collective szabo wisdom®

SZABO ASSOCIATES, INC. VOLUME 18, ISSUE 4, DECEMBER 31, 2003

Dear Friends:

The beginning of each year is traditionally the time to begin anew … to review and reevaluate business needs and decisions, to clean up your aging, and to make sure your credit and collections "house" is in order.

This is apropos in particular going into 2004. We are – hopefully – coming out of an economic recession that has impacted how all of us need to conduct business. And in the collections industry, there have been significant trends that have the potential for major impact on collections clients, not just this year but also in those ahead.

This issue's feature article discusses these trends, and gives us the opportunity to reaffirm to you our commitment to the media community and to continue delivering to you the best total collection services value.

We wish you all a happy and prosperous 2004!

Best wishes,

Pete Szabo, President
Szabo Associates, Inc.

Collection Industry Trends—And the Szabo Perspective

The pace of change across virtually all industries continues to increase. The global marketplace and relentlessly advancing technology are driving extreme competitive pressures. The media industry has certainly felt these effects, and so has the collections business.

As we enter 2004, we at Szabo thought this an apt time to summarize what we see as the major collections industry trends, and to share our perspective on these trends. Generally speaking, trends in the collections industry can be distilled into two broad categories: structural change and technology driven change. In this article we will concentrate on the first, and in a subsequent article, the second.

Structural Change

A structural change is where a company fundamentally alters its organization and business models. Unlike changes in, say, process "re-engineering" or expenses management, structural changes tend to be long-term (if not permanent) and involve a major internal shift of resources and focus. Structural change does not happen quickly; typically it takes at least two to three years to "digest" the change and to prove out whether the change will meet expectations.

In the collections industry, there have been two structural shifts underway. The first has been the move towards outsourcing, and the second has been in mergers and acquisitions, or major internal restructuring. Both have been principally driven by a desire to radically reduce operating costs while using this cost structure leverage to move into entirely new revenue streams. Interestingly, there is a corollary and overlap between the two.

The outsourcing trend in the collections industry follows what has already been happening in many other industries. The value proposition is straightforward: Anywhere from 30-60% less collections cost. The basis for this is, first, the much cheaper labor and infrastructure costs in countries such as India, Mexico, Jamaica, and the Philippines. Additionally, when lower employee turnover rates, cheaper training, and a college-educated workforce are factored in, the overhead burden is much less. Finally, by shifting significant portions of the firm's organization to another company, management can redirect its energies to more profitable activities and can free up capital for other purposes, all while enabling greater business flexibility through having few organizational components.

The numbers and a look at the change in mix of functions being outsourced confirm that many firms have embraced this hypothesis. Initially, collections outsourcing was limited to labor-intensive call-center or back-office activities. Outsourced debt was mostly low-balance accounts, with the activities typi-

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cally being early stage collections or reminder calls. However, in the last several years, outsourcing companies have been re-positioning themselves as "business process outsourcers" and are now marketing "customer relationship management" and other "customer intimacy" services. McKinsey estimates that there has been a 60% growth in outsourcing in 2003 and forecasts a ten-fold increase by 2008.

What has been the result, again particularly for the collections industry? Clearly some industries have benefited from offshore operations and outsourcing; however, for the collections industry, the jury is still out. It is clear that there is still a lot of "shaking out" to do before determining precisely what most benefits the firm and what is in the best interest of the firm's clients, which may not necessarily be the same. For certain, there is not a "one size fits all" answer that applies across industry segments or for that matter, even from firm to firm.

The fundamental issue for collections firms is one of remaining price competitive while also maintaining productivity and most importantly, service to the client. So far, the results have been uneven. Many firms that have outsourced have had to pull back some activities due to problems with language and, in particular, culture. As a general rule, there has been a scale of diminishing collections as the collection situation becomes more complex, as collection effectiveness requires greater understanding of the client's industry and business, or as the collection activity requires extended and close personal contact with the client or customer.

The second indirectly related structural change trend has been one of organizational restructuring, either internally within firms or through mergers, acquisitions, and spin-offs. Again, the common driver is the desire to significantly reduce the firm's overall cost structure in order to boost operating margins.

Collections firms have become attractive acquisition targets because this industry is mature, with an established business model and real cash flow. Holding companies that focus on growth through acquisition and venture capitalists that in the 90's concentrated on the Internet bubble are both investing in collections businesses. However, a significant change in the acquisition dynamics is the shift in focus to the small-to-middle size sectors, driven by the belief that there is greater growth upside in these sectors.

This is where the overlap between M&A and outsourcing comes into play. Several recent examples tell the story. First, there is Equitant, which just sold off its debt collection division (formerly known as French & Associates) to the collections firm Resolve2Collect, Ltd. Equitant's primary focus is business process outsourcing, particularly the "order-to-cash" process comprising activities such as credit analysis and approval, billing, cash collections, and dispute resolution. This process is typically non-core and labor intensive. By contrast, Resolve2Collect specializes in customer account management, debt collection, credit risk and management, and debtor litigation.

Also instructive is the recent restructuring of Capital Crossing, as indicated by its name change to Riscuity. The company has been a provider of offshore receivables management outsourcing. Its value proposition has centered around overseas lower cost economics. However, in its own words, "We have seen a number of companies that were disappointed by their experience with outsourcing, which failed due to the many cultural differences between the U.S. and other countries."

A third useful example is the recent acquisition activities of the NCO Group, particularly since NCO positions itself as "the largest provider of accounts receivable collection services in the world" (although not having a market focus on media specifically). Following a debt restructuring last year, and several acquisitions over the last few years, NCO announced its plan to acquire RMH Teleservices, Inc. RMH is a large CRM company with outsourcing facilities in Canada and the Philippines. NCO already has substantial outsourcing operations in India, Barbados, and the U.K. This acquisition was characterized as "a critical step in our strategy of transitioning into a global provider of Business Process Outsourcing." NCO therefore is a case of significantly pushing business offshore while at the same time attempting to add entirely new categories of services for those offshore facilities to deliver.

What is the common denominator throughout what is happening with outsourcing and restructuring in the collections industry? Firms are looking for opportunities to capitalize on lower offshore costs while at the same time re-focusing their internal resources – which in some cases means not only subcontracting to outsourcing companies but even selling off businesses that do not leverage well or acquiring operations in fundamentally new service categories.

The Szabo Perspective

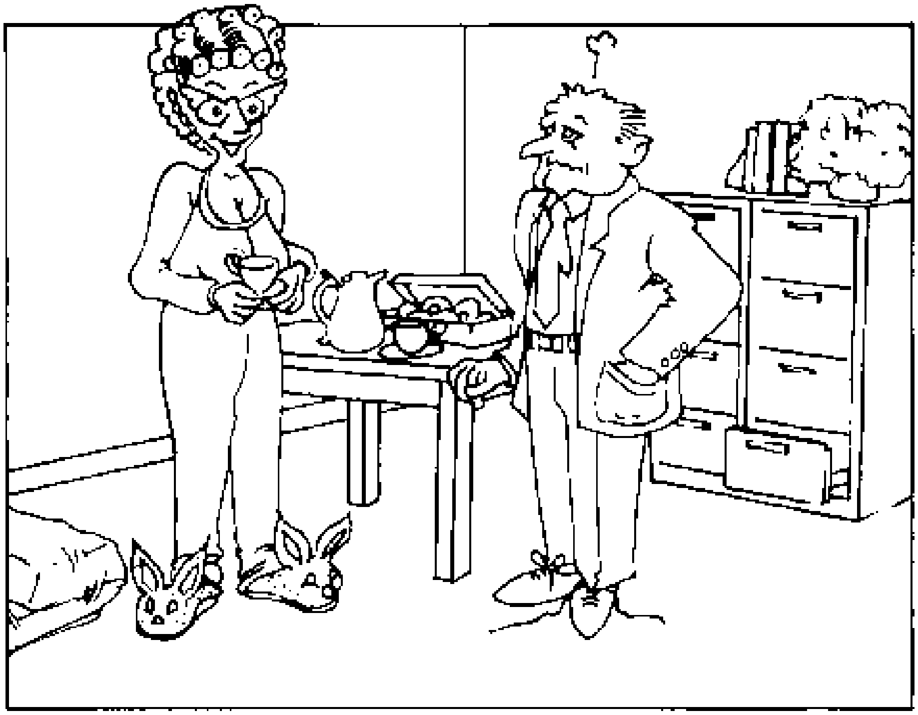
While we at Szabo would not debate the advantages of outsourcing or acquisitions for certain industries or even certain firms within the at-large collections industry, we must note that as with any other such massive industry restructuring, only time will tell which particular strategies or company's execution will, in the final analysis, be proved best <u>for</u> <u>the</u> <u>client</u>.

Although collections price points have sometimes fallen with outsourcing, it is also true that collector tenure remains low, and, even in the largest of firms, net labor efficiency and revenue per resource has not increased (and even sometimes has even slightly decreased). Consequently, we think it important to not "take our eye off the ball" in terms of what has been, and we believe should continue to be, our central focus: Providing the greatest possible total value specifically to the media community. What form does that take?

It begins with our *organizational structure*. Szabo exclusively focuses on media, and internally we have divisions that are divided along the lines of how media segments itself, e.g., with one division dedicated to print, another to radio, and yet another to television and cable. Each unit uses the language of the segment it serves. Our culture reflects our media clients' culture by understanding media business models and priorities, ensuring that all activities are defined and measured in ways consistent with the unique priorities and interests of media.

Applying the same customer-centric principle, Szabo has organizational units that functionally specialize for media as well. For example, the Legal Department is expert in the broad and complex media law. It keeps abreast of legal developments impacting media, court opinions, and regulations at the local, state, and national levels. Szabo Legal also manages 380 law firms which have specific agreements with Szabo. These attorneys are pre-qualified and have an established track record, including the necessary experience in media nuances, such as liability issues, verbal agreements, etc. Szabo Legal mitigates concerns regarding rates, processes, local jurisdiction availability, and "teaming" between the firms by working out these details beforehand.

Another example is the International Department. Doing business in foreign countries requires the replication of a wide range of domestic expertise, but with different form factors and rules. Szabo provides specialization and critical mass in this area so it can be safely entrusted with complex international collections.



"YOU TOLD ME TO RESEARCH 'INDUSTRY TRENDS.' THIS ONE IS CALLED, 'CASUAL FRIDAY'."

The second dimension of the Szabo "total" value proposition is based upon the *effectiveness of our personnel*. Szabo is committed to providing fast, cost-effective service while having the depth of experience to manage the most challenging and complex ones. Having personnel who truly understand their media client's needs and are committed to long-term client satisfaction enables this.

The foundation for such a high-quality workforce is Szabo's personnel policies, practices, and culture. In hiring, Szabo requires tenure and a proven track record in dollar results along with demonstrated negotiation and customer relationship management skills. Szabo also looks for personal characteristics such as self-reliance plus an ability to learn and steadily progress from experience. Furthermore, Szabo provides media-specific training and professional development programs that ensure that each employee is well grounded in the unique culture and practices of media and their specific collections needs. Finally, the Szabo culture is unique, with employees who are not on straight commission yet are held accountable for financial results and client satisfaction, with an employee-friendly environment which fosters high productivity (e.g., individual offices rather than a "bull pen"), and with a performance focus driven using MBO (management by objective) techniques. The result is much longer tenured collectors who produce well above industry norms.

One of the best day-to-day indicators of this high level of professionalism is Szabo's responsiveness. Going well beyond just quickly reacting to expressed needs, responsiveness means respect for the time value of money for the client. Every

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day that a debt goes uncollected represents dollars unavailable for use elsewhere in the business or for return to stakeholders.

While Szabo's primary objective is "hard" dollars debt recovery, we also think in terms of "soft" dollars as delivered through *value-add services*. This means a focus on ensuring that the media-customer business relationship remains intact, thus positioning media for follow-on sales. It also translates into making investments in value-add capabilities to assist clients in assessing customer credit risk up front, or other capabilities that assist the client in using his sales resources most productively. On the cost side, there is soft-dollar value in cost avoidance – for example, costs of ineffective handling of litigation situations or opportunity cost of utilizing resources (including the collection firm) unnecessarily.

Value-add can take different forms. For example, Szabo provides an array of information resources such as news about trends, and industry data on such issues as DSO, aging, and bad debt. Szabo maintains information on companies across media and its customer base, assisting with comparisons between a media company's risk profile and industry norms. We provide in-depth profiles and assist with the evaluation of media customers, providing insight into the customer relationship and helping to avoid misinformation and misunderstandings. And Szabo can provide useful information for the entire credit process from first credit application to sales contracts to billing to media in-house collection efforts prior to engaging the collections firm, to conform to industry standards and also maximize the chance of success of downstream litigation. In fact, the Szabo proprietary collections database – the technology enabler for its DebtorNet® service (credit information) – is the largest and most reliable database of its kind, and saves Szabo clients millions of dollars in the aggregate every year.

In yet another area, Szabo provides proactive formal risk assessment and process management, covering all the potential steps between the earliest marketing efforts through to final payment, including collections. Consistent with the media "soft" dollar objective of customer recovery and retention, risk management balances safety with maximizing customer potential.

The driving strategy behind how Szabo operates is one of superior net client value. We know that what is more important to our clients than price point is the net amount collected after costs are subtracted. And so while cost restructuring (through outsourcing, for example) can conceivably be a factor in lower price, the other more critical side of that equation is collection performance.

At Szabo, our experience continues to be that having the best possible organization, personnel, and portfolio of services translates into superior net collection dollars, greater client productivity and better business decisions, and media customer retention and repeat business. For many clients, this effectively is a "net zero collection cost" value proposition.

SZABO ASSOCIATES INC. szabo MEDIA COLLECTION PROFESSIONALS

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