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Debt begets debt, which begets defaults. Defaults beget debt collectors, which begets the debt (and the equity) of the debt collectors themselves. It's the way of the world, especially in this time of tiny little interest rates. Arrow Global Group PLC's equity (ARW on the London Stock Exchange) and Lowell Group's bonds are the securities under the *Grant's* lens. To anticipate, we're bearish on them.

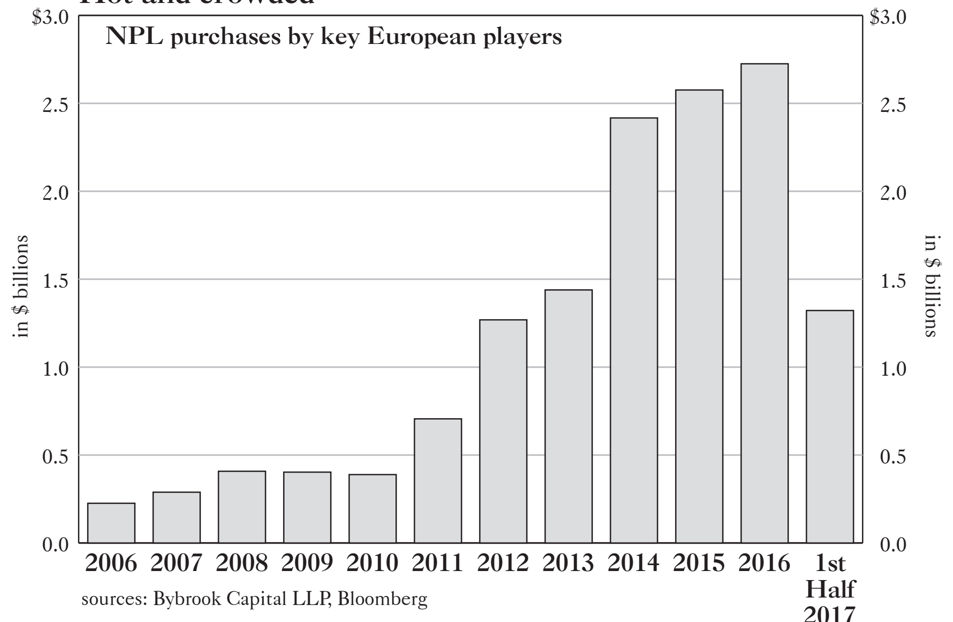
Don't stop reading, please. For the majority of readers who would sooner consider running for Parliament than selling short the securities of a London-domiciled business, we offer a lesson in the consequences of errant lending (the remote problem), of central-bank manipulation (an immediate problem) and of wishful thinking (a universal problem). Here, then, is the story of humanity in markets.

Europe's wealth of defaulted debt is the reason for the existence of niche collection companies. They mine it for salvage value (harranguing the defaulters to shake the tree). At the start, the buyers paid little, bought much and posted 20% per annum returns. Then imitators arrived to share the wealth. Up went the prices of the nonperforming loans. Down went the collectors' returns.

There was only one thing for the aspiring industrial-scale NPL collection companies to do, and they did it. In the past five years, they have issued (to a warm reception) some €13 billion worth of their own securities. Bulls spin a story of growth and cash generation. EBITDA margins hover above 60%. Capital expenditures are under 5% of revenues, and those revenues, and the earnings they produce, are growing at double-digit rates. Leverage, in the range of four to five times EBITDA, is in-line with that of other high-yield issuers.

The story's the thing. An Oct. 5, 2016, Bloomberg dispatch, noting the growth in high-yield issuance by debt purchasers and other non-bank lenders, quoted Paul Atefi, an executive director in JP Morgan Chase & Co.'s acquisition and leveraged-finance team in London. "[A]n ingredient for a successful sale is to reposition the issuer's credit story," said Atefi. The banker had successfully recast Garfunkelux Holdco 2 S.A., a collection business better known as Lowell, "not as a debt purchaser, but rather as a data- and technology-driven company." Well, the NPL merchants do own computers, and they do crunch data.

Ash Thomas-Watson, analyst at British hedge fund Bybrook Capital LLP, which is bearish on the collections business, furnishes an overview of the standard NPL-recovery business model: "These guys go out to banks and buy defaulted consumer debt which might be five, ten years old," he tells colleague Fabiano Santin. "So, say I didn't pay my credit-card bill in 2012. These companies turn up at the bank and say, 'OK, I'll buy Ash's defaulted debt. I will pay £100 to take the £1,000 he owes you off your hands.' The bank gets a recovery, and the companies hope to get back double the price they paid in collections over 10 years. So they spend £100 today, and plan to get £200 back in collections on a £1,000 debt by 2027. It typically costs them 30



sources: Bybrook Capital LLP, Bloomberg

pence to collect every pound because they've got to pay staff, make phone calls, send letters and hire lawyers—so that £200 over 10 years is more like £140 after costs. And at the end of the day they're doing all this work and taking risk on people with the least ability to afford their debt, to make anywhere from an 8% to 12% internal rate of return on those purchases."

Arrow Global Group PLC, founded in 2005 and public since 2013, our first pick not to click, has two different but overlapping businesses. The bigger of the two invests in defaulted consumer loans. The smaller manages loan collections on behalf of third parties. In 2016 sales, they chipped in £190 million and £46 million, respectively. Arrow's net income was £26.3 million in 2016, down from £31.7 million the year before. A refinancing charge of £27.3 million (£17.3 million related to a call premium and interest-rate hedging accounted for most of it) whittled net income down to £3.7 million in the first six months of 2017 vs. £16.5 million in the same period the year before.

The M.O. of the debt buyers is the opposite of that of the banks from which they acquire their raw material. Banks borrow short and lend long. Arrow and its ilk do the opposite, using long-term debt to buy short duration assets. Although debt collection spreads over 10 years, a span of time known as the "120-month estimated remaining collections," or ERC, most of the cash is collected in the beginning. For instance, from the collection projected over the next decade, Arrow estimates it will receive 43% by the end of 2019.

For its own debt portfolio, Arrow generated £115.6 million and £84.3 million in revenues, for the first half of 2017 and 2016, respectively. The balance-sheet value of the portfolio is £901 million. Management reckons it will yield £1.7 billion in ERC spread throughout the U.K. (57.5%), Portugal (28.5%), Netherlands (13.2%) and Italy (0.8%). Arrow, like its peers, doesn't disclose the breakdown of its ERC by asset type, but tells Santin that the majority is in unsecured loans.

On the liability side, Arrow carries £922 million in long-term borrowings, maturing from 2022 to 2025. Tangible common equity weighs in at minus £20 million, although the market values ARW at £742 million, not far from its August all-time high. Liquidity appears adequate, given the front-loaded nature of collections, in addition to £38 million in cash and £71 million available under a revolving facility maturing in 2022.

The debt-purchasing market in Europe is hot and crowded. In 2013, Arrow paid seven pence per pound of NPL. So far this year, it has paid 13 pence. Prior to 2011, Arrow collected over three times the value of each pound of NPL purchased. This year it expects to generate only 1.9 times of the price paid.

"Yet," Santin observes, "cheerleaders mention the near-two-times return on money as if to claim 50% investment margins. Bulls like to say that collections may extend over 10 years, ignoring the small relevance of distant payments on a present-value basis. Moreover, collection figures per se are short sighted because they ignore the cost of collection."

Debt collection costs vary anywhere between 20% and 45% depending on the type of debt and the jurisdiction. In 2013 Arrow expensed about 27% of the amount collected. As tightening oversight by U.K.'s Financial Conduct Authority (FCA) has increased costs throughout the industry, it's safe to assume that Arrow's average is today closer to 30% of the amount collected—always assuming that the future unfolds as management expects it to.

Sometimes a deal is auctioned without detailed information; revisions duly follow. For example, in 2013 Arrow acquired £101 million in loans projected to generate 2.4 times face amount. A year later came a revision to 2.1 times. Fragmentation of sellers, modeling risk and the many different flavors of debt make analyses difficult.

Andrew Jenke, a Partner at KPMG LLP, who helps banks package NPLs to debt-purchasing companies, tells Santin that the outside investor labors at a disadvantage: "You either do or don't buy what's in the debt-purchasing companies model. You're basically backing them on track record to continue to hit the IRR target." How would a stock or debt investor go about stress testing the collectors' portfolios? "To be honest, it would be almost impossible to stress test this by just looking at their publicly available information."

You can collect debts. The question is whether you can collect them profitably. Spending more to shake the trees

By the numbers
Discounted value of Arrow's portfolio*

	2017	2018	2019	2020	2021	2022	2023	2024	2025	2026	2027
Estimated remaining collections	£158	£305	£270	£261	£182	£139	£113	£96	£83	£73	£29
Collection cost**	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%	30%
Net cash collection	111	214	189	183	127	97	79	67	58	51	20
Present value of net cash collection	108	194	156	137	87	60	45	34	27	22	8
NPV of portfolio discounted at 10%	879										
Estimated value of third-party-servicing business	68										
Enterprise value	947										
Less net debt	884										
Implied equity value	63										
Actual market capitalization	742										

*All amounts in £ mns, except for percentages and per-share figures
** *Grant's* assumption
sources: company filings, *Grant's* analysis

will, indeed, produce more apples. It just may not produce more earnings. The collection companies have not failed to notice the opportunity to borrow on the cheap.

"Arrow nearly quintupled its long term debt to over £900 million from £200 million at the end of 2013," Santin points out. "It expanded with acquisitions and portfolio expansion, seemingly indifferent to growth quality. But the company may have backed itself into a corner now that NPL prices are rising in an overheated market. Furthermore, earnings for Arrow and other European collectors could be far from the true earnings because of the way they are booked under IFRS.

"IFRS allows companies to front-load revenues (and therefore earnings)," Santin proceeds. "By making more loan purchases, it becomes difficult to evaluate organic growth and hold company projections accountable in the short term. For instance, Arrow collected £154 million, of which £112.6 million was considered revenue and the remaining £41.4 million a return on the original investment, a.k.a., portfolio amortization. Still, management expanded the portfolio by purchasing £116 million, nearly three times that amortization. Yet, sell-side analysts use P/E multiples to value ARW shares."

Better to analyze such businesses as you would an oil company, an anonymity-seeking hedge-fund investor advises. The debt, like the oil, is a finite asset: "You buy a piece of debt, and there's a certain amount of collections you get out of it, a certain amount of cost to get it out of the ground, and so this is a balance-sheet company."

Santin ran a discounted cash-flow model to value the NPL portfolio: "Taking the company's cash-flow projection and assuming a 30% cost to collect and a 10% discount rate," he advises, "the net present value of the cash flows for the next 10 years is £880 million. Assuming a 10% EBITDA margin for the servicing business (on £68.4 million in revenues) and a generous multiple of 10 times that figure, the business adds another £68 million to the enterprise value, for a £948 million total. Subtract £884 million in net debt and equity foots £63 million vs. the £742 million from the current market cap.

"Looking from a different optic," Santin goes on, "in the next ten years, Arrow estimates it will collect £1.9 for every pound currently invested. It pays 30% in collection costs, or £0.57 from what will be collected. Subtract that and the £1 invested and you have £0.33 left. That's before interest. Average interest cost is 3.9% per year, or 39% in 10 years. Since the debt size is roughly the same size of the amount invested, subtract £0.39 and one sees that Arrow Global is a money-losing machine."

On, next, to the sterling-denominated Lowell's 11% senior unsecured notes due 2023 (£230 million outstanding, Caa1 from Moody's, B-minus from S&P). It trades at 113.5 pence on the pound for a 5% yield to next call on Nov. 1, 2018, at 108.25. If there is no refinancing, the yield to maturity springs to (a promised) 8%.

Lowell divides itself into two divisions, UK and DACH, the latter signifying Germany, Austria, Switzerland, Croatia and Slovenia (2016 division revenues were £216 million and £238 million, respectively). ERC consists of £1.44 billion in the UK and £460 million in DACH. Segment-operating income in 2016 was £89.9 million for UK and £36.8 million for DACH.

Total revenue for the second quarter of 2017 was £131.2 million (£88.7 million from the NPL portfolio and £42.5 million from third-party collection) vs. £110.3 million (£74.2 million from NPL and £36.1 million from third-party collection) in the same period last year. There was a high level of revenue from "portfolio write up," including £29.8 million out of that £88.7 million in NPL revenue. Accounting rules allow it.

High-interest expense pushed the company into losses in 2016 and 2015 (minus £31.2 million and minus £91.8 million, respectively, in net income), as well as for the first six months of 2017 (minus £9.6 million). Take £284.4 million in the last 12 months adjusted EBITDA, subtract £226.7 million for portfolio amortization and £57.7 million is left to service £108 million in going-forward interest costs. Unsustainable? So it would seem, barring a timely equity infusion or a refinancing that would lead—somehow—to a plunge in interest costs.

The 11% notes are subordinated to £1.26 billion in secured notes (none of which is due until 2022). Equity foots to £271 million, though tangible book value is negative owing to £1.1 billion in goodwill and intangibles. A revolving credit facility, which runs till 2021, offers liquidity of €200 million.

"Although 40% of the £1.9 billion ERC is expected to come in the next two years," Santin concludes, "Lowell's collection costs are running at 40% of the debt collected. Take the undiscounted £1.9 billion, deduct 40% in collection charges and portfolio value shrinks to £1.14 billion. Value the third-party servicing business at roughly £100 million, based on an estimated £12 million EBITDA and eight times multiple. Even so, the two businesses sum up to £1.24 billion, which doesn't cover even the secured notes."

It's a precarious business, this shaking of the tree of NPLs. In America, SquareTwo Financial Corp, which reported positive net income until 2013, filed for Chapter 11 protection in March. Private-equity sponsor Bridgepoint Advisers Ltd. invested £67 million in U.K. based 1st Credit in 2004; it realized SEK 57 million (£5 million) for that property in a February sale. In 2013, U.K.-based Equidebt Ltd. appointed administrators to wind down the business in accordance with British insolvency conventions.

In a Sept. 20 policy meeting of the Bank of England, participants noticed that growth in consumer credit was running well in excess of growth in household disposable income. Minutes noted that "defaults on consumer credit tend to rise substantially during recessions." We wonder: Is Mark Carney keeping tabs on the highly valued raw material of the pubic-debt collectors? Defaults on already-defaulted debt cast no flattering light on today's central-bank enabled, free-and-easy credit culture.

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