

PORTFOLIO RECOVERY ASSOCIATES INC

Form 10-Q

November 02, 2005

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

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934

For the quarterly period ended September 30, 2005

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 No

Indicate by check mark whether the registrant is an accelerated filer (as defined in Rule 12b-2 of the Exchange Act).

Yes No

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act).

Yes No

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 19, 2005

Common Stock, \$0.01 par value

15,717,393

PORTFOLIO RECOVERY ASSOCIATES, INC.
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PORTFOLIO RECOVERY ASSOCIATES, INC.
CONSOLIDATED BALANCE SHEETS
September 30, 2005 and December 31, 2004
(unaudited)

	September 30, 2005	December 31, 2004
Assets		
Cash and cash equivalents	\$ 67,398,268	\$ 24,512,575
Investments		23,950,000
Finance receivables, net	117,246,471	105,188,906
Property and equipment, net	7,431,544	5,752,489
Goodwill	18,287,511	6,397,138
Intangible assets, net	9,777,568	6,318,838
Other assets	1,687,821	3,056,023
Total assets	\$ 221,829,183	\$ 175,175,969
Liabilities and Stockholders Equity		
Liabilities:		
Accounts payable	\$ 2,738,360	\$ 1,413,726
Accrued expenses	1,963,799	1,563,285
Income taxes payable	3,485,759	182,221
Accrued payroll and bonuses	5,535,060	4,475,919
Deferred tax liability	21,864,507	13,650,722
Long-term debt	1,269,331	1,924,422
Obligations under capital lease	427,742	576,234
Total liabilities	37,284,558	23,786,529
 Commitments and contingencies (Note 11)		
 Stockholders equity:		
Preferred stock, par value \$0.01, authorized shares, 2,000,000, issued and outstanding shares - 0		
Common stock, par value \$0.01, authorized shares, 30,000,000, issued and outstanding shares - 15,714,463 at September 30, 2005, and 15,498,210 at December 31, 2004	157,145	154,982
Additional paid in capital	106,735,523	100,905,851
Retained earnings	77,651,957	50,328,607
Total stockholders equity	184,544,625	151,389,440
Total liabilities and stockholders equity	\$ 221,829,183	\$ 175,175,969

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, 2005 and 2004
(unaudited)

	Three Months Ended September 30, 2005	Three Months Ended September 30, 2004	Nine Months Ended September 30, 2005	Nine Months Ended September 30, 2004
Revenues:				
Income recognized on finance receivables	\$ 33,987,480	\$ 27,069,524	\$ 100,060,121	\$ 77,867,413
Commissions	3,517,617	1,216,054	9,139,288	3,826,564
 Total revenue	 37,505,097	 28,285,578	 109,199,409	 81,693,977
Operating expenses:				
Compensation and employee services	11,215,665	9,154,696	32,491,172	26,902,987
Outside legal and other fees and services	7,417,463	5,347,702	22,153,943	15,038,953
Communications	1,115,603	840,321	3,213,324	2,658,619
Rent and occupancy	554,675	434,541	1,543,004	1,296,577
Other operating expenses	833,815	648,512	2,315,722	2,028,266
Depreciation and amortization	1,288,649	487,757	3,268,654	1,398,091
 Total operating expenses	 22,425,870	 16,913,529	 64,985,819	 49,323,493
 Income from operations	 15,079,227	 11,372,049	 44,213,590	 32,370,484
Other income and (expense):				
Interest income	188,220	77,259	475,680	105,841
Interest expense	(59,001)	(69,383)	(185,816)	(206,451)
 Income before income taxes	 15,208,446	 11,379,925	 44,503,454	 32,269,874
 Provision for income taxes	 5,866,624	 4,405,160	 17,180,104	 12,533,777
 Net income	 \$ 9,341,822	 \$ 6,974,765	 \$ 27,323,350	 \$ 19,736,097
 Net income per common share				
Basic	\$ 0.60	\$ 0.45	\$ 1.75	\$ 1.29
Diluted	\$ 0.58	\$ 0.44	\$ 1.69	\$ 1.25

Weighted average number of shares
outstanding

Basic	15,692,417	15,341,801	15,607,596	15,322,675
Diluted	16,172,657	15,831,660	16,132,869	15,793,935

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

PORTFOLIO RECOVERY ASSOCIATES, INC.
CONSOLIDATED STATEMENTS OF CHANGES IN STOCKHOLDERS EQUITY
For the Nine Months Ended September 30, 2005
(unaudited)

	Common Stock	Additional Paid in Capital	Retained Earnings	Total Stockholders Equity
Balance at December 31, 2004	\$ 154,982	\$ 100,905,851	\$ 50,328,607	\$ 151,389,440
Net income			27,323,350	27,323,350
Exercise of stock options, warrants and vesting of restricted shares	1,826	2,215,575		2,217,401
Issuance of common stock for acquisition	337	1,443,426		1,443,763
Amortization of stock-based compensation		382,523		382,523
Stock-based compensation income tax benefits		1,788,148		1,788,148
Balance at September 30, 2005	\$ 157,145	\$ 106,735,523	\$ 77,651,957	\$ 184,544,625

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, 2005 and 2004
(unaudited)

	Nine Months Ended September 30, 2005	Nine Months Ended September 30, 2004
Operating activities:		
Net income	\$ 27,323,350	\$ 19,736,097
Adjustments to reconcile net income to cash provided by operating activities:		
Increase in equity from vested options and warrants	718,942	456,379
Income tax benefit from stock option exercises	1,788,148	437,514
Depreciation and amortization	3,268,654	1,398,091
Deferred tax expense	8,213,785	11,729,031
Changes in operating assets and liabilities:		
Other assets	1,742,935	558,704
Accounts payable	313,433	(114,556)
Income taxes	3,303,538	499,590
Accrued expenses	241,765	699,745
Accrued payroll and bonuses	1,059,141	682,866
 Net cash provided by operating activities	 47,973,691	 36,083,461
 Cash flows from investing activities:		
Purchases of property and equipment	(3,074,499)	(1,967,964)
Acquisition of finance receivables, net of buybacks	(56,133,504)	(37,626,129)
Collections applied to principal on finance receivables	44,075,939	34,882,955
Acquisition of RDS, net of acquisition costs and cash received	(14,983,332)	
Purchase of auction rate certificates	(84,475,000)	(20,950,000)
Sales of auction rate certificates	108,425,000	
 Net cash (used in) investing activities	 (6,165,396)	 (25,661,138)
 Cash flows from financing activities:		
Proceeds from exercise of options and warrants	1,880,981	309,570
Proceeds from long-term debt		750,000
Payments on long-term debt	(655,091)	(357,226)
Payments on capital lease obligations	(148,492)	(221,257)
 Net cash provided by financing activities	 1,077,398	 481,087

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Net increase in cash and cash equivalents	42,885,693	10,903,410
Cash and cash equivalents, beginning of period	24,512,575	24,911,841
Cash and cash equivalents, end of period	\$ 67,398,268	\$ 35,815,251
Supplemental disclosure of cash flow information:		
Cash paid for interest	\$ 185,816	\$ 206,451
Cash paid for income taxes	\$ 3,874,533	\$ 280,642
Noncash investing and financing activities:		
Capital lease obligations incurred	\$	\$ 296,910
Acquisition of RDS Common stock issued	\$ 1,443,763	\$
<i>The accompanying notes are an integral part of these consolidated financial statements.</i>		

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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 Receivables Management, LLC (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 Thomas West Associates, LLC (TWA). 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 TWA and its Legal Recovery Department, collects accounts judicially, either by using its own attorneys, or by contracting with independent attorneys throughout the country with 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, Anchor, IGS, TWA and RDS. Certain 2004 amounts have been reclassified to conform to the 2005 presentation.

The accompanying unaudited 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 and, therefore, do not include all information and footnotes necessary for a fair presentation of financial position, results of operations and cash flows in conformity with accounting principles generally accepted in the United States of America. 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 statement of the Company s balance sheet as of September 30, 2005, its income statements for the three and nine month periods ended September 30, 2005 and 2004 and its statements of cash flows for the nine month periods ended September 30, 2005 and 2004, respectively. The income statements of the Company for the three and nine month periods ended September 30, 2005 and 2004 may not be indicative of future results. These 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, 2004.

2. Finance Receivables, net:

The Company s principal business consists of the acquisition and collection of accounts that have experienced deterioration of credit quality between origination and the Company s acquisition of the accounts. The amount paid for an account reflects the Company s determination that it is probable the Company will be unable to collect all amounts due according to the account s contractual terms. At acquisition, the Company reviews each account 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 aggregated 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 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).

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

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 are 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. The SOP 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. 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. Likewise, cash flows that are less than the accrual will accrete the carrying balance. 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. 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, 2005, the Company had unamortized purchased principal (purchase price) of \$1,656,746 in pools accounted for under the cost recovery method.

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, 2005, the Company had no valuation allowance on its finance receivables. Prior to January 1, 2005, in the event that estimated future cash collections would be inadequate to amortize the carrying balance, an impairment charge would be taken with a corresponding write-off of the receivable balance.

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, 2005 and 2004 was \$998,192 and \$1,225,998, respectively. During the three and nine months ended September 30, 2005 the Company capitalized \$228,150 and \$353,730, respectively, of these direct acquisition fees. During the three and nine months ended September 30, 2004 the Company capitalized \$354,751 and \$688,765, respectively, of these direct acquisition fees. During the three and nine months ended September 30, 2005 the Company amortized \$138,193 and \$454,054, respectively, of these direct acquisition fees. During the three and nine months ended September 30, 2004

the Company amortized \$163,906 and \$734,312, respectively, of these direct acquisition fees. At June 30, 2004 the Company wrote-off \$530,580 related to the capitalization of fees paid to third parties for address correction and other customer data associated with the acquisition of portfolios purchased over the past five years. As a result of a review of the Company's accounting, the Company determined these capitalized acquisition fees should be expensed.

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

The agreements to purchase the aforementioned receivables include general representations and warranties from the sellers covering account holder death or bankruptcy and accounts paid in full, 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.

As of September 30, 2005 and 2004, the Company had \$117,246,471 and \$95,311,731, respectively, remaining of finance receivables. Changes in finance receivables for the three and nine months ended September 30, 2005 and 2004 were as follows:

	Three Months Ended September 30, 2005	Three Months Ended September 30, 2004	Nine Months Ended September 30, 2005	Nine Months Ended September 30, 2004
Balance at beginning of period	\$ 114,837,794	\$ 96,270,285	\$ 105,188,906	\$ 92,568,557
Acquisitions of finance receivables, net of buybacks	15,916,690	10,821,842	56,133,504	37,626,129
Cash collections	(47,495,493)	(38,849,920)	(144,136,060)	(112,750,368)
Income recognized on finance receivables	33,987,480	27,069,524	100,060,121	77,867,413
Cash collections applied to principal	(13,508,013)	(11,780,396)	(44,075,939)	(34,882,955)
Balance at end of period	\$ 117,246,471	\$ 95,311,731	\$ 117,246,471	\$ 95,311,731

Based upon current projections, cash collections applied to principal is estimated to be as follows for the twelve months in the periods ending:

September 30, 2006	\$ 33,753,214
September 30, 2007	29,397,388
September 30, 2008	25,693,090
September 30, 2009	16,891,519
September 30, 2010	9,072,231
September 30, 2011	2,439,029
	\$ 117,246,471

Accretable yield represents the amount of income the Company can expect to generate over the remaining life of its existing portfolios based on estimated future cash flows as of September 30, 2005 and 2004. Reclassifications from nonaccretable difference to accretable yield primarily result from the Company's increase in its estimate of future cash

flows. Changes in accretable yield for the three and nine months ended September 30, 2005 and 2004 were as follows:

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

	Three Months Ended September 30, 2005	Three Months Ended September 30, 2004	Nine Months Ended September 30, 2005	Nine Months Ended September 30, 2004
Balance at beginning of period	\$ 224,453,203	\$ 187,970,086	\$ 202,841,339	\$ 175,098,132
Income recognized on finance receivables	(33,987,480)	(27,069,524)	(100,060,121)	(77,867,413)
Additions	20,054,019	15,613,073	60,482,154	55,958,806
Sales				
Reclassifications from nonaccretable difference	22,268,147	14,909,816	69,524,517	38,233,926
Balance at end of period	\$ 232,787,889	\$ 191,423,451	\$ 232,787,889	\$ 191,423,451

During the three and nine months ended September 30, 2005, the Company purchased \$445.3 million and \$2.47 billion of face value of charged-off consumer receivables. During the three and nine months ended September 30, 2004, the Company purchased \$564.9 million and \$2.67 billion of face value of charged-off consumer receivables. At September 30, 2005, the estimated remaining collections on the receivables purchased in the three and nine months ended September 30, 2005 are \$36,404,931 and \$109,415,694, respectively. At September 30, 2005, the estimated remaining collections on the receivables purchased in the three and nine months ended September 30, 2004 are \$17,809,235 and \$58,503,723, respectively.

3. Investments:

The Company accounts for its investments under the guidance of SFAS 115, Accounting for Certain Investments in Debt and Equity Securities. At December 31, 2004, the Company had investments totaling \$23,950,000 which consist of variable rate auction rate certificates classified as available-for-sale securities. These securities are recorded at cost, which approximates fair market value due to their variable interest rates, which typically reset every 7 to 35 days, and, despite the long term nature of their stated contractual maturities, the Company has the ability to quickly liquidate these investments. As a result, the Company had no cumulative gross unrealized holding gains (losses) or gross realized gains (losses) from these investments and all income generated was recorded as interest income. The Company may continue to invest in these types of securities within a given reporting period.

4. Revolving Line of Credit:

The Company maintains a \$25.0 million revolving line of credit pursuant to an agreement entered into on November 28, 2003 and amended on November 22, 2004. The credit facility bears interest at a spread of 2.50% over LIBOR and extends through November 28, 2006. The agreement calls for:

restrictions on monthly borrowings are limited to 20% of estimated remaining collections;

a debt coverage ratio of at least 8.0 to 1.0, calculated on a rolling twelve-month average;

a debt to tangible net worth ratio of less than 0.40 to 1.00;

net income per quarter of at least \$1.00, calculated on a consolidated basis; and

restrictions on change of control.

This facility had no amounts outstanding at September 30, 2005. As of September 30, 2005 the Company is in compliance with all of the covenants of this agreement.

In accordance with the credit agreement, the Company obtained approval from the lender for the RDS acquisition.

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

5. Long-Term Debt:

In July 2000, the Company purchased a building in Hutchinson, Kansas. The building was financed with a commercial loan for \$550,000 with a variable interest rate based on LIBOR. This commercial loan is collateralized by the real estate in Kansas. Monthly principal payments on the loan were \$4,583 for an amortized term of 10 years. A balloon payment of \$275,000 was due July 21, 2005, which resulted in a five-year principal payout. The loan was paid in full at its maturity date of July 21, 2005.

On February 9, 2001, the Company purchased a generator for its Norfolk location. The generator was financed with a commercial loan for \$107,000 with a fixed rate of 7.9%. This commercial loan is collateralized by the generator. Monthly payments on the loan are \$2,170 and the loan matures on February 1, 2006.

On February 20, 2002, the Company completed the construction of a satellite parking lot at its Norfolk location. The parking lot was financed with a commercial loan for \$500,000 with a fixed rate of 6.47%. The loan is collateralized by the parking lot. The loan required only interest payments during the first six months. Beginning October 1, 2002, monthly payments on the loan are \$9,797 and the loan matures on September 1, 2007.

On May 1, 2003, the Company secured financing for its computer equipment purchases related to the Hampton, Virginia office opening. The computer equipment was financed with a commercial loan for \$975,000 with a fixed rate of 4.25%. This loan is collateralized by computer equipme