Encore, Encore

Industries often don't remain static in the face of cyclical ebbs and flows, which can create the type of investment opportunity Broad Run Investment Management sees today in debt-collector Encore Capital Group.

For a firm with 20%-plus returns on equity and annual earnings per share growth over the past five years of nearly 35%, Encore Capital Group garners little market respect. Shares of the company, which buys defaulted consumer receivables at a deep discount to face value, have significantly lagged those of top publicly traded competitor Portfolio Recovery Associates [PRAA] over the past year and now trade at just 8.6x estimated 2014 earnings. On the same metric, Portfolio Recovery goes for more than 14x.

The bear case for Encore, says Broad Run Investment Management's Ira Rothberg, appears to be the sharp decrease in available-for-purchase receivables and the sharp increase in market pricing since the immediate aftermath of the financial crisis. "The argument seems to be, these are cyclical businesses and it's a matter of time before that impacts earnings," says Rothberg. "We'd argue that's a bit simplistic."

That argument misses an ongoing evolution of the debt-collection business that dramatically favors the largest players like Encore, he says. It is the #2 player – behind private Sherman Financial and ahead of Portfolio Recovery – and is the industry's acknowledged cost-efficiency leader. Since 2007, Encore's cost to collect has declined from 51.5% of receivables to 36.5%, driven by collection centers in India and Costa Rica that operate at roughly one-third the cost of U.S. operations.

That cost advantage translates into higher profits – Rothberg estimates the company earns high-teens pre-tax unlevered rates of return on today's receivable purchases – and allows it and other big players to put the squeeze on smaller competitors. Since 2008 seven firms, then representing one-third of industry purchasing volume, have left the business. With Encore's pending acquisition of top-five competitor Asset Acceptance Capital, the strong continue to get stronger. "It's survival of the fittest," says Rothberg. Efforts by the Consumer Financial Protection Bureau will likely further fuel consolidation, he says, as small players struggle to meet stricter, more costly regulatory standards.

While historically focused on U.S. credit card paper, Encore just bought a 50% interest in U.K. debt collector Cabot Credit and has successfully expanded into telecom receivables, bankruptcy-related debt and property tax liens. "Collections expertise is quite transferable across categories," says Rothberg, who expects market-share gains and organic growth to result in 15-20% per year increases in Encore's EPS over the next few years.

While he sees no good reason for Encore's shares to trade at *any* discount to Portfolio Recovery's, he says the stock has plenty of upside just if the valuation gap narrows. At 11.3x his $4.15 per share 2014 earnings estimate – using PRAA's average forward multiple over the past five years – Encore's stock would trade at $47, 30% above today's price. VII

INVESTMENT SNAPSHOT

Encore Capital
(Nasdaq: ECPG)

Business: Purchases and manages portfolios of defaulted consumer loans originally made by banks and other consumer lenders.

Share Information (@5/30/13):

Price	**35.86**
52-Week Range	23.54 - 36.35
Dividend Yield	0.0%
Market Cap	$836.8 million

Financials (TTM):

Revenue	$578.3 million
Operating Profit Margin	28.9%
Net Profit Margin	13.4%

Valuation Metrics
(@5/30/13):

	ECPG	Russell 2000
P/E (TTM)	11.8	35.8
Forward P/E (Est.)	8.8	17.5
EV/EBITDA (TTM)	8.1	

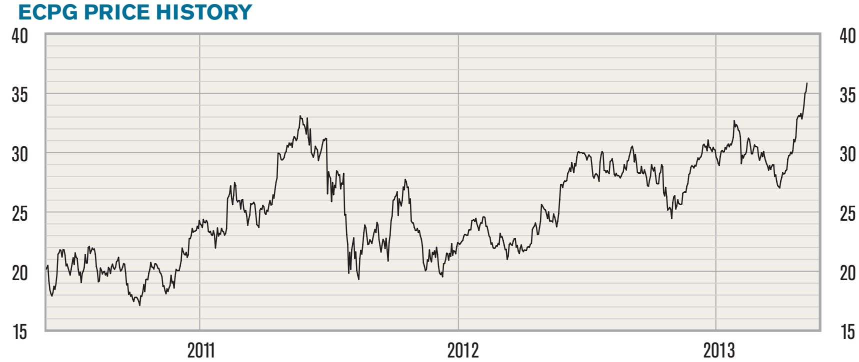
Largest Institutional Owners
(@3/31/13):

Company	% Owned
William Blair & Co	7.5%
Fidelity Mgmt & Research	6.1%
Vanguard Group	5.5%

Short Interest (as of 4/30/13):

Shares Short/Float	18.1%

ECPG PRICE HISTORY



THE BOTTOM LINE

The market doesn't sufficiently appreciate the extent to which the evolution of the debt-collection industry will favor large and efficient players like the company, says Ira Rothberg. He believes its shares warrant at least the average multiple over the past five years of its top competitor, which would translate into a share price 30% above today's level.

Sources: Company reports, other publicly available information

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BROAD RUN
INVESTMENT MANAGEMENT, LLC

Broad Run uses a concentrated, low-turnover investment approach, and generally seeks to invest in high quality, growth-oriented companies trading at discounts to intrinsic value. Broad Run manages equity portfolios for institutional and individual investors through separate accounts and a sub-advised mutual fund.

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