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$6 Billion and Growing

That's how much private equity firms have invested in accounts receivable management deals; expect more money and more deals ahead.

By Brian Greenberg, Milestone Advisors

PRIVATE EQUITY FIRMS HAVE invested approximately $3.3 billion in transactions in the Accounts Receivable Management (ARM) industry since May 2005, with more than $2.4 billion of that invested so far in 2006. Tracking deals back to the mid-1990s, that investment easily exceeds $6 billion.

This interest is fueling what is already a record-breaking deal year in the ARM industry, far surpassing any other year in the industry's history.

With three large public-to-private transactions announced within a three-week span earlier this summer, the buzz of many industry conversations surrounds these deals as people consider why private equity is so prevalent in the industry today, and what impact its presence will have on their own ARM business.

The similarly timed announcements involve NCO Group, West Corp. and Encore Capital Group (which is reviewing its strategic alternatives). Is this a trend, or just a coincidence?

Conventional wisdom says that it's just more difficult today to manage a public company than it ever has been. After all, Sarbanes-Oxley requirements and widely-publicized corporate scandals have led to increased costs for public companies, elevated liability for boards of directors, and an intense focus on corporate governance, all of which makes daily life in a public company much less enjoyable, to say the least.

As a result, the traditional advantages of being public (such as the ease of liquidity, access to capital, and stature) don't dramatically outweigh the advantages of being privately held.

This, in conjunction with the fact that debt markets are still relatively flush with available capital, as are thousands of private equity firms, provides shareholders of public companies with appealing alternatives, namely a going-private transaction.

These deals have been so popular, in fact, that deal volumes for public-to-private transactions have risen 34% from 2004 to 2005, and deal values have more than tripled from $18 billion in 2004 to $69 billion in 2005, according to *Buyouts* newsletter.

Will public-to-private deals continue? In the overall economy, I think they will continue, and the first half of 2006 represented a busy start. In the ARM business, however, there are few public companies remaining that could take this path and I expect that at least one more will.

Private Equity Activity

Private equity firms have been in overdrive lately, in terms of both deal volume and fund raising, a good indication of future deal activity. So far in 2006, private equity-backed merger and acquisition activity across all industries has surpassed record levels, according to research firm Dealogic. A record 500 deals were announced through mid-June, almost double the volume during the same period of 2005.

Private equity firms have played such a vital role in recent M&A activity that a recent Pricewaterhouse-Coopers study shows that they were responsible for 30% of all deal value in the second quarter of 2006, a level not achieved in more than 10 years. And they have plenty of capital yet to invest, with many reports estimating their wallet at over $100 billon.

In 2006, the ARM industry has seen its fair share of this capital, in both public-to-private and private-to-private deals. Nikko Principle Investment, Allco Equity Partners, Thomas H. Lee Partners and One Equity Partners are among the newest entrants into the ARM industry. They continue to turn heads with competitive pricing and their ability to complete some of the largest deals the industry has ever seen, as is the case with the NCO Group transaction, valued at approximately $1.2 billion.

Similarly, the sale of West Corp. is valued at approximately $4.1 billion, with an estimated $450 million attributable to the West Asset Management unit, which performs ARM functions.

Spend It or Fade Away

There's another force behind much of this heightened activity — the billions of dollars that many private equity firms still seek to deploy. Usually the explanation ends there, but while this is definitely an important factor, it's not an end-all-be-all kind of fact, and it certainly is not the only reason for the increased M&A activity in our industry. The heap of capital in the coffers of private equity firms, however, gives them the ability and motivation to compete more aggressively in bidding wars to win the deals they really want. In fact, *they have to do deals.*

Years ago, this was not the case. In speaking with private equity firms six to seven years ago, my experience was that they often backed away from bidding wars. Some flat out wouldn't participate. And while that is still the case for a few firms, many have so much capital to deploy now that they can't afford not to compete. It's pretty simple really: If they don't spend the money, they have to return it, which leaves their investors (called "Limited Partners" aka "LPs") without the returns they had expected. If the LPs don't get the desired returns, they aren't likely to commit funds to that same firm during its next fund-raising effort.

This is part of a constant cycle for private equity firms. So if any link in the chain is broken, for instance, they don't invest the capital, it puts a firm's very existence at risk, and for that reason, we've seen a lot of increased activity and competitiveness among firms for deals.

Raising the Value

Large and growing, the ARM industry will continue to draw private equity investment for years to come. Beyond size and profitability, the industry offers the characteristics that most private equity firms seek, including favorable economic trends, opportunities to use technology as a competitive advantage and many opportunities for strategic add-on acquisitions.

Given today's environment for funding transactions, owners of well-run ARM firms should be very happy about private equity's interest in the industry. Below are a few of the reasons.

1. Raising the Industry's Profile: Because they are professional investors, private equity firms require certain standards in any deal they complete. For instance, they may require that certain accounting procedures or reporting requirements be met.

This benefits all ARM company owners because, while it may force some changes in the short term, those who adhere to higher standards will be very well received by clients and potential clients over those who do not.

If you've tried recently to gain business from financial institutions, you can easily understand this point. The banks and credit card issuers have imposed stringent requirements on vendors just to compete for their business. Such requirements include costly items like halon fire suppression systems, video surveillance and increased security measures. Once you've met the requirements, however, you are in top form to compete for most any client's business.

2. Improving the Industry's Image: Because private equity firms are backed by large money sources, word gets around at the highest levels of the economy. We all know that when people have considerable amounts of capital at risk, they go to great lengths to increase the value of their investment. Therefore, it's logical to conclude that private equity firms, as well as their investors, will do as much as possible to further a positive image of the ARM industry.

While it won't eliminate all of the inevitable negative press that the industry (often undeservedly) receives, I expect the extra visibility will reduce the number of occurrences. It should also create a "circular" effect where positive news attracts more investors, more interest and more opportunities for the industry.

3. Maximum Values for Sellers: And finally, as I've said for many years, more well-funded and knowledgeable buyers in the market means more competition to acquire good companies, which always results in better pricing and terms for sellers.

With the recent investments in the ARM industry by private equity firms and more deals currently in progress, owners and industry participants will have many more opportunities to maximize the value that they have created in their businesses. It's clear now that private equity firms are here to stay in the ARM industry, and that should continue to benefit the entire industry. ■

Brian Greenberg is a managing director of Milestone Advisors, LLC, a Washington, DC-based investment bank where he directs the firm's activities in the ARM, debt purchasing and related industries. He has completed approximately 60 M&A (sell-side and buy-side) and corporate finance transactions within the ARM industry over the past 10 years. He can be reached at 202-741-3669 or bgreenberg@milestonecap.com.