percent of gross collections through this channel to 41.4% during the six months ended June 30, 2011, from 46.1% during the six months ended June 30, 2010, primarily due to a more targeted placement volume as part of an initiative to primarily focus our legal collections on higher quality accounts.

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

| | Three Months Ended June 30, | | | | Six Months Ended June 30, | | | |
|-----------------------------------|-----------------------------|---------|-----------|---------|---------------------------|---------|------------|--------|
| | 2011 | | 2010 | | 2011 | | 2010 | |
| Collections ⁽¹⁾ | \$ 98,084 | 100.0% | \$ 68,049 | 100.0% | \$ 186,572 | 100.0% | \$ 125,222 | 100.0% |
| Court costs advanced | 24,354 | 24.8% | 18,479 | 27.2% | 47,653 | 25.5% | 31,800 | 25.4% |
| Court costs deferred | (11,038) | (11.3)% | (7,054) | (10.4)% | (22,629) | (12.1)% | (11,843) | (9.5)% |
| Court cost expense ⁽²⁾ | 13,316 | 13.6% | 11,425 | 16.8% | 25,024 | 13.4% | 19,957 | 15.9% |
| Other ⁽³⁾ | 421 | 0.4% | 593 | 0.9% | 915 | 0.5% | 1,214 | 1.0% |
| Commissions | 26,949 | 27.5% | 19,217 | 28.2% | 51,256 | 27.5% | 36,497 | 29.2% |

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

| | | | | | | | | |
|-------------|-----------|-------|-----------|-------|-----------|-------|-----------|-------|
| Total Costs | \$ 40,686 | 41.5% | \$ 31,235 | 45.9% | \$ 77,195 | 41.4% | \$ 57,668 | 46.1% |
|-------------|-----------|-------|-----------|-------|-----------|-------|-----------|-------|

- (1) Collections include approximately \$0.2 million and \$0.3 million from our internal legal channel for the three and six months ended June 30, 2011, respectively.
- (2) 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. This amount also includes court costs expensed through our internal legal channel of approximately \$0.2 million and \$0.3 million for the three and six months ended June 30, 2011, respectively.
- (3) Other costs consist of costs related to counter claims and legal network subscription fees.

Table of Contents

Other operating expenses

Other operating expenses increased \$0.2 million, or 1.8%, to \$9.2 million during the three months ended June 30, 2011, from \$9.0 million during the three months ended June 30, 2010. Other operating expenses increased \$1.2 million, or 6.3%, to \$19.3 million during the six months ended June 30, 2011, from \$18.1 million during the six months ended June 30, 2010. The increases were primarily the result of increases in various other operating expenses to support our growth.

Collection agency commissions

During the three months ended June 30, 2011, we incurred \$3.6 million in commissions to third party collection agencies, or 29.0%, of the related gross collections of \$12.4 million, compared to \$6.4 million in commissions, or 29.2% of the related gross collections of \$22.0 million during the three months ended June 30, 2010. The decline in commissions and collections in this channel is part of our strategy to place more accounts internally to reduce our overall cost to collect. The decrease in commissions was due to the decrease in collections through this channel and 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.

During the six months ended June 30, 2011, we incurred \$7.5 million in commissions to third party collection agencies, or 28.4%, of the related gross collections of \$26.4 million, compared to \$11.7 million in commissions, or 29.5%, of the related gross collections of \$39.7 million during the six months ended June 30, 2010. The decline in commissions and collections in this channel is part of our strategy to place more accounts internally to reduce our overall cost to collect. The decrease in commissions was due to the decrease in collections through this channel and 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.

General and administrative expenses

General and administrative expenses increased \$2.2 million, or 29.6%, to \$9.6 million during the three months ended June 30, 2011, from \$7.4 million during the three months ended June 30, 2010. The increase was primarily the result of an increase of \$0.9 million in litigation and corporate legal expenses, an increase of \$0.4 million in system maintenance costs, an increase of \$0.3 million in building rent, and a net increase in other general and administrative expenses of \$1.2 million. The increase was partially offset by a decrease of \$0.6 million in corporate settlements.

General and administrative expenses increased \$5.5 million, or 38.4%, to \$19.8 million during the six months ended June 30, 2011, from \$14.3 million during the six months ended June 30, 2010. The increase was primarily the result of an increase of \$2.7 million in litigation and corporate legal expenses, an increase of \$0.5 million in building rent, an increase of \$0.5 million in system maintenance costs, and a net increase in other general and administrative expenses of \$1.8 million. The legal expenses associated with responding to governmental requests and litigation are expected to continue to be elevated in the near-term.

Table of Contents**Cost per Dollar Collected**

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

| | Three Months Ended June 30, | | | | | | | |
|-------------------------------------|-----------------------------|--------------------------|-----------------------------------|---------------------------------|-------------|--------------------------|-----------------------------------|---------------------------------|
| | 2011 | | | | 2010 | | | |
| | Collections | Cost | Cost Per Channel Dollar Collected | Cost Per Total Dollar Collected | Collections | Cost | Cost Per Channel Dollar Collected | Cost Per Total Dollar Collected |
| Legal networks ⁽¹⁾ | \$ 98,084 | \$ 40,686 | 41.5% | 20.9% | \$ 68,049 | \$ 31,235 | 45.9% | 19.9% |
| Collection sites ⁽²⁾ | 84,576 | 7,070 | 8.4% | 3.6% | 66,619 | 6,346 | 9.5% | 4.0% |
| Collection agency outsourcing | 12,421 | 3,596 | 29.0% | 1.8% | 21,960 | 6,413 | 29.2% | 4.1% |
| Other | | | | | 161 | | | |
| Other indirect costs ⁽³⁾ | | 28,356 | | 14.5% | | 24,042 | | 15.4% |
| Total | \$ 195,081 | \$ 79,708 ⁽⁴⁾ | | 40.9% | \$ 156,789 | \$ 68,036 ⁽⁴⁾ | | 43.4% |

| | Six Months Ended June 30, | | | | | | | |
|-------------------------------------|---------------------------|---------------------------|-----------------------------------|---------------------------------|-------------|---------------------------|-----------------------------------|---------------------------------|
| | 2011 | | | | 2010 | | | |
| | Collections | Cost | Cost Per Channel Dollar Collected | Cost Per Total Dollar Collected | Collections | Cost | Cost Per Channel Dollar Collected | Cost Per Total Dollar Collected |
| Legal networks ⁽¹⁾ | \$ 186,572 | \$ 77,195 | 41.4% | 20.0% | \$ 125,222 | \$ 57,668 | 46.1% | 19.3% |
| Collection sites ⁽²⁾ | 173,117 | 14,116 | 8.2% | 3.7% | 132,424 | 12,368 | 9.3% | 4.2% |
| Collection agency outsourcing | 26,411 | 7,510 | 28.4% | 1.9% | 39,712 | 11,709 | 29.5% | 3.9% |
| Other | 54 | | | | 698 | | | |
| Other indirect costs ⁽³⁾ | | 57,349 | | 14.9% | | 46,860 | | 15.7% |
| Total | \$ 386,154 | \$ 156,170 ⁽⁴⁾ | | 40.4% | \$ 298,056 | \$ 128,605 ⁽⁴⁾ | | 43.1% |

(1) Collections include approximately \$0.2 million and \$0.3 million from our internal legal channel for the three and six months ended June 30, 2011, respectively. Court costs expensed through our internal legal channel were approximately \$0.2 million and \$0.3 million for the three and six months ended June 30, 2011, respectively.

(2) Cost in collection sites represents only account manager salaries, variable compensation and employee benefits.

(3) Other indirect costs represent non collection salaries and employee benefits, general and administrative expenses, other operating expenses, and depreciation and amortization. Included in other indirect costs were costs related to our internal collection channel of approximately \$0.8 million and \$1.1 million for the three and six months ended June 30, 2011, respectively.

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

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

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

| | Three Months Ended June 30, | | Six Months Ended June 30, | |
|--|-----------------------------|-----------|---------------------------|------------|
| | 2011 | 2010 | 2011 | 2010 |
| GAAP total operating expenses, as reported | \$ 86,223 | \$ 72,782 | \$ 168,769 | \$ 138,423 |
| Stock-based compensation expense | (1,810) | (1,446) | (3,575) | (3,207) |
| Bankruptcy servicing operating expenses | (4,705) | (3,300) | (9,024) | (6,611) |

During the three months ended June 30, 2011, cost per dollar collected decreased by 250 basis points to 40.9% of gross collections from 43.4% of gross collections during the three months ended June 30, 2010. This decrease was due to several factors, including:

Collection agency commissions, as a percentage of total collections, decreased to 1.8% during the three months ended June 30, 2011 from 4.1% during the three months ended June 30, 2010. The decrease in the percentage of commissions to total collections was due to our strategy to place more accounts internally, resulting in a significant decline in collections through this channel. Commissions as a percentage of channel collections also declined slightly to 29.0% during the three months ended June 30, 2011, as compared to 29.2% during the same period in the prior year.

Table of Contents

The costs from our collection sites, account manager salaries, variable compensation and employee benefits, as a percentage of total collections, decreased to 3.6% during the three months ended June 30, 2011 from 4.0% during the three months ended June 30, 2010 and, as a percentage of our site collections, decreased to 8.4% during the three months ended June 30, 2011 from 9.5% during the three months ended June 30, 2010. The decrease was primarily due to the continued growth of our collection workforce in India.

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, decreased as a percentage of total collections to 14.5% during the three months ended June 30, 2011 from 15.3% during the three months ended June 30, 2010. These costs increased in order to support the growth of our business. However, our collections grew at a rate greater than that of the indirect costs, as we continue to leverage our costs across our higher collections, resulting in a reduction in other indirect costs as a percent of total collections.

The decrease was offset by:

An increase in cost of legal collections, as a percent of total collections, to 20.9% during the three months ended June 30, 2011 from 19.9% during the three months ended June 30, 2010. The increase in the cost of legal collections to total collections is due to collections in our legal channel growing at a rate faster than total collections. Cost per dollar collected in this channel declined to 41.5% during the three months ended June 30, 2011, from 45.9% during the same period in the prior year. This was primarily a result of our strategy to focus our legal collections on better quality accounts in this channel (see Cost of legal collections section above for details).

During the six months ended June 30, 2011, cost per dollar collected decreased by 270 basis points to 40.4% of gross collections from 43.1% of gross collections during the six months ended June 30, 2010. This decrease was due to several factors, including:

Collection agency commissions, as a percentage of total collections, decreased to 1.9% during the six months ended June 30, 2011 from 3.9% during the six months ended June 30, 2010. The decrease in the percentage of commissions to total collections was due to our strategy to place more accounts internally, resulting in a significant decline in collections through this channel. Commissions as a percentage of channel collections also declined to 28.4% during the six months ended June 30, 2011, as compared to 29.5% during the same period in the prior year due to the mix of accounts placed in this channel.

The costs from our collection sites, account manager salaries, variable compensation and employee benefits, as a percentage of total collections, decreased to 3.7% during the six months ended June 30, 2011 from 4.1% during the six months ended June 30, 2010 and, as a percentage of our site collections, decreased to 8.2% during the six months ended June 30, 2011 from 9.3% during the six months ended June 30, 2010. The decrease was primarily due to the continued growth of our collection workforce in India.

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, decreased as a percentage of total collections to 14.9% during the six months ended June 30, 2011 from 15.7% during the six months ended June 30, 2010. These costs increased in order to support the growth of our business. However, our collections grew at a rate greater than that of the indirect costs, as we continue to leverage our costs across our higher collections, resulting in a reduction in other indirect costs as a percent of total collections.

The decrease was offset by:

An increase in cost of legal collections, as a percent of total collections, to 20.0% during the six months ended June 30, 2011 from 19.3% during the six months ended June 30, 2010. The increase in the cost of legal collections to total collections is due to collections in our legal channel growing at a rate faster than total collections. Cost per dollar collected in this channel declined to 41.4% during the six months ended June 30, 2011, from 46.1% during the same period in the prior year. This was primarily a result of our strategy to focus our legal collections on better quality accounts in this channel (see Cost of legal collections section above for

details).

Table of Contents**Interest Expense**

Interest expense increased \$0.5 million, or 10.0%, to \$5.4 million during the three months ended June 30, 2011, from \$4.9 million during the three months ended June 30, 2010. Interest expense increased \$1.6 million, or 16.4%, to \$11.0 million during the six months ended June 30, 2011, from \$9.4 million during the six months ended June 30, 2010.

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

| | Three Months Ended June 30, | | | |
|---|------------------------------------|-----------------|------------------|-----------------|
| | 2011 | 2010 | \$ Change | % Change |
| Stated interest on debt obligations | \$ 4,908 | \$ 3,749 | \$ 1,159 | 30.9% |
| Amortization of loan fees and other loan costs | 461 | 425 | 36 | 8.5% |
| Amortization of debt discount convertible notes | | 706 | (706) | (100.0)% |
| Total interest expense | \$ 5,369 | \$ 4,880 | \$ 489 | 10.0% |

| | Six Months Ended June 30, | | | |
|---|----------------------------------|-----------------|------------------|-----------------|
| | 2011 | 2010 | \$ Change | % Change |
| Stated interest on debt obligations | \$ 10,061 | \$ 7,224 | \$ 2,837 | 39.3% |
| Amortization of loan fees and other loan costs | 901 | 809 | 92 | 11.4% |
| Amortization of debt discount convertible notes | | 1,385 | (1,385) | (100.0)% |
| Total interest expense | \$ 10,962 | \$ 9,418 | \$ 1,544 | 16.4% |

Stated interest on debt obligations increased \$1.2 million during the three months ended June 30, 2011, compared to the same period of the prior year. Stated interest on debt obligations increased \$2.8 million during the six months ended June 30, 2011, compared to the same period of the prior year. The increases in stated interest on debt obligations for the three and six months ended June 30, 2011, were primarily due to higher interest rates on our senior secured notes, offset by lower outstanding loan balances under our revolving credit facility.

Provision for Income Taxes

During the three months ended June 30, 2011, we recorded an income tax provision of \$9.5 million, reflecting an effective rate of 39.1% of pretax income. The effective tax rate for the three months ended June 30, 2011 primarily consisted of a provision for federal income taxes of 32.5% (which is net of a benefit for state taxes of 2.5%), a blended provision for state taxes of 7.0% and a benefit for permanent book versus tax differences of 0.4%. During the three months ended June 30, 2010, we recorded an income tax provision of \$6.7 million, reflecting an effective rate of 36.5% of pretax income. The effective tax rate for the three months ended June 30, 2010 primarily consisted 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%, a benefit for permanent book versus tax differences of 1.5%, and a benefit for an Internal Revenue Service (IRS) refund of 1.7%.

During the six months ended June 30, 2011, we recorded an income tax provision of \$18.1 million, reflecting an effective rate of 38.9% of pretax income. The effective tax rate for the six months ended June 30, 2011 primarily consisted of a provision for federal income taxes of 32.5% (which is net of a benefit for state taxes of 2.5%), a blended provision for state taxes of 7.0% and a benefit for permanent book versus tax differences of 0.6%. During the six months ended June 30, 2010, we recorded an income tax provision of \$13.2 million, reflecting an effective rate of 36.9% of pretax income. The effective tax rate for the six months ended June 30, 2010 primarily consisted 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%, a benefit for the effect of permanent book versus tax differences of 1.9%, and a benefit for an IRS refund of 0.9%.

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 ⁽¹⁾ | Cumulative Collections through June 30, 2011 | | | | | | | | | CCM ⁽³⁾ |
|------------------|-------------------------------|--|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|-------------------|----------------------|--------------------|
| | | <2005 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | Total ⁽²⁾ | |
| <2005 | \$ 385,478 ⁽⁴⁾ | \$ 749,791 | \$ 224,620 | \$ 164,211 | \$ 85,333 | \$ 45,893 | \$ 27,708 | \$ 19,986 | \$ 8,479 | \$ 1,326,021 | 3.4 |
| 2005 | 192,585 | | 66,491 | 129,809 | 109,078 | 67,346 | 42,387 | 27,210 | 10,633 | 452,954 | 2.4 |
| 2006 | 141,028 | | | 42,354 | 92,265 | 70,743 | 44,553 | 26,201 | 10,367 | 286,483 | 2.0 |
| 2007 | 204,106 | | | | 68,048 | 145,272 | 111,117 | 70,572 | 25,631 | 420,640 | 2.1 |
| 2008 | 227,872 | | | | | 69,049 | 165,164 | 127,799 | 50,634 | 412,646 | 1.8 |
| 2009 | 253,414 | | | | | | 96,529 | 206,773 | 93,905 | 397,207 | 1.6 |
| 2010 | 359,305 | | | | | | | 125,853 | 156,051 | 281,904 | 0.8 |
| 2011 | 183,853 | | | | | | | | 30,368 | 30,368 | 0.2 |
| Total | \$ 1,947,641 | \$ 749,791 | \$ 291,111 | \$ 336,374 | \$ 354,724 | \$ 398,303 | \$ 487,458 | \$ 604,394 | \$ 386,068 | \$ 3,608,223 | 1.9 |

(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 June 30, 2011, excluding collections on behalf of others.

(3) Cumulative Collections Multiple (CCM) through June 30, 2011 collections as a multiple of purchase price.

(4) From inception through December 31, 2004.

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 ⁽¹⁾ | Historical Collections ⁽²⁾ | Estimated Remaining Collections | Total Estimated Gross Collections | Total Estimated Gross Collections to Purchase Price |
|--------------|-------------------------------|---------------------------------------|---------------------------------|-----------------------------------|---|
| <2005 | \$ 385,478 ⁽³⁾ | \$ 1,326,021 | \$ 824 | \$ 1,326,845 | 3.4 |
| 2005 | 192,585 | 452,954 | 15,432 | 468,386 | 2.4 |
| 2006 | 141,028 | 286,483 | 39,226 | 325,709 | 2.3 |
| 2007 | 204,106 | 420,640 | 54,762 | 475,402 | 2.3 |
| 2008 | 227,872 | 412,646 | 151,471 | 564,117 | 2.5 |
| 2009 | 253,414 | 397,207 | 272,289 | 669,496 | 2.6 |
| 2010 | 359,305 | 281,904 | 538,803 | 820,707 | 2.3 |
| 2011 | 183,853 | 30,368 | 342,384 | 372,752 | 2.0 |
| Total | \$ 1,947,641 | \$ 3,608,223 | \$ 1,415,191 | \$ 5,023,414 | 2.6 |

- (1) Adjusted for Put-Backs, Recalls, purchase price rescissions, and the impact of an acquisition in 2000.
- (2) Cumulative collections from inception through June 30, 2011, excluding collections on behalf of others.
- (3) From inception through December 31, 2004.

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 | | | | | | | | |
|----------------------|---|-------------------|-------------------|-------------------|------------------|------------------|------------------|-----------------|---------------------|
| | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017 | 2018 | Total |
| <2005 ⁽¹⁾ | \$ 824 | \$ | \$ | \$ | \$ | \$ | \$ | \$ | \$ 824 |
| 2005 | 8,566 | 6,849 | 17 | | | | | | 15,432 |
| 2006 | 10,773 | 19,189 | 9,264 | | | | | | 39,226 |
| 2007 | 15,843 | 22,348 | 12,750 | 3,821 | | | | | 54,762 |
| 2008 | 39,197 | 54,221 | 33,330 | 18,227 | 6,496 | | | | 151,471 |
| 2009 | 68,112 | 102,539 | 53,702 | 28,920 | 13,939 | 5,077 | | | 272,289 |
| 2010 | 111,649 | 184,814 | 111,073 | 64,659 | 37,512 | 20,755 | 8,341 | | 538,803 |
| 2011 | 52,019 | 110,297 | 79,948 | 45,313 | 27,408 | 15,736 | 9,485 | 2,178 | 342,384 |
| Total | \$ 306,983 | \$ 500,257 | \$ 300,084 | \$ 160,940 | \$ 85,355 | \$ 41,568 | \$ 17,826 | \$ 2,178 | \$ 1,415,191 |

⁽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*):

| | Purchase Price(1) Unamortized Balance as of June 30, 2011 | Purchase Price(1) Purchase Price ⁽¹⁾ | Purchase Price(1) Unamortized Balance as a Percentage of Purchase Price | Purchase Price(1) Unamortized Balance as a Percentage of Total |
|--------------|--|--|--|---|
| 2005 | \$ 11,050 | \$ 192,585 | 5.7% | 1.7% |
| 2006 | 22,661 | 141,028 | 16.1% | 3.4% |
| 2007 | 26,710 | 204,106 | 13.1% | 4.1% |
| 2008 | 75,471 | 227,872 | 33.1% | 11.5% |
| 2009 | 110,723 | 253,414 | 43.7% | 16.8% |
| 2010 | 240,543 | 359,305 | 66.9% | 36.6% |
| 2011 | 170,625 | 183,853 | 92.8% | 25.9% |
| Total | \$ 657,783 | \$ 1,562,163 | 42.1% | 100.0% |

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

Changes in the Investment in Receivable Portfolios

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

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 Portfolios | Three Months Ended June 30, 2011 | | Total |
|---|-----------------------------|----------------------------------|--------------------------|------------|
| | | Cost Recovery Portfolios | Zero Basis Portfolios | |
| Balance, beginning of period | \$ 648,820 | \$ | \$ | \$ 648,820 |
| Purchases of receivable portfolios | 93,701 | | | 93,701 |
| Gross collections ⁽¹⁾ | (190,901) | | (4,132) | (195,033) |
| Put-backs and recalls | (798) | | | (798) |
| Revenue recognized ⁽²⁾ | 109,185 | | 2,914 | 112,099 |
| (Portfolio allowances) portfolio allowance reversals, net | (2,224) | | 1,218 | (1,006) |
| Balance, end of period | \$ 657,783 | \$ | \$ | \$ 657,783 |
| Revenue as a percentage of collections ⁽³⁾ | 57.2% | 0.0% | 70.5% | 57.5% |

| | Accrual Basis Portfolios | Three Months Ended June 30, 2010 | | Total |
|---|-----------------------------|----------------------------------|--------------------------|------------|
| | | Cost Recovery Portfolios | Zero Basis Portfolios | |
| Balance, beginning of period | \$ 549,180 | \$ 480 | \$ | \$ 549,660 |
| Purchases of receivable portfolios | 83,336 | | | 83,336 |
| Gross collections ⁽¹⁾ | (154,367) | (24) | (2,355) | (156,746) |
| Put-backs and recalls | (1,280) | | | (1,280) |
| Revenue recognized ⁽²⁾ | 92,329 | | 2,355 | 94,684 |
| (Portfolio allowances) portfolio allowance reversals, net | (2,383) | (456) | | (2,839) |
| Balance, end of period | \$ 566,815 | \$ | \$ | \$ 566,815 |
| Revenue as a percentage of collections ⁽³⁾ | 59.8% | 0.0% | 100.0% | 60.4% |

| | Accrual Basis Portfolios | Six Months Ended June 30, 2011 | | Total |
|---|-----------------------------|--------------------------------|--------------------------|------------|
| | | Cost Recovery Portfolios | Zero Basis Portfolios | |
| Balance, beginning of period | \$ 644,753 | \$ | \$ | \$ 644,753 |
| Purchases of receivable portfolios | 184,376 | | | 184,376 |
| Gross collections ⁽¹⁾ | (378,318) | | (7,749) | (386,067) |
| Put-backs and recalls | (1,698) | | | (1,698) |
| Revenue recognized ⁽²⁾ | 216,989 | | 5,934 | 222,923 |
| (Portfolio allowances) portfolio allowance reversals, net | (8,319) | | 1,815 | (6,504) |
| Balance, end of period | \$ 657,783 | \$ | \$ | \$ 657,783 |
| Revenue as a percentage of collections ⁽³⁾ | 57.4% | 0.0% | 76.6% | 57.7% |

| | Accrual Basis Portfolios | Six Months Ended June 30, 2010 | | Total |
|------------------------------------|-----------------------------|--------------------------------|--------------------------|------------|
| | | Cost Recovery Portfolios | Zero Basis Portfolios | |
| Balance, beginning of period | \$ 526,366 | \$ 511 | \$ | \$ 526,877 |
| Purchases of receivable portfolios | 164,968 | | | 164,968 |
| Gross collections ⁽¹⁾ | (293,451) | (55) | (4,412) | (297,918) |

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

| | | | | |
|---|-------------------|-----------|-----------|-------------------|
| Put-backs and recalls | (1,864) | | | (1,864) |
| Revenue recognized ⁽²⁾ | 181,061 | | 4,411 | 185,472 |
| (Portfolio allowances) portfolio allowance reversals, net | (10,265) | (456) | 1 | (10,720) |
| Balance, end of period | \$ 566,815 | \$ | \$ | \$ 566,815 |
| Revenue as a percentage of collections ⁽³⁾ | 61.7% | 0.0% | 100.0% | 62.3% |

(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.

Table of Contents

As of June 30, 2011, we had \$657.8 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 |
|-------------------------|-------------------|
| 2011 ⁽¹⁾ | \$ 111,913 |
| 2012 | 226,006 |
| 2013 | 150,617 |
| 2014 | 82,440 |
| 2015 | 46,117 |
| 2016 | 24,981 |
| 2017 | 13,726 |
| 2018 | 1,983 |
| Total | \$ 657,783 |

⁽¹⁾ 2011 amount consists of six months data from July 1, 2011 to December 31, 2011.

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 June 30, | | Six Months Ended June 30, | |
|---------------------|-----------------------------|------------|---------------------------|------------|
| | 2011 | 2010 | 2011 | 2010 |
| Legal collections | \$ 98,084 | \$ 68,049 | \$ 186,572 | \$ 125,222 |
| Collection sites | 84,576 | 66,619 | 173,117 | 132,424 |
| Collection agencies | 12,421 | 21,960 | 26,411 | 39,712 |
| Other | | 161 | 54 | 698 |
| | \$ 195,081 | \$ 156,789 | \$ 386,154 | \$ 298,056 |

External Collection Channels and Related Direct Costs

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

| | Legal Collections | | | | Collection Agencies | | | |
|-----------------------------------|----------------------------------|--------------|------------------|--------------|----------------------------------|--------------|-----------------|--------------|
| | Three Months Ended June 30, 2011 | | 2010 | | Three Months Ended June 30, 2011 | | 2010 | |
| Collections | \$ 98,084 | 100.0% | \$ 68,049 | 100.0% | \$ 12,421 | 100.0% | \$ 21,960 | 100.0% |
| Commissions | \$ 26,949 | 27.5% | \$ 19,217 | 28.2% | \$ 3,596 | 29.0% | \$ 6,413 | 29.2% |
| Court cost expense ⁽¹⁾ | 13,316 | 13.6% | 11,425 | 16.8% | | | | |
| Other ⁽²⁾ | 421 | 0.4% | 593 | 0.9% | | | | |
| Total Costs | \$ 40,686 | 41.5% | \$ 31,235 | 45.9% | \$ 3,596 | 29.0% | \$ 6,413 | 29.2% |

Table of Contents

| | Legal Collections | | | | Collection Agencies | | | |
|-----------------------------------|-----------------------------------|--------------|-----------------------------------|--------------|-----------------------------------|--------------|-----------------------------------|--------------|
| | Six Months Ended June 30, 2011 | | Six Months Ended June 30, 2010 | | Six Months Ended June 30, 2011 | | Six Months Ended June 30, 2010 | |
| Collections ⁽¹⁾ | \$ 186,572 | 100.0% | \$ 125,222 | 100.0% | \$ 26,411 | 100.0% | \$ 39,712 | 100.0% |
| Commissions | \$ 51,256 | 27.5% | \$ 36,497 | 29.2% | \$ 7,510 | 28.4% | \$ 11,709 | 29.5% |
| Court cost expense ⁽²⁾ | 25,024 | 13.4% | 19,957 | 15.9% | | | | |
| Other ⁽³⁾ | 915 | 0.5% | 1,214 | 1.0% | | | | |
| Total Costs | \$ 77,195 | 41.4% | \$ 57,668 | 46.1% | \$ 7,510 | 28.4% | \$ 11,709 | 29.5% |

(1) Collections include approximately \$0.2 million and \$0.3 million from our internal legal channel for the three and six months ended June 30, 2011, respectively.

(2) 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. This amount also includes court costs expensed through our internal legal channel of approximately \$0.2 million and \$0.3 million for the three and six months ended June 30, 2011, respectively.

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

Legal Collections and Related Costs

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

Gross Collections by Year of Collection⁽¹⁾

| Placement Year | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | Total Collections |
|---------------------|-----------|-----------|-----------|----------|----------|----------|----------|----------|--------|-------------------|
| 2003 | \$ 10,750 | \$ 27,192 | \$ 17,212 | \$ 9,566 | \$ 5,561 | \$ 3,050 | \$ 2,014 | \$ 1,603 | \$ 660 | \$ 77,608 |
| 2004 | | 23,455 | 37,674 | 21,676 | 12,029 | 5,840 | 3,665 | 2,811 | 1,214 | 108,364 |
| 2005 | | | 21,694 | 40,762 | 22,152 | 10,582 | 6,226 | 4,740 | 2,006 | 108,162 |
| 2006 | | | | 39,395 | 82,740 | 43,303 | 22,527 | 14,148 | 6,046 | 208,159 |
| 2007 | | | | | 41,958 | 80,211 | 44,321 | 24,067 | 8,811 | 199,368 |
| 2008 | | | | | | 47,320 | 110,868 | 64,998 | 22,108 | 245,294 |
| 2009 | | | | | | | 40,856 | 92,124 | 34,508 | 167,488 |
| 2010 | | | | | | | | 60,706 | 92,462 | 153,168 |
| 2011 ⁽²⁾ | | | | | | | | | 18,052 | 18,052 |

(1) 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.

(2) Collections include approximately \$0.3 million from our internal legal channel.

Court Costs by Year of Collection⁽¹⁾

| Placement Year | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | Total Court Costs |
|----------------|--------|----------|--------|--------|--------|--------|-------|-------|-------|-------------------|
| 2003 | \$ 908 | \$ 2,046 | \$ 571 | \$ 300 | \$ 147 | \$ 103 | \$ 86 | \$ 67 | \$ 20 | \$ 4,248 |
| 2004 | | 2,509 | 2,937 | 1,087 | 406 | 223 | 153 | 147 | 34 | 7,496 |
| 2005 | | | 3,271 | 4,426 | 859 | 356 | 218 | 224 | 73 | 9,427 |

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

| | | | | | | | |
|---------------------|--------|--------|--------|--------|--------|--------|--------|
| 2006 | 10,158 | 10,291 | 1,829 | 407 | 617 | 290 | 23,592 |
| 2007 | | 15,357 | 11,952 | 1,178 | 719 | 347 | 29,553 |
| 2008 | | | 19,322 | 15,842 | 2,562 | 650 | 38,376 |
| 2009 | | | | 17,009 | 11,998 | 1,342 | 30,349 |
| 2010 | | | | | 27,121 | 14,667 | 41,788 |
| 2011 ⁽²⁾ | | | | | | 9,932 | 9,932 |

(1) 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.

(2) Court costs include approximately \$0.3 million from our internal legal channel.

Table of Contents**Commissions by Year of Collection⁽¹⁾**

| Placement Year | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | Total Commissions |
|----------------|----------|----------|----------|----------|----------|--------|--------|--------|--------|-------------------|
| 2003 | \$ 3,574 | \$ 8,606 | \$ 5,496 | \$ 2,898 | \$ 1,574 | \$ 872 | \$ 577 | \$ 465 | \$ 181 | \$ 24,243 |
| 2004 | | 7,273 | 12,060 | 6,653 | 3,498 | 1,690 | 1,063 | 827 | 337 | 33,401 |
| 2005 | | | 6,725 | 12,108 | 6,364 | 3,036 | 1,792 | 1,388 | 560 | 31,973 |
| 2006 | | | | 11,451 | 23,659 | 12,370 | 6,464 | 4,120 | 1,689 | 59,753 |
| 2007 | | | | | 11,845 | 22,927 | 12,697 | 7,040 | 2,490 | 56,999 |
| 2008 | | | | | | 13,678 | 31,794 | 18,926 | 6,203 | 70,601 |
| 2009 | | | | | | | 11,476 | 26,110 | 9,448 | 47,034 |
| 2010 | | | | | | | | 16,881 | 25,403 | 42,284 |
| 2011 | | | | | | | | | 4,787 | 4,787 |

⁽¹⁾ 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.

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

| Placement Year | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | Cumulative Average |
|----------------|-------|-------|-------|-------|-------|-------|-------|-------|-------|--------------------|
| 2003 | 41.7% | 39.2% | 35.2% | 33.4% | 31.0% | 32.0% | 32.9% | 33.2% | 30.5% | 36.7% |
| 2004 | | 41.7% | 39.8% | 35.7% | 32.4% | 32.8% | 33.2% | 34.6% | 30.6% | 37.7% |
| 2005 | | | 46.1% | 40.6% | 32.6% | 32.1% | 32.3% | 34.0% | 31.6% | 38.3% |
| 2006 | | | | 54.9% | 41.0% | 32.8% | 30.5% | 33.5% | 32.7% | 40.0% |
| 2007 | | | | | 64.8% | 43.5% | 31.3% | 32.2% | 32.2% | 43.4% |
| 2008 | | | | | | 69.7% | 43.0% | 33.1% | 31.0% | 44.4% |
| 2009 | | | | | | | 69.7% | 41.4% | 31.3% | 46.2% |
| 2010 | | | | | | | | 72.5% | 43.3% | 54.9% |
| 2011 | | | | | | | | | 81.5% | 81.5% |

Headcount by Function by Site

The following table summarizes our headcount by function by site:

| | Headcount as of June 30, | | | |
|--------------------------|--------------------------|-------|------|-------|
| | 2011 | | 2010 | |
| | U.S. | India | U.S. | India |
| General & Administrative | 413 | 281 | 351 | 212 |
| Account Manager | 232 | 1,019 | 230 | 822 |
| Bankruptcy Specialist | 114 | 94 | 59 | 73 |
| | 759 | 1,394 | 640 | 1,107 |

Gross Collections by Account Manager

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

| | Three Months Ended | | Six Months Ended | |
|------------------------------------|--------------------|---------------|------------------|---------------|
| | June 30, 2011 | June 30, 2010 | June 30, 2011 | June 30, 2010 |
| Gross collections collection sites | \$ 84,576 | \$ 66,619 | \$ 173,117 | \$ 132,424 |
| Average active account managers | 1,217 | 1,019 | 1,179 | 979 |

| | | | | |
|--|---------|---------|----------|----------|
| Collections per average active account manager | \$ 69.5 | \$ 65.4 | \$ 146.8 | \$ 135.3 |
|--|---------|---------|----------|----------|

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 June 30, | | Six Months Ended June 30, | |
|------------------------------------|--------------------------------|-----------|------------------------------|------------|
| | 2011 | 2010 | 2011 | 2010 |
| Gross collections collection sites | \$ 84,576 | \$ 66,619 | \$ 173,117 | \$ 132,424 |
| Total hours paid | 589 | 499 | 1,114 | 938 |
| Collections per hour paid | \$ 143.6 | \$ 133.5 | \$ 155.4 | \$ 141.2 |

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 June 30, | | Six Months Ended June 30, | |
|------------------------------------|--------------------------------|-----------|------------------------------|------------|
| | 2011 | 2010 | 2011 | 2010 |
| Gross collections collection sites | \$ 84,576 | \$ 66,619 | \$ 173,117 | \$ 132,424 |
| Direct cost ⁽¹⁾ | \$ 7,070 | \$ 6,346 | \$ 14,116 | \$ 12,368 |
| Cost per dollar collected | 8.4% | 9.5% | 8.2% | 9.3% |

⁽¹⁾ 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 June 30, | | Six Months Ended June 30, | |
|--|--------------------------------|-----------|------------------------------|-----------|
| | 2011 | 2010 | 2011 | 2010 |
| Portfolio Purchasing and Collecting Activities | | | | |
| Collections related | \$ 7,070 | \$ 6,346 | \$ 14,116 | \$ 12,368 |
| General & administrative | 10,059 | 8,289 | 19,680 | 15,875 |
| Subtotal | 17,129 | 14,635 | 33,796 | 28,243 |
| Bankruptcy Services | 3,083 | 1,848 | 5,456 | 3,726 |
| | \$ 20,212 | \$ 16,483 | \$ 39,252 | \$ 31,969 |

Purchases by Quarter

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

| Quarter | # of Accounts | Face Value | Purchase Price | Forward Flow Allocation ⁽¹⁾ |
|---------|------------------|--------------|-------------------|--|
| Q1 2008 | 647 | \$ 1,199,703 | \$ 47,902 | \$ 2,926 |

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

| | | | | |
|---------|-------|-----------|---------|--------|
| 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 | |
| Q2 2010 | 1,002 | 2,245,713 | 83,336 | |
| Q3 2010 | 1,101 | 2,616,678 | 77,889 | |
| Q4 2010 | 1,206 | 3,882,646 | 119,100 | |
| Q1 2011 | 1,243 | 2,895,805 | 90,675 | |
| Q2 2011 | 1,477 | 2,998,564 | 93,701 | |

(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 Systems, LLC (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.

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, operating expenses, and the payment of interest and principal on bank borrowings and tax payments.

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

| | Six Months Ended | |
|---|-------------------------|-------------|
| | June 30, | |
| | 2011 | 2010 |
| Net cash provided by operating activities | \$ 31,743 | \$ 34,823 |
| Net cash used in investing activities | (20,995) | (52,305) |
| Net cash (used in) provided by financing activities | (6,993) | 19,496 |

On February 11, 2011, we increased the amount available for borrowing under our revolving credit facility from \$360.5 million to \$410.5 million by exercising \$50.0 million of our \$100.0 million accordion feature. As of June 30, 2011, available borrowing capacity and borrowing base availability under our revolving credit facility were \$115.5 million and \$54.6 million, respectively.

On February 10, 2011, we issued an additional \$25.0 million in senior secured notes to certain affiliates of Prudential Capital Group through an amended and restated note purchase agreement. The notes bear an annual interest rate of 7.375% and mature in 2018 with principal amortization beginning in May 2013. The proceeds from the notes were primarily used to reduce aggregate outstanding borrowings under our revolving credit facility.

See Note 9 Debt to our unaudited condensed consolidated financial statements for a further discussion of our debt.

Currently, all of our portfolio purchases are funded with cash from operations and borrowings under our revolving credit facility.

Operating Cash Flows

Net cash provided by operating activities was \$31.7 million and \$34.8 million during the six months ended June 30, 2011 and 2010, respectively.

Cash provided by operating activities during the six months ended June 30, 2011, was primarily related to net income of \$28.5 million and \$6.5 million in a non-cash add back related to the net provision for allowance on our receivable portfolios. Cash provided by operating activities during the six months ended June 30, 2010, was primarily attributable to net income of \$22.6 million and \$10.7 million in a non-cash add back related to the net provision for allowance on our receivable portfolios.

Investing Cash Flows

Net cash used in investing activities was \$21.0 million and \$52.3 million during the six months ended June 30, 2011 and 2010, respectively.

The cash flows used in investing activities during the six months ended June 30, 2011, were primarily related to receivable portfolio purchases of \$184.4 million, offset by gross collection proceeds applied to the principal of our receivable portfolios in the amount of \$163.1 million. The cash flows used in investing activities during the six months ended June 30, 2010, were primarily related to receivable portfolio purchases of \$165.0 million, offset by gross collection proceeds applied to the principal of our receivable portfolios in the amount of \$112.4 million.

Capital expenditures for fixed assets acquired with internal cash flow were \$1.2 million and \$1.6 million for the six months ended June 30, 2011 and 2010, respectively.

Financing Cash Flows

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

Net cash used in financing activities was \$7.0 million during the six months ended June 30, 2011 and net cash provided by financing activities was \$19.5 million during the six months ended June 30, 2010.

The cash used in financing activities during the six months ended June 30, 2011, reflects \$87.0 million in repayments of amounts outstanding under our line of credit, offset by \$55.0 million in borrowings under our line of credit agreement and \$25.0 million in borrowings under our senior secured notes. The cash provided by financing activities during the six months ended June 30, 2010, reflects \$31.0 million in repayments of amounts outstanding under our line of credit, offset by \$53.0 million in borrowings under our line of credit.

Table of Contents

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 38 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 \$14.7 million as of June 30, 2011, our access to the capital markets and availability under our revolving credit facility, which expires in December 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

Foreign Currency. At June 30, 2011, there had not been a material change in any of the foreign currency risk information disclosed in Item 7A, Quantitative and Qualitative Disclosures About Market Risk, of our Annual Report on Form 10-K for the fiscal year ended December 31, 2010.

Interest Rate. At June 30, 2011, there had not been a material change in the interest rate risk information disclosed in Item 7A, Quantitative and Qualitative Disclosures About Market Risk, of our Annual Report on Form 10-K for the fiscal year ended December 31, 2010.

Item 4. Controls and Procedures

Evaluation of Disclosure Controls and Procedures

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

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

Changes in Internal Control over Financial Reporting

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

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

We are involved in disputes and legal actions from time to time in the ordinary course of business. We, along with others in our industry, are routinely subject to legal actions based on the Fair Debt Collection Practices Act, or FDCPA, comparable state statutes, the Telephone Consumer Protection act, state and federal unfair competition statutes, and common law causes of action. The violations of law alleged in these actions often include claims that we lack specified licenses to conduct our business, attempt to collect debts on which the statute of limitations has run, have made inaccurate assertions of fact in support of our collection actions, and/or have acted improperly in connection with our efforts to contact consumers. These cases are frequently styled as putative class actions.

On May 19, 2008, an action captioned *Brent v. Midland Credit Management, Inc et. al* was filed in the United States District Court for the Northern District of Ohio Western Division, in which the plaintiff, Andrea Brent, has filed a class action counter-claim against our subsidiaries Midland Credit Management, Inc. and Midland Funding LLC (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. On November 4, 2010, the court granted in part, and denied in part, plaintiff s motion for class certification of a statewide class. On February 10, 2011, the parties reached an agreement in principal to settle this lawsuit, as well as two other pending lawsuits in the Northern District of Ohio *Franklin v. Midland Funding LLC* and *Vassalle v. Midland Funding LLC*, on a national class basis, subject to entering into a definitive settlement agreement and obtaining court approval after notice to the class. On March 9, 2011, the parties entered into a final settlement agreement, which was preliminarily approved by the court on March 11, 2011. On July 11, 2011, the court held a final approval hearing with respect to the settlement, and the parties are awaiting the court s decision.

In addition, from time to time, we are subject to various governmental litigation, investigations, inquiries and other actions, relating to our collection activities.

On March 28, 2011, the Office of the Attorney General of the State of Minnesota filed a motion in the United States District Court for the Northern District of Ohio, seeking clarification of an order granting preliminary injunction against parallel litigation (the Order) issued by that court in connection with the case captioned *Brent v. Midland Credit Management, Inc et. al*. The Minnesota Attorney General sought a ruling clarifying that the Order did not prevent it from filing a complaint against us in Minnesota state court concerning our debt collection practices and related topics. On May 17, 2011, the District Court in Ohio ruled that the Order did not apply to the State of Minnesota. On May 19, 2011, the State of Minnesota filed a complaint against us in Hennepin County District Court alleging, among other things, contempt of court and violations of Minnesota s Collection Agencies Act based on our debt collection and related practices in the State of Minnesota. The complaint seeks civil penalties, disgorgement of profits, injunctive relief, and attorney s fees. We intend to vigorously defend the allegations set forth in the complaint.

On January 12, 2011, the Office of the Attorney General of the State of Texas issued a civil investigative demand to us to produce documents in an investigation of our methods of collecting consumer debts in the State of Texas and related topics. On July 8, 2011, the Texas Attorney General filed a petition in the District Court of Harris County, Texas against us alleging violations of the Texas Deceptive Trade Practices Act and the Texas Debt Collection Act, based on our debt collection and related practices in the State of Texas. The complaint seeks civil penalties, disgorgement of profits, injunctive relief and attorney s fees. We intend to vigorously defend the allegations set forth in the complaint.

On May 2, 2011, the Department of Justice of the State of Oregon issued an investigative demand to us to produce documents and answer interrogatories concerning our debt collection practices in the State of Oregon and related topics. We have and intend to continue to cooperate fully with the State of Oregon in response to this subpoena, subject to applicable law. In addition, on June 28, 2011, the Office of the Attorney General of the State of New York issued a subpoena to us to produce documents concerning our debt collection practices in the State of New York and related topics. We intend to cooperate fully with the State of New York in response to this subpoena, subject to applicable law.

In certain legal proceedings, we may have recourse to insurance or third party contractual indemnities to cover all or portions of our litigation expenses, judgments or settlements. In accordance with authoritative guidance, we have recorded loss contingencies in our financial statements

only for matters in which losses are probable and can be reasonably estimated.

Table of Contents

Item 1A Risk Factors

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.

Risk Factors

We are exposed to risks associated with worldwide financial markets and the global economy.

As a result of the global economic downturn, individual consumers are experiencing high unemployment, a lack of credit availability and depressed real estate values. This in turn places continued financial pressure on the consumer, which may reduce our ability to collect on our purchased consumer receivable portfolios and may adversely affect the value of our consumer receivable portfolios. Further, increased financial pressures on the distressed consumer may result in additional regulatory restrictions on our operations and increased litigation filed against us. We are unable to predict the likely duration or severity of the current disruption in financial markets and adverse economic conditions and the effects they may have on our business, financial condition and results of operations.

Our quarterly operating results may fluctuate significantly.

Our quarterly operating results will likely vary in the future due to a variety of factors that could affect our revenues and operating expenses in any particular quarter. We expect that our operating expenses as a percentage of collections will fluctuate in the future as we expand into new markets, increase our business development efforts, hire additional personnel and incur increased insurance and regulatory compliance costs. In addition, our operating results have fluctuated and may continue to fluctuate as the result of the factors described below and elsewhere in this Quarterly Report on Form 10-Q and in our Annual Report on Form 10-K for the fiscal year ended December 31, 2010:

the timing and amount of collections on our receivable portfolios, including the effects of seasonality and economic recessions;

any charge to earnings resulting from an allowance against the carrying value of our receivable portfolios;

increases in operating expenses associated with the growth or change of our operations;

the cost of credit to finance our purchases of receivable portfolios; and

the timing and terms of our purchases of receivable portfolios.

Due to fluctuating prices for receivable portfolios, there has been considerable variation in our purchasing volume from quarter to quarter and we expect that to continue. The volume of our portfolio purchases will be limited when prices are high, and may or may not increase when portfolio pricing is more favorable to us. We believe our ability to collect on receivable portfolios may be negatively impacted because of current economic conditions, and this may require us to increase our projected return hurdles in calculating prices we are willing to pay for individual portfolios. An increase in portfolio return hurdles may decrease the volume of portfolios we are successful in purchasing. Because we recognize revenue on the basis of projected collections on purchased portfolios, we may experience variations in quarterly revenue and earnings due to the timing of portfolio purchases.

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

Our ability to continue to operate profitably depends upon the continued availability of receivable portfolios that meet our purchasing standards and are cost-effective based upon projected collections exceeding our costs. Our profitability also depends on our actual collections on accounts meeting or exceeding our projected collections. There is no assurance as to how long portfolios will be available for purchase on terms acceptable to us, or at all.

Table of Contents

The availability of receivable portfolios at favorable prices and on favorable terms depends on a number of factors, including:

continued high levels of default in consumer debt;

continued sale of receivable portfolios by originating institutions at prevailing price levels;

our ability to develop and maintain long-term relationships with key major credit originators;

our ability to obtain adequate data from credit originators or portfolio resellers to appropriately evaluate the collectability of, and estimate the value of, portfolios;

changes in laws and regulations governing consumer lending, bankruptcy and collections; and

potential availability of government funding to competing purchasers for the acquisition of account portfolios under various programs intended to serve as an economic stimulus.

In addition, because of the length of time involved in collecting charged-off consumer receivables on acquired portfolios and the volatility in the timing of our collections, we may not be able to identify trends and make changes in our purchasing strategies in a timely manner. Ultimately, if we are unable to continually purchase and collect on a sufficient volume of receivables to generate cash collections that exceed our costs, our business will be materially and adversely affected.

We may experience losses on portfolios consisting of new types of receivables.

We continually look for opportunities to expand the classes of assets that make up the portfolios we acquire. Therefore, we may acquire portfolios consisting of assets with which we have little or no collection experience. Our lack of experience with new types of receivables may cause us to pay too much for these receivable portfolios, which may substantially hinder our ability to generate profits from such portfolios. Further, our existing methods of collections may prove ineffective for such new receivables, and we may not be able to collect on these portfolios. Our inexperience may have a material and adverse affect on our results of operations.

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.

We acquire and service receivables that the obligors have failed to pay and the sellers have deemed uncollectible and written off. The originating institutions generally make numerous attempts to recover on their nonperforming receivables, often using a combination of their in-house collection and legal departments as well as third-party collection agencies. In order to operate profitably over the long term, we must continually purchase and collect on a sufficient volume of receivables to generate revenue that exceeds our costs. These receivables are difficult to collect, and we may not be successful in collecting amounts sufficient to cover the costs associated with purchasing the receivables and funding our operations. If we are not able to collect on these receivables or collect sufficient amounts to cover our costs, this may materially and adversely affect our results of operations.

Sellers may deliver portfolios that contain accounts which do not meet our account collection criteria.

In the normal course of our portfolio acquisitions, some receivables may be included in the portfolios that fail to conform to the terms of the purchase agreements and we may seek to return these receivables to the seller for payment or replacement. However, we cannot guarantee that sellers will be able to meet their obligations to us. Accounts that we are unable to return to sellers may yield no return. If sellers deliver portfolios containing too many accounts that do not conform to the terms of the purchase contracts, we may be unable to collect a sufficient amount and the portfolio purchase could be unprofitable, which would have an adverse effect on our cash flows. If cash flows from operations are less than anticipated, our ability to satisfy our debt obligations and purchase new portfolios and our future growth and profitability may be

materially and adversely affected.

Our failure to purchase sufficient quantities of receivable portfolios or collect sufficient amounts on receivables we own may necessitate workforce reductions, which may harm our business.

Because fixed costs, such as certain personnel costs and lease or other facilities costs, constitute a significant portion of our overhead, we may be required to reduce the number of employees in our collection operations if we do not continually augment the receivable portfolios we service with additional receivable portfolios or collect sufficient amounts on receivables we own for the reasons indicated above. Reducing the number of employees can affect our business adversely due to:

lower employee morale, higher employee attrition rates, fewer experienced employees and higher recruiting and training costs;

disruptions in our operations and loss of efficiency in collection functions; and

excess costs associated with unused space in collection facilities.

Table of Contents

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

We expect that a significant percentage of our portfolio purchases for any given fiscal year may be concentrated with a few large sellers, some of which also may involve forward flow arrangements. For example, in 2010, we purchased 67% of our portfolios from our five top sellers. We cannot be certain that any of our significant sellers will continue to sell charged-off receivables to us on terms or in quantities acceptable to us, or that we would be able to replace such purchases with purchases from other sellers.

A significant decrease in the volume of purchases available from any of our principal sellers on terms acceptable to us would force us to seek alternative sources of charged-off receivables. We may be unable to find alternative sources from which to purchase charged-off receivables, and even if we could successfully replace such purchases, the search could take time, the receivables could be of lower quality, cost more, or both, any of which could materially adversely affect our financial performance.

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

We use our internally developed Unified Collection Score, or UCS model, and Behavioral Liquidation Score, or BLS model, to project the remaining cash flows from our receivable portfolios. Our UCS and BLS models consider known data about our consumers' accounts, including, among other things, our collection experience and changes in external consumer factors, in addition to all data known when we acquired the accounts. There can be no assurance, however, that we will be able to achieve the collections forecasted by our UCS and BLS models. If we are not able to achieve these levels of forecasted collection, our revenues will be reduced or we may be required to record an allowance charge, which may materially and adversely impact our results of operations.

We may incur allowance charges based on the authoritative guidance for loans and debt securities acquired with deteriorated credit quality.

We account for our portfolio revenue in accordance with the authoritative guidance for loans and debt securities acquired with deteriorated credit quality. The authoritative guidance limits the revenue that may be accrued to the excess of the estimate of expected future cash flows over a portfolio's initial cost of accounts receivable acquired, requires that the excess of the contractual cash flows over expected cash flows not be recognized as an adjustment of revenue, expense, or on the balance sheet, and freezes the IRR originally estimated when the accounts receivable are purchased for subsequent allowance testing. Rather than lower the estimated IRR if the expected future cash flow estimates are decreased, the carrying value of our receivable portfolios would be written down to maintain the then-current IRR. Increases in expected future cash flows would be recognized prospectively through an upward adjustment of the IRR over a portfolio's remaining life. Any increased yield then becomes the new benchmark for allowance testing. Since the authoritative guidance does not permit yields to be lowered, there is an increased probability of our having to incur allowance charges in the future, which would negatively impact our results of operations.

Our business of enforcing the collection of purchased receivables is subject to extensive statutory and regulatory oversight, which has increased and may continue to increase.

Laws and regulations applicable to credit card issuers or other debt originators may preclude us from collecting on receivables we purchase, regardless of any act or omission on our part. For instance, we may be precluded from collecting on receivables where the card issuer or originator failed to comply with applicable federal or state laws in generating or servicing the receivables that we have acquired. Because our receivables generally are originated and serviced nationwide, we cannot be certain that the originating lenders have complied with applicable laws and regulations. While our receivable acquisition contracts typically contain provisions indemnifying us for losses owing to the originating institution's failure to comply with applicable laws and other events, we cannot be certain that any indemnities received from originating institutions will be adequate to protect us from losses on the receivables or liabilities to consumers. Laws relating to debt collections also directly apply to our business. Our failure or the failure of third party agencies and attorneys or the originators of our receivables to comply with existing or new laws, rules or regulations could limit our ability to recover on receivables or cause us to pay damages to the original consumers, which could reduce our revenues and harm our business.

We sometimes purchase accounts in asset classes that are subject to industry-specific restrictions that limit the collection methods that we can use on those accounts. Our inability to collect sufficient amounts from these accounts through available collections methods could materially and adversely affect our results of operations.

In response to the global economic downturn, or otherwise, additional consumer protection or privacy laws, rules and regulations may be enacted that impose additional restrictions on the collection of receivables. Such new laws, rules and regulations may materially adversely affect our ability to collect on our receivables, which could materially and adversely affect our business and results of operations. In addition, enforcement of any such new laws, rules and regulations or increased enforcement of existing consumer protection or privacy laws, rules and regulations could materially and adversely affect our business and results of operations.

Table of Contents

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

Our business model may be uniquely vulnerable to an economic recession, which typically results in an increase in the amount of defaulted consumer receivables, thereby contributing to an increase in the amount of personal bankruptcy filings. Under certain bankruptcy filings, a consumer's assets are sold to repay credit originators, with priority given to holders of secured debt. Since the defaulted consumer receivables we typically purchase are generally unsecured, we often would not be able to collect on those receivables. In addition, since we purchase receivables that may have been delinquent for a long period of time, this may be an indication that many of the consumers from whom we collect will be unable to service their debts going forward and are more likely to file for bankruptcy in an economic recession. We cannot be certain that our collection experience would not decline with an increase in bankruptcy filings. If our actual collection experience with respect to a defaulted consumer receivable portfolio is significantly lower than we projected when we purchased the portfolio, our results of operations could be materially and adversely affected.

In 2005, the Bankruptcy Abuse Prevention and Consumer Protection Act, or the Protection Act, which made significant changes in the treatment of consumer filers for bankruptcy protection, was enacted. Since the Protection Act was enacted, the number of bankruptcy filings has increased, and the volume of business at Ascension has increased as a result. We cannot determine the impact of the Protection Act on the number of bankruptcy filings, on a prospective basis, and its impact on the collectability of consumer debt.

Passage of the Rules and Regulations Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act may increase our operational and compliance costs.

The Dodd-Frank Act contains a variety of provisions designed to regulate financial markets, including credit and derivatives transactions. The Dodd-Frank Act requires various federal agencies to adopt a broad range of new rules and regulations, and to prepare numerous studies and reports for Congress. The federal agencies are given significant discretion in drafting the rules and regulations, and consequently, many of the details and much of the impact of the Dodd-Frank Act may not be known for many months or years.

The Dodd-Frank Act requires publicly traded companies to give stockholders a non-binding vote on executive compensation and so-called "golden parachute" payments. It is difficult to predict at this time what specific impact the Dodd-Frank Act and the yet to be written implementing rules and regulations will have. However, if the Dodd-Frank Act and the implementing rules and regulations cause a material increase in our compliance and operating costs or materially inhibit our ability to collect on our receivables, they may have a material adverse impact on our results of operations.

Failure to comply with government regulation 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.

The collections industry is heavily regulated under various federal, state and local laws, rules and regulations. Many states and several cities require that we be licensed as a debt collection company. The Federal Trade Commission, state Attorneys General and other regulatory bodies have the authority to investigate a variety of matters, including consumer complaints against debt collection companies, and to recommend enforcement actions and seek monetary penalties. If we or our third party collection agencies or law firms fail to comply with applicable laws, rules and regulations, including, but not limited to, identity theft, privacy, data security, the use of automated dialing equipment, laws related to consumer protection, debt collection, and laws applicable to specific types of debt, it could result in the suspension or termination of our ability to conduct collection operations, which would materially adversely affect us. Further, our ability to collect our receivables may be impacted by state laws which require that certain types of account documentation be in our possession prior to the institution of any collection activities. In addition, new federal, state or local laws or regulations, or changes in the ways these rules or laws are interpreted or enforced, could limit our activities in the future and/or significantly increase the cost of regulatory compliance.

We are dependent upon third parties to service more than half of our consumer receivable portfolios.

We use outside collection services to collect a substantial portion of our receivables. We are dependent upon the efforts of third-party collection agencies and attorneys to service and collect our consumer receivables. Any failure by our third-party collection agencies and attorneys to perform collection services for us adequately or remit such collections to us could materially reduce our revenue and our profitability. In addition, if one or more of those third-party collection agencies or attorneys were to cease operations abruptly, or

Table of Contents

to become insolvent, such cessation or insolvency could materially reduce our revenue and profitability. Our revenue and profitability could also be materially adversely affected if we were not able to secure replacement third party collection agencies or attorneys or promptly transfer account information to our new third party collection agencies, attorneys or in-house in the event our agreements with our third-party collection agencies and attorneys were terminated. Our revenue and profitability could also be materially adversely affected if our third-party collection agencies or attorneys fail to perform their obligations adequately, or if our relationships with such third-party collection agencies and attorneys otherwise change adversely.

Increases in costs associated with our collections through a network of attorneys can materially raise our costs associated with our collection strategies and the individual lawsuits brought against consumers to collect on judgments in our favor.

We contract with a nationwide network of attorneys that specialize in collection matters. In connection with our agreements with our contracted attorneys, we advance certain out-of-pocket court costs, or Deferred Court Costs. Deferred Court Costs represent amounts we believe we will recover from our consumers, in addition to the amounts owed on our consumers' accounts that we expect to collect. These court costs may be difficult or impossible to collect, and we may not be successful in collecting amounts sufficient to cover the amounts deferred in our financial statements. If we are not able to recover these court costs, this may materially and adversely affect our results of operations.

Further, we are increasing our collection activity through our legal channel and as a consequence, due to an increase in Deferred Court Costs and an increase in costs related to counterclaims, our costs in collecting on these accounts may increase, which may have a material, adverse effect on our results of operations.

Our network of third party agencies and attorneys may not utilize amounts collected on our behalf or amounts we advance for court costs in the manner for which they were intended.

Third party collection agencies and attorneys may receive funds owed to us. We advance court costs to third party attorneys. These third parties may fail to remit amounts owed to us in a timely manner or at all. Further, third party attorneys may misuse some or all of the funds we advance for court costs. Our ability to recoup our funds may be diminished if these third parties become insolvent or enter into bankruptcy proceedings.

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.

We generate a significant portion of our revenue by collecting on judgments that are granted by courts in lawsuits filed against consumers. A decrease in the willingness of courts to grant such judgments, a change in the requirements for filing such cases or obtaining such judgments, or a decrease in our ability to collect on such judgments could have a material and adverse effect on our results of operations. As we increase our use of the legal channel for collections, our short-term margins may decrease as a result of an increase in upfront court costs and costs related to counter claims. We may not be able to collect on certain aged accounts because of applicable statutes of limitations and we may be subject to adverse effects of regulatory changes that we cannot predict. Further, courts in certain jurisdictions require that a copy of the account statements or applications be attached to the pleadings in order to obtain a judgment against consumers. If we are unable to produce those account documents, because the account documents have not been provided by the account's seller or otherwise, these courts could deny our claims.

We are subject to ongoing risks of litigation, including individual and class action lawsuits under consumer credit, consumer protection, theft, privacy, collections, and other laws, and may be subject to awards of substantial damages.

We operate in an extremely litigious climate and currently are, and may in the future be, named as defendants in litigation, including individual and class action lawsuits under consumer credit, consumer protection, theft, privacy, data security, automated dialing equipment, debt collections and other laws. Many of these cases present novel issues on which there is no clear legal precedent, which increases the difficulty in predicting both the potential outcomes and costs of defending these cases. We currently are, and may in the future be, subject to regulatory investigations, inquiries, litigation and other actions relating to our activities. The litigation and regulatory actions in which we are currently engaged or which we may become subject to involve potential compensatory or 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. Defending lawsuits, regardless of their merit, could be costly and divert management's attention from the operation of our business. All of these factors could have a material adverse effect on our business and financial condition.

Table of Contents

Negative publicity associated with litigation, governmental investigations, regulatory actions and other public statements could damage our reputation.

From time to time there are negative news stories about our industry or company, especially with respect to alleged conduct in collecting debt from customers. Such stories may follow the announcements of litigation or regulatory actions involving the company or others in our industry. Negative publicity about our alleged or actual debt collection practices or about the debt collection industry generally could adversely impact our stock price and our ability to retain and attract customers and employees.

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

From time to time, we consider acquisitions of other companies that could complement our business, including the acquisition of entities in diverse geographic regions and entities offering greater access to businesses and markets that we do not currently serve. For example, in 2005, we acquired Ascension and certain assets of Jefferson Capital. We may not be able to successfully acquire other businesses or, if we do, the acquisition may be unprofitable. If we do acquire one or more businesses, we may not successfully operate the businesses acquired, or may not successfully integrate such businesses with our own, which may result in our inability to maintain our goals, objectives, standards, controls, policies, culture or profitability. In addition, through acquisitions, we may enter markets in which we have limited or no experience. The occurrence of one or more of these events may place additional constraints on our resources such as diverting the attention of our management from other business concerns, which may materially adversely affect our operations and financial condition. Moreover, any acquisition may result in a potentially dilutive issuance of equity securities, incurrence of additional debt and amortization of identifiable intangible assets, all of which could reduce our profitability.

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

Our management team has considerable experience in finance, banking, consumer collections and other industries. We believe that the expertise of our executives obtained by managing businesses across numerous other industries has been critical to the enhancement of our operations. Our management team has created a culture of new ideas and progressive thinking, coupled with increased use of technology and statistical analysis. The loss of the services of one or more of our key executive officers could disrupt our operations and seriously impair our ability to continue to acquire or collect on portfolios of charged-off consumer receivables and to manage and expand our business. Our success depends on the continued service and performance of our management team, and we cannot guarantee that we will be able to retain such individuals.

Further, we are developing a senior management succession plan in order to effectively prepare for changes in our executive officers over time, but there can be no guarantee that the plan will be successful or that we will find appropriate candidates. If we are unable to hire and retain qualified employees, our business and operating results could be adversely affected.

Regulatory, political and economic conditions in India expose us to risk, including loss of business.

A significant element of our business strategy is to continue to develop and expand offshore operations in India. While wage costs in India are significantly lower than in the U.S. and other industrialized countries for comparably skilled workers, wages in India are increasing at a faster rate than in the U.S., and we experience higher employee turnover in our operations in India than is typical in our U.S. locations. The continuation of these trends could result in the loss of the cost savings we sought to achieve by establishing a portion of our collection operations to India. In the past, India has experienced significant inflation and shortages of readily available foreign currency for exchange and has been subject to civil unrest. We may be adversely affected by changes in inflation, exchange rate fluctuations, interest rates, tax provisions, social stability or other political, economic or diplomatic developments in or affecting India in the future. In addition, the infrastructure of the economy in India is relatively poor. Further, the Indian government is significantly involved in and exerts considerable influence over its economy through its complicated tax code and pervasive bureaucracy. In the recent past, the Indian government has provided significant tax incentives and relaxed certain regulatory restrictions in order to encourage foreign investment in certain sectors of the economy, including the technology industry. Changes in the business or regulatory climate of India could have a material and adverse effect on our business, results of operations and financial condition.

Table of Contents

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

We have expanded significantly in recent years. However, future growth will place additional demands on our resources, and we cannot be sure that we will be able to manage our growth effectively. Continued growth could place a strain on our management, operations and financial resources. We cannot be certain that our infrastructure, facilities and personnel will be adequate to support our future operations or to effectively adapt to future growth. To support our growth and improve our operations, we continue to make investments in infrastructure, facilities and personnel in our operations in the U.S. and in India; however, we cannot be certain that these additional investments will be successful or that our investments will produce profitable results. If we cannot manage our growth effectively, our results of operations may be materially and adversely affected.

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

Our success depends in large part on sophisticated computer and telecommunications systems. The temporary or permanent loss of our computer and telecommunications equipment and software systems, through casualty, operating malfunction, software virus, or service provider failure, could disrupt our operations. In the normal course of our business, we must record and process significant amounts of data quickly and accurately to properly bid on prospective acquisitions of receivable portfolios and to access, maintain and expand the databases we use for our collection activities. Any simultaneous failure of our information systems and their backup systems would interrupt our business operations.

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

Our business relies on computer and telecommunications technologies, and our ability to integrate new technologies into our business is essential to our competitive position and our success. We may not be successful in anticipating, investing in, or adopting technological changes in a timely basis. Computer and telecommunications technologies are evolving rapidly and are characterized by short product life cycles.

We are making significant modifications to our information systems to ensure that they continue to meet our current and foreseeable demands and continued expansion, and our future growth may require additional investment in these systems. These system modifications may exceed our cost or time estimates for completion or may be unsuccessful. If we cannot update our information systems effectively, our results of operations may be materially and adversely affected.

We depend on having the capital resources necessary to invest in new technologies to acquire and service receivables. We cannot be certain that adequate capital resources will be available to us.

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

We rely on proprietary software programs and valuation and collection processes and techniques, and we believe that these assets provide us with a competitive advantage. We consider our proprietary software, processes and techniques to be trade secrets, but they are not protected by patent or registered copyright. We may not be able to protect our technology and data resources adequately, which may materially diminish our competitive advantage.

Item 2 Unregistered Sales of Equity Securities and Use of Proceeds

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

Table of Contents

Item 6. Exhibits

- 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).
- 101 The following financial statements and footnotes from the Encore Capital Group, Inc. Quarterly Report on Form 10-Q for the quarter ended June 30, 2011 formatted in Extensible Business Reporting Language (XBRL): (i) Condensed Consolidated Statements of Financial Condition; (ii) Condensed Consolidated Statements of Income; (iii) Condensed Consolidated Statements of Stockholders Equity and Comprehensive Income; (iv) Condensed Consolidated Statements of Cash Flows; and (v) the Notes to Condensed Consolidated Financial Statements, tagged as blocks of text.

Table of Contents

SIGNATURES

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

ENCORE CAPITAL GROUP, INC.

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

Date: August 1, 2011

Table of Contents

EXHIBIT INDEX

- 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).
- 101 The following financial statements and footnotes from the Encore Capital Group, Inc. Quarterly Report on Form 10-Q for the quarter ended June 30, 2011 formatted in Extensible Business Reporting Language (XBRL): (i) Condensed Consolidated Statements of Financial Condition; (ii) Condensed Consolidated Statements of Income; (iii) Condensed Consolidated Statements of Stockholders Equity and Comprehensive Income; (iv) Condensed Consolidated Statements of Cash Flows; and (v) the Notes to Condensed Consolidated Financial Statements, tagged as blocks of text.