PORTFOLIO RECOVERY ASSOCIATES INC
Form 10-Q
November 06, 2008

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, 2008

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

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 October 20, 2008
Common Stock, $0.01 par value	15,280,809

PORTFOLIO RECOVERY ASSOCIATES, INC.

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PORTFOLIO RECOVERY ASSOCIATES, INC.
CONSOLIDATED BALANCE SHEETS
September 30, 2008 and December 31, 2007
(unaudited)
(Amounts in thousands, except per share amounts)

	September 30, 2008	December 31, 2007
Assets		
Cash and cash equivalents	$ 28,006	$ 16,730
Finance receivables, net	535,430	410,297
Income taxes receivable	3,715	3,022
Property and equipment, net	23,354	16,171
Goodwill	28,058	18,620
Intangible assets, net	13,747	5,046
Other assets	9,251	6,421
Total assets	$ 641,561	$ 476,307
Liabilities and Stockholders Equity		
Liabilities:		
Accounts payable	$ 4,527	$ 4,055
Accrued expenses	5,294	4,471
Accrued payroll and bonuses	9,605	6,819
Deferred tax liability	81,350	57,579
Line of credit	267,300	168,000
Obligations under capital lease	23	103
Total liabilities	368,099	241,027
Commitments and contingencies (Note 10)		
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, 15,392 issued and 15,280 outstanding shares - at September 30, 2008, and 15,159 issued and outstanding at December 31, 2007	153	152
Additional paid-in capital	74,873	71,443
Retained earnings	198,436	163,685
Total stockholders equity	273,462	235,280
Total liabilities and stockholders equity	$ 641,561	$ 476,307

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

PORTFOLIO RECOVERY ASSOCIATES, INC.
CONSOLIDATED INCOME STATEMENTS
For the three and nine months ended September 30, 2008 and 2007
(unaudited)
(Amounts in thousands, except per share amounts)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2008	2007	2008	2007
Revenues:				
Income recognized on finance receivables, net	$ 52,738	$ 46,111	$ 158,412	$ 137,964
Commissions	15,848	8,529	37,891	25,460
Total revenues	68,586	54,640	196,303	163,424
Operating expenses:				
Compensation and employee services	22,983	17,322	64,983	50,438
Outside legal and other fees and services	16,709	11,847	46,400	34,530
Communications	2,263	2,038	7,535	5,927
Rent and occupancy	1,123	819	2,830	2,217
Other operating expenses	1,912	1,605	4,863	4,467
Depreciation and amortization	2,162	1,455	5,138	4,112
Total operating expenses	47,152	35,086	131,749	101,691
Income from operations	21,434	19,554	64,554	61,733
Other income and (expense):				
Interest income	17	65	50	364
Interest expense	(3,066)	(1,137)	(8,215)	(1,543)
Income before income taxes	18,385	18,482	56,389	60,554
Provision for income taxes	6,930	6,787	21,638	22,991
Net income	$ 11,455	$ 11,695	$ 34,751	$ 37,563
Net income per common share:				
Basic	$ 0.75	$ 0.76	$ 2.28	$ 2.37
Diluted	$ 0.75	$ 0.75	$ 2.27	$ 2.35
Weighted average number of shares outstanding:				
Basic	15,267	15,451	15,210	15,816
Diluted	15,336	15,577	15,280	15,962

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

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PORTFOLIO RECOVERY ASSOCIATES, INC.
CONSOLIDATED STATEMENT OF CHANGES IN STOCKHOLDERS EQUITY
For the nine months ended September 30, 2008
(unaudited)
(Amounts in thousands)

	Common Stock	Additional Paid-in Capital	Retained Earnings	Total Stockholders Equity
Balance at December 31, 2007	$ 152	$ 71,443	$ 163,685	$ 235,280
Net income			34,751	34,751
Exercise of stock options and vesting of nonvested shares	1	593		594
Issuance of common stock for acquisition		1,847		1,847
Amortization of share-based compensation		442		442
Income tax benefit from share-based compensation		368		368
Reversal of FIN 48 reserve		180		180
Balance at September 30, 2008	$ 153	$ 74,873	$ 198,436	$ 273,462

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

PORTFOLIO RECOVERY ASSOCIATES, INC.
CONSOLIDATED STATEMENTS OF CASH FLOWS
For the nine months ended September 30, 2008 and 2007
(unaudited)
(Amounts in thousands)

	Nine Months Ended September 30,	
	2008	**2007**
Cash flows from operating activities:		
Net income	$ 34,751	$ 37,563
Adjustments to reconcile net income to net cash provided by operating activities:		
Amortization of share-based compensation	442	2,218
Depreciation and amortization	5,138	4,112
Deferred tax expense	23,771	17,566
Changes in operating assets and liabilities:		
Other assets	105	(352)
Accounts payable	(77)	(77)
Income taxes	(513)	(918)
Accrued expenses	567	958
Accrued payroll and bonuses	1,875	200
Net cash provided by operating activities	66,059	61,270
Cash flows from investing activities:		
Purchases of property and equipment	(4,041)	(6,654)
Acquisition of finance receivables, net of buybacks	(214,172)	(159,131)
Collections applied to principal on finance receivables	89,039	59,102
Company acquisitions, including acquisition costs and net of cash acquired	(25,791)	(409)
Net cash used in investing activities	(154,965)	(107,092)
Cash flows from financing activities:		
Dividends paid		(16,070)
Proceeds from exercise of options	594	1,461
Income tax benefit from share-based compensation	368	1,145
Proceeds from line of credit	146,300	103,000
Principal payments on line of credit	(47,000)	(3,000)
Repurchases of common stock		(50,557)
Principal payments on long-term debt		(690)
Principal payments on capital lease obligations	(80)	(104)
Net cash provided by financing activities	100,182	35,185

Net increase/(decrease) in cash and cash equivalents	11,276	(10,637)
Cash and cash equivalents, beginning of period	16,730	25,101
Cash and cash equivalents, end of period	$ 28,006	$ 14,464
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 8,272	$ 1,096
Cash paid for income taxes	$ 3	$ 5,285
Noncash investing and financing activities:		
Company acquisitions Common stock issued	$ 1,847	$ 50

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

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. As a result, all of the membership units and warrants of PRA were exchanged on a one to one basis for warrants and shares of a single class of common stock of PRA Inc. PRA Inc owns all outstanding membership units of PRA, PRA Holding I, LLC (PRA Holding I), PRA Holding II, LLC (PRA Holding II), PRA Receivables Management, LLC (which 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 Alatax and RDS) (RDS) and MuniServices, LLC (MuniServices). PRA Inc, a Delaware corporation, and its subsidiaries (collectively, the Company) are full-service providers of outsourced receivables management and related services. The Company is engaged in the business of purchasing, managing and collecting portfolios of defaulted consumer receivables, as well as offering a broad range of accounts receivable management services. The majority of the Company s business activities involve the purchase, management and collection of defaulted consumer receivables. These 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 Legal Recovery 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 standard collection services on delinquent accounts, obtaining location information for clients in support of their collection activities (known as skip tracing), and the management of both delinquent and non-delinquent tax receivables for government entities.

The consolidated financial statements of the Company include the accounts of PRA Inc, PRA, PRA Holding I, PRA Holding II, Anchor, IGS, RDS and MuniServices.

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, 2008, its consolidated income statements for the three and nine months ended September 30, 2008 and 2007, its consolidated statement of changes in stockholders equity for the nine months ended September 30, 2008, and its consolidated statements of cash flows for the nine months ended September 30, 2008 and 2007. The income statement of the Company for the three and nine months ended September 30, 2008 and 2007 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/A, as filed for the year ended December 31, 2007.

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 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.

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

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 account 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 account or pool (accretable yield).

Prior to January 1, 2005, the Company accounted for its investment in finance receivables using the interest method under the guidance of Practice Bulletin 6, Amortization of Discounts on Certain Acquired Loans. Effective January 1, 2005, the Company adopted and began to account for its investment in finance receivables using the interest method under the guidance of American Institute of Certified Public Accountants (AICPA) Statement of Position (SOP) 03-3, Accounting for Loans or Certain Securities Acquired in a Transfer. For loans acquired in fiscal years beginning prior to December 15, 2004, Practice Bulletin 6 is still effective; however, Practice Bulletin 6 was amended by SOP 03-3 as described further in this note. For loans acquired in fiscal years beginning after December 15, 2004, SOP 03-3 is effective. Under the guidance of SOP 03-3 (and the amended Practice Bulletin 6), 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 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). SOP 03-3 (and the amended Practice Bulletin 6) requires that the excess of the contractual cash flows over expected cash flows not be recognized as an adjustment of revenue or expense or on the balance sheet. SOP 03-3 initially freezes the internal rate of return, referred to as IRR, estimated when the accounts receivable 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 IRR over a portfolio s remaining life. Any increase to the IRR then becomes the new benchmark for impairment testing. Effective for fiscal years beginning after December 15, 2004 under SOP 03-3 (and the amended Practice Bulletin 6), rather than lowering the estimated IRR 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 IRR and is shown as a reduction in revenue in the consolidated income statements with a corresponding valuation allowance offsetting the finance receivables, net, on the balance sheet. Income on finance receivables is accrued quarterly based on each static pool s effective IRR. 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 accrual will accrete the carrying balance. The Company generally does not allow accretion in the first six to twelve months. The IRR 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. Additionally, the Company uses the cost recovery method when collections on a particular pool of accounts cannot be reasonably predicted. These 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, 2008 and 2007, the Company had unamortized purchased principal (purchase price) in pools accounted for under the cost recovery method of $3,546,509 and $4,998,673, respectively.

The Company establishes valuation allowances for all acquired accounts subject to SOP 03-3 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, 2008 and 2007, the Company had an allowance against its finance receivables of $14,755,000 and $2,935,000, respectively. Prior to January 1, 2005, in the event that a reduction of the yield to as low as zero in conjunction with estimated future cash collections that were inadequate to amortize the carrying balance, an allowance charge would be taken with a corresponding write-off of the receivable balance.

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

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, 2008 and 2007 was $3,013,671 and $2,133,480, respectively. During the three and nine months ended September 30, 2008, the Company capitalized $198,257 and $1,065,786, respectively, of these direct acquisition fees. During the three and nine months ended September 30, 2007, the Company capitalized $469,868 and $1,263,578, respectively, of these direct acquisition fees. During the three and nine months ended September 30, 2008, the Company amortized $153,391 and $487,031, respectively, of these direct acquisition fees. During the three and nine months ended September 30, 2007, the Company amortized $135,110 and $452,819, 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 simply 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, 2008 and 2007 were as follows (amounts in thousands):

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Balance at beginning of period	$ 515,367	$ 288,648	$ 410,297	$ 226,447
Acquisitions of finance receivables, net of buybacks	50,333	56,868	214,172	159,131
Cash collections	(83,008)	(65,151)	(247,451)	(197,066)
Income recognized on finance receivables, net	52,738	46,111	158,412	137,964
Cash collections applied to principal	(30,270)	(19,040)	(89,039)	(59,102)
Balance at end of period	$ 535,430	$ 326,476	$ 535,430	$ 326,476

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 receipts using the proprietary models of the Company. As of September 30, 2008, the Company had $535,430,442 in net finance receivables. Based upon current projections, cash collections applied to principal are estimated to be as follows for the twelve months in the periods ending (amounts in thousands):

September 30, 2009	$ 121,285
September 30, 2010	128,292

September 30, 2011	116,936
September 30, 2012	93,134
September 30, 2013	45,751
September 30, 2014	24,338
September 30, 2015	4,818
September 30, 2016	876
	$ 535,430

During the three and nine months ended September 30, 2008, the Company purchased approximately $857.2 million and $3.28 billion, respectively, of face value of charged-off consumer receivables. During the three and nine months ended September 30, 2007, the Company purchased approximately $2.61 billion and $7.45 billion, respectively, of face value of charged-off consumer receivables.

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

At September 30, 2008, the estimated remaining collections on the receivables purchased in the three and nine months ended September 30, 2008 were $108.3 million and $399.4 million, respectively. At September 30, 2008, the estimated remaining collections on the receivables purchased in the three and nine months ended September 30, 2007 were $94.4 million and $242.6 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, 2008 and 2007. 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 results from 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, 2008 and 2007 were as follows (amounts in thousands):

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Balance at beginning of period	$ 549,716	$ 410,843	$ 492,269	$ 326,775
Income recognized on finance receivables, net	(52,738)	(46,111)	(158,412)	(137,964)
Additions	57,184	71,601	220,573	198,191
Reclassifications from/(to) nonaccretable difference	(4,592)	10,055	(4,860)	59,386
Balance at end of period	$ 549,570	$ 446,388	$ 549,570	$ 446,388

During the three and nine months ended September 30, 2008, the Company recorded $3,985,000 and $10,870,000, respectively, in allowance charges on pools that had underperformed the Company s most recent expectations as of September 30, 2008. During the three and nine months ended September 30, 2008, the Company also reversed $205,000 and $345,000, respectively, of allowance charges recorded in prior periods. During the three and nine months ended September 30, 2007, the Company recorded $1,180,000 and $1,880,000, respectively, in allowance charges on pools that had underperformed the Company s most recent expectations as of September 30, 2007. During the three and nine months ended September 30, 2007, the Company also reversed $0 and $245,000, respectively, of allowance charges recorded in prior periods. The change in the valuation allowance for the three and nine months ended September 30, 2008 and 2007 is as follows (amounts in thousands):

	Three Months Ended September 30, 2008	Three Months Ended September 30, 2007	Nine Months Ended September 30, 2008	Nine Months Ended September 30, 2007
Balance at beginning of period	$ 10,975	$ 1,755	$ 4,230	$ 1,300
Allowance charges recorded	3,985	1,180	10,870	1,880
Reversal of previously recorded allowance charges	(205)		(345)	(245)
Change in allowance charge	3,780	1,180	10,525	1,635

Balance at end of period	$	14,755	$	2,935	$	14,755	$	2,935

3. Line of Credit:

On November 29, 2005, the Company entered into a Loan and Security Agreement for a revolving line of credit jointly offered by Bank of America, N. A. and Wachovia Bank, National Association. The agreement was amended on May 9, 2006 to include RBC Centura Bank as an additional lender, again on May 4, 2007 to increase the line of credit to $150,000,000 and incorporate a $50,000,000 non-revolving fixed rate sub-limit, again on October 26, 20