PORTFOLIO RECOVERY ASSOCIATES INC
Form 10-Q
November 09, 2010

Table of Contents

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

FORM 10-Q

þ **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the quarterly period ended September 30, 2010.

o **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**
For the transition period from __________ to __________

Commission File Number: 000-50058
Portfolio Recovery Associates, Inc.
(Exact name of registrant as specified in its charter)

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

(888) 772-7326
(Registrant s telephone number, including area code)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days.
YES þ NO o

Indicate by check mark whether the registrant 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 o NO o

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

Large accelerated filer þ	Accelerated filer o	Non-accelerated filer o (Do not check if a smaller reporting company)	Smaller Reporting Company o

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).
YES o NO þ

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

Class	Outstanding as of November 3, 2010
Common Stock, $0.01 par value	17,061,914

PORTFOLIO RECOVERY ASSOCIATES, INC.
INDEX

EX-101 DEFINITION LINKBASE DOCUMENT

2

Table of Contents

Part I. FINANCIAL INFORMATION
Item 1. Financial Statements

PORTFOLIO RECOVERY ASSOCIATES, INC.
CONSOLIDATED BALANCE SHEETS
September 30, 2010 and December 31, 2009
(unaudited)
(Amounts in thousands, except per share amounts)

	September 30, 2010	December 31, 2009
Assets		
Cash and cash equivalents	$ 20,297	$ 20,265
Finance receivables, net	807,239	693,462
Accounts receivable, net	7,789	9,169
Income taxes receivable	2,603	4,460
Property and equipment, net	22,794	21,864
Goodwill	61,665	29,299
Intangible assets, net	19,945	10,756
Other assets	5,405	5,158
Total assets	$ 947,737	$ 794,433
Liabilities and Stockholders Equity		
Liabilities:		
Accounts payable	$ 5,739	$ 4,108
Accrued expenses and other liabilities	6,922	4,506
Accrued payroll and bonuses	10,447	11,633
Deferred tax liability	151,638	117,206
Line of credit	288,500	319,300
Long-term debt	998	1,499
Derivative instrument	537	701
Total liabilities	464,781	458,953
Commitments and contingencies (Note 14)		
Redeemable noncontrolling interest	14,531	
Stockholders equity:		
Preferred stock, par value $0.01, authorized shares, 2,000, issued and outstanding shares - 0		
Common stock, par value $0.01, authorized shares, 30,000, 17,061 issued and outstanding shares at September 30, 2010, and 15,596 issued and 15,514	171	155

outstanding shares at December 31, 2009				
Additional paid-in capital		162,418		82,400
Retained earnings		306,164		253,353
Accumulated other comprehensive loss, net of taxes		(328)		(428)
Total stockholders equity		468,425		335,480
Total liabilities and stockholders equity	$	947,737	$	794,433

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

3

Table of Contents

PORTFOLIO RECOVERY ASSOCIATES, INC.

CONSOLIDATED INCOME STATEMENTS
For the three and nine months ended September 30, 2010 and 2009
(unaudited)
(Amounts in thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2010	2009	2010	2009
Revenues:				
Income recognized on finance receivables, net	$ 80,026	$ 54,336	$ 224,897	$ 159,650
Fee income	15,518	14,229	47,054	48,225
Total revenues	95,544	68,565	271,951	207,875
Operating expenses:				
Compensation and employee services	31,213	26,844	91,725	79,940
Legal and agency fees and costs	16,748	11,296	43,573	34,460
Outside fees and services	3,470	2,284	9,454	6,854
Communications	4,000	3,472	13,160	11,157
Rent and occupancy	1,362	1,270	3,912	3,515
Depreciation and amortization	3,294	2,269	9,050	6,874
Other operating expenses	2,634	2,341	7,488	6,565
Total operating expenses	62,721	49,776	178,362	149,365
Income from operations	32,823	18,789	93,589	58,510
Other income and (expense):				
Interest income			35	3
Interest expense	(2,178)	(1,964)	(6,535)	(5,891)
Income before income taxes	30,645	16,825	87,089	52,622
Provision for income taxes	11,888	6,729	33,847	20,730
Net income	$ 18,757	$ 10,096	$ 53,242	$ 31,892
Less net income attributable to redeemable noncontrolling interest	(276)		(431)	
	$ 18,481	$ 10,096	$ 52,811	$ 31,892

Net income attributable to Portfolio Recovery Associates, Inc.				
Net income per common share attributable to Portfolio Recovery Associates, Inc:				
Basic	$ 1.08	$ 0.65	$ 3.15	$ 2.07
Diluted	$ 1.08	$ 0.65	$ 3.15	$ 2.07
Weighted average number of shares outstanding:				
Basic	17,058	15,466	16,740	15,392
Diluted	17,093	15,502	16,792	15,428

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

4

Table of Contents

PORTFOLIO RECOVERY ASSOCIATES, INC.

CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY AND COMPREHENSIVE INCOME
For the nine months ended September 30, 2010
(unaudited)
(Amounts in thousands)

	Common Stock	Additional Paid-in Capital	Retained Earnings	Accumulated Other Comprehensive Loss, Net of Taxes	Total Stockholders Equity
Balance at December 31, 2009	$ 155	$ 82,400	$ 253,353	$ (428)	$ 335,480
Net income			52,811		52,811
Net unrealized change in:					
Interest rate swap derivative, net of tax				100	100
Comprehensive income					52,911
Exercise of stock options and vesting of nonvested shares	2	55			57
Proceeds from stock offering, net of offering costs	14	71,674			71,688
Amortization of share-based compensation		3,114			3,114
Income tax benefit from share-based compensation		225			225
Issuance of common stock for acquisition		4,950			4,950
Balance at September 30, 2010	$ 171	$ 162,418	$ 306,164	$ (328)	$ 468,425

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

5

Table of Contents

PORTFOLIO RECOVERY ASSOCIATES, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS
For the nine months ended September 30, 2010 and 2009
(unaudited)
(Amounts in thousands)

	Nine Months Ended September 30,	
	2010	**2009**
Cash flows from operating activities:		
Net income	$ 53,242	$ 31,892
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of share-based compensation	3,114	3,240
Depreciation and amortization	9,050	6,874
Deferred tax expense	34,368	22,000
Changes in operating assets and liabilities:		
Other assets	(244)	(14)
Accounts receivable	1,380	1,369
Accounts payable	1,631	520
Income taxes	1,857	(2,306)
Accrued expenses	194	(851)
Accrued payroll and bonuses	(1,186)	1,443
Net cash provided by operating activities	103,406	64,167
Cash flows from investing activities:		
Purchases of property and equipment	(6,162)	(3,079)
Acquisition of finance receivables, net of buybacks	(273,858)	(210,116)
Collections applied to principal on finance receivables	160,081	113,067
Business acquisitions, net of cash acquired	(23,000)	
Contingent payments made for business acquisition	(104)	(100)
Net cash used in investing activities	(143,043)	(100,228)
Cash flows from financing activities:		
Proceeds from exercise of options	57	1,630
Income tax benefit from share-based compensation	225	746
Payments of liability-classified contingent consideration	(1,000)	
Proceeds from line of credit	131,000	84,500
Principal payments on line of credit	(161,800)	(46,500)
Proceeds from stock offering, net of offering costs	71,688	
Proceeds from long-term debt		2,036
Principal payments on long-term debt	(501)	(373)
Principal payments on capital lease obligations		(5)

Net cash provided by financing activities	39,669	42,034
Net increase in cash and cash equivalents	32	5,973
Cash and cash equivalents, beginning of period	20,265	13,901
Cash and cash equivalents, end of period	$ 20,297	$ 19,874
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 6,508	$ 6,028
Cash paid for income taxes	89	321
Noncash investing and financing activities:		
Net unrealized change in fair value of derivative instrument	$ 164	$ (655)
Common stock issued for acquisition	4,950	1,170

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

Table of Contents

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

1. Organization and Business:

Portfolio Recovery Associates, LLC (PRA) was formed on March 20, 1996. Portfolio Recovery Associates, Inc. (PRA Inc) was formed in August 2002. On November 8, 2002, PRA Inc completed its initial public offering (IPO) of common stock. In connection with the IPO, all of the membership units and warrants of PRA were exchanged on a one to one basis for shares of a single class of common stock of PRA Inc and warrants to purchase shares of PRA Inc common stock, respectively. PRA Inc owns all outstanding membership units of PRA, PRA Holding I, LLC (PRA Holding I), PRA Holding II, LLC (PRA Holding II), PRA Holding III, LLC (PRA Holding III), PRA Receivables Management, LLC (formerly d/b/a Anchor Receivables Management) (Anchor), PRA Location Services, LLC (d/b/a IGS Nevada) (IGS), PRA Government Services, LLC (d/b/a RDS) (RDS) and MuniServices, LLC (d/b/a PRA Government Services) (MuniServices). On March 15, 2010, PRA Inc acquired 62% of the membership units of Claims Compensation Bureau, LLC (CCB). The business of PRA Inc, a Delaware corporation, and its subsidiaries (collectively, the Company) revolves around the detection, collection, and processing of both unpaid and normal-course receivables originally owed to credit grantors, governments, retailers and others. The Company s primary business is the purchase, collection and management of portfolios of defaulted consumer receivables. These accounts are purchased from sellers of finance receivables and collected by a highly skilled staff whose purpose is to locate and contact customers and arrange payment or resolution of their debts. The Company, through its Litigation Department, collects accounts judicially, either by using its own attorneys or by contracting with independent attorneys throughout the country through whom the Company takes legal action to satisfy consumer debts. The Company also services receivables on behalf of clients on either a commission or transaction-fee basis. Clients include entities in the financial services, auto, retail, utility, health care and government sectors. Services provided to these clients include obtaining location information for clients in support of their collection activities (known as skip tracing), and the management of both delinquent and non-delinquent receivables for government entities. In addition, through its newly acquired CCB subsidiary, the Company provides class action claims settlement recovery services and related payment processing to its corporate clients.

The consolidated financial statements of the Company include the accounts of PRA Inc, PRA, PRA Holding I, PRA Holding II, PRA Holding III, Anchor, IGS, RDS, MuniServices and CCB. Under the guidance of ASC Topic 280 Segment Reporting (ASC 280), the Company has determined that it has several operating segments that meet the aggregation criteria of ASC 280 and, therefore, it has one reportable segment, receivables management, based on similarities among the operating units including homogeneity of services, service delivery methods and use of technology.

The accompanying unaudited consolidated financial statements of the Company have been prepared in accordance with Rule 10-01 of Regulation S-X promulgated by the Securities and Exchange Commission (SEC) and, therefore, do not include all information and disclosures required by U.S. generally accepted accounting principles for complete financial statements. In the opinion of the Company, however, the accompanying unaudited consolidated financial statements contain all adjustments, consisting only of normal recurring adjustments, necessary for a fair presentation of the Company s consolidated balance sheet as of September 30, 2010, its consolidated income statements for the three and nine months ended September 30, 2010 and 2009, its consolidated statement of changes in stockholders equity and comprehensive income for the nine months ended September 30, 2010, and its consolidated statements of cash flows for the nine months ended September 30, 2010 and 2009. The consolidated income statement of the Company for the nine months ended September 30, 2010 may not be indicative of future results. These unaudited consolidated financial statements should be read in conjunction with the audited consolidated financial statements and notes thereto included in the Company s Annual Report on Form 10-K, as filed for the year ended December 31, 2009.

2. Finance Receivables, net:

The Company s principal business consists of the acquisition and collection of pools of accounts that have experienced deterioration of credit quality between origination and the Company s acquisition of the accounts. The amount paid for any pool reflects the Company s determination that it is probable the Company will be unable to

7

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

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

The Company accounts for its investment in finance receivables under the guidance of FASB ASC Topic 310-30 Loans and Debt Securities Acquired with Deteriorated Credit Quality (ASC 310-30). Under ASC 310-30, static pools of accounts may be established. These pools are aggregated based on certain common risk criteria. Each static pool is recorded at cost, which includes certain direct costs of acquisition paid to third parties, and is accounted for as a single unit for the recognition of income, principal payments and loss provision. Once a static pool is established for a calendar quarter, individual receivable accounts are not added to the pool (unless replaced by the seller) or removed from the pool (unless sold or returned to the seller). ASC 310-30 requires that the excess of the contractual cash flows over expected cash flows, based on the Company s estimates derived from its proprietary collection models, not be recognized as an adjustment of revenue or expense or on the balance sheet. ASC 310-30, utilizing the interest method, initially freezes the yield estimated when the accounts are purchased as the basis for subsequent impairment testing. Significant increases in actual, or expected future cash flows may be recognized prospectively through an upward adjustment of the yield over a portfolio s remaining life. Any increase to the yield then becomes the new benchmark for impairment testing. Under ASC 310-30, rather than lowering the estimated yield if the collection estimates are not received or projected to be received, the carrying value of a pool would be written down to maintain the then current yield and is shown as a reduction in revenue in the consolidated income statements with a corresponding valuation allowance offsetting finance receivables, net, on the consolidated balance sheet. Income on finance receivables is accrued quarterly based on each static pool s effective yield. Quarterly cash flows greater than the interest accrual will reduce the carrying value of the static pool. This reduction in carrying value is defined as payments applied to principal (also referred to as finance receivable amortization). Likewise, cash flows that are less than the interest accrual will accrete the carrying balance. The Company generally does not allow accretion in the first six to twelve months; accordingly, the Company utilizes either the cost recovery method or cash method when necessary to prevent accretion as permitted by ASC 310-30. The yield is estimated and periodically recalculated based on the timing and amount of anticipated cash flows using the Company s proprietary collection models. A pool can become fully amortized (zero carrying balance on the balance sheet) while still generating cash collections. In this case, all cash collections are recognized as revenue when received. Under the cash method, revenue is recognized as it would be under the interest method up to the amount of cash collections. Additionally, the Company uses the cost recovery method when collections on a particular pool of accounts cannot be reasonably predicted. These cost recovery pools are not aggregated with other portfolios. Under the cost recovery method, no revenue is recognized until the Company has fully collected the cost of the portfolio, or until such time that the Company considers the collections to be probable and estimable and begins to recognize income based on the interest method as described above. At September 30, 2010 and December 31, 2009, the Company had unamortized purchased principal (purchase price) in pools accounted for under the cost recovery method of $1.8 million and $2.9 million, respectively.

The Company establishes valuation allowances, if necessary, for acquired accounts subject to ASC 310-30 to reflect only those losses incurred after acquisition (that is, the present value of cash flows initially expected at acquisition that are no longer expected to be collected). Valuation allowances are established only subsequent to acquisition of the accounts. At September 30, 2010 and December 31, 2009, the Company had an allowance against its finance receivables of $70,965,000 and $51,255,000, respectively.

Table of Contents

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

The Company implements the accounting for income recognized on finance receivables under ASC 310-30 as follows. The Company creates each accounting pool using its projections of estimated cash flows and expected economic life. The Company then computes the effective yield that fully amortizes the pool to the end of its expected economic life based on the current projections of estimated cash flows using the interest method. As actual cash flow results are recorded, the Company balances those results to the data contained in its proprietary models to ensure accuracy, then reviews each accounting pool watching for trends, actual performance versus projections and curve shape (a graphical depiction of the timing of cash flows), sometimes re-forecasting future cash flows utilizing the Company s statistical models. The review process is primarily performed by the Company s finance staff; additionally, the Company s operational and statistical staffs may also be involved. To the extent there is overperformance, the Company will either increase the yield or release the allowance and consider increasing future cash projections, if persuasive evidence indicates that the overperformance is considered to be a significant betterment. If the overperformance is considered more of an acceleration of cash flows (a timing difference), the Company will adjust estimated future cash flows downward which effectively extends the amortization period, or take no action at all if the amortization period is reasonable and falls within the pool s expected economic life. In either case, the yield may or may not be increased due to the time value of money (accelerated cash collections). To the extent there is underperformance, the Company will record an allowance if the underperformance is significant and will also consider revising estimated future cash flows based on current period information, or take no action if the pool s amortization period is reasonable and falls within the currently projected economic life.

The Company capitalizes certain fees paid to third parties related to the direct acquisition of a portfolio of accounts. These fees are added to the acquisition cost of the portfolio and accordingly are amortized over the life of the portfolio using the interest method. The balance of the unamortized capitalized fees at September 30, 2010 and 2009 was $3,105,239 and $3,262,929, respectively. During the three and nine months ended September 30, 2010, the Company capitalized $177,337 and $624,168, respectively, of these direct acquisition fees. During the three and nine months ended September 30, 2009, the Company capitalized $156,248 and $805,962, respectively, of these direct acquisition fees. During the three and nine months ended September 30, 2010, the Company amortized $233,603 and $750,855, respectively, of these direct acquisition fees. During the three and nine months ended September 30, 2009, the Company amortized $206,270 and $621,593, respectively, of these direct acquisition fees.

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

Changes in finance receivables, net for the three and nine months ended September 30, 2010 and 2009 are as follows (amounts in thousands):

	Three Months Ended September 30, 2010	Three Months Ended September 30, 2009	Nine Months Ended September 30, 2010	Nine Months Ended September 30, 2009
Balance at beginning of period	$ 775,606	$ 624,592	$ 693,462	$ 563,830
Acquisitions of finance receivables, net of buybacks	88,984	74,318	273,858	210,116

Cash collections		(137,377)		(92,367)		(384,978)		(272,717)
Income recognized on finance receivables, net		80,026		54,336		224,897		159,650
Cash collections applied to principal		(57,351)		(38,031)		(160,081)		(113,067)
Balance at end of period	$	807,239	$	660,879	$	807,239	$	660,879

At the time of acquisition, the life of each pool is generally estimated to be between 84 to 96 months based on projected amounts and timing of future cash collections using the proprietary models of the Company. As of

Table of Contents

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

September 30, 2010, the Company had $807.2 million in finance receivables, net. Based upon projections as of September 30, 2010, cash collections applied to principal are estimated to be as follows for the twelve months in the periods ending (amounts in thousands):

September 30, 2011	$ 188,821
September 30, 2012	207,400
September 30, 2013	208,665
September 30, 2014	150,098
September 30, 2015	45,993
September 30, 2016	5,816
September 30, 2017	446
	$ 807,239

During the three and nine months ended September 30, 2010, the Company purchased approximately $1.38 billion and $4.94 billion, respectively, in face value of charged-off consumer receivables. During the three and nine months ended September 30, 2009, the Company purchased approximately $1.75 billion and $6.09 billion, respectively, in face value of charged-off consumer receivables. At September 30, 2010, the estimated remaining collections (ERC) on the receivables purchased in the three and nine months ended September 30, 2010 were $171.6 million and $537.1 million, respectively. At September 30, 2010, ERC on the receivables purchased in the three and nine months ended September 30, 2009 were $137.7 million and $375.1 million, respectively.

Accretable yield represents the amount of income recognized on finance receivables the Company can expect to generate over the remaining life of its existing portfolios based on estimated future cash flows as of September 30, 2010 and 2009. Reclassifications from nonaccretable difference to accretable yield primarily result from the Company s increase in its estimate of future cash flows. Reclassifications to nonaccretable difference from accretable yield result from the Company s decrease in its estimates of future cash flows and allowance charges that exceed the Company s increase in its estimate of future cash flows. Changes in accretable yield for the three and nine months ended September 30, 2010 and 2009 were as follows (amounts in thousands):