ENCORE CAPITAL GROUP INC
Form 10-Q
November 07, 2018
Table of Contents

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

FORM 10-Q

(Mark One)
x QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended September 30, 2018
OR
¨ 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: 000-26489
ENCORE CAPITAL GROUP, INC.
(Exact name of registrant as specified in its charter)

Delaware	48-1090909
(State or other jurisdiction of incorporation or organization)	(IRS Employer Identification No.)
3111 Camino Del Rio North, Suite 103 San Diego, California	92108
(Address of principal executive offices)	(Zip code)

(877) 445 - 4581
(Registrant’s telephone number, including area code)
(Not Applicable)
(Former name, former address and former fiscal year, if changed since last report)

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 last 90 days. Yes x No ¨
Indicate by check mark whether the registrant has submitted electronically every Interactive Data File required to be submitted pursuant to Rule 405 of Regulation S-T (Section 232.405 of this chapter) during the preceding 12 months (or for such shorter period that the registrant was required to submit such files). Yes x No ¨
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,” “smaller reporting company” and “emerging growth company” in Rule 12b-2 of the Exchange Act. (Check one): Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company ¨ Emerging growth company ¨
If an emerging growth company, indicate by check mark if the registrant has elected not to use the extended transition period for complying with any new or revised financial accounting standards provided pursuant to Section 13(a) of the Exchange Act. ¨
Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Act). Yes ¨ No x

Indicate the number of shares outstanding of each of the issuer’s classes of common stock, as of the latest practicable date.

Class	Outstanding at October 31, 2018
Common Stock, $0.01 par value	30,852,178 shares

Table of Contents

ENCORE CAPITAL GROUP, INC.
INDEX TO FORM 10-Q

	Page
PART I – FINANCIAL INFORMATION	3
Item 1—Condensed Consolidated Financial Statements (Unaudited)	3
Condensed Consolidated Statements of Financial Condition	3
Condensed Consolidated Statements of Operations	4
Condensed Consolidated Statements of Comprehensive Income	5
Condensed Consolidated Statement of Equity	6
Condensed Consolidated Statements of Cash Flows	7
Notes to Condensed Consolidated Financial Statements	8
Item 2 – Management's Discussion and Analysis of Financial Condition and Results of Operations	33
Item 3 – Quantitative and Qualitative Disclosures About Market Risk	64
Item 4 – Controls and Procedures	64
PART II – OTHER INFORMATION	65
Item 1 – Legal Proceedings	65
Item 1A – Risk Factors	65
Item 5 - Other Information	65
Item 6 – Exhibits	65
SIGNATURES	67

Table of Contents

PART I – FINANCIAL INFORMATION
Item 1—Condensed Consolidated Financial Statements (Unaudited)
ENCORE CAPITAL GROUP, INC.
Condensed Consolidated Statements of Financial Condition
(In Thousands, Except Par Value Amounts)
(Unaudited)

	September 30, 2018	December 31, 2017
Assets		
Cash and cash equivalents	$ 204,649	$ 212,139
Investment in receivable portfolios, net	3,109,116	2,890,613
Deferred court costs, net	94,017	79,963
Property and equipment, net	96,429	76,276
Other assets	244,602	302,728
Goodwill	898,591	928,993
Total assets	$ 4,647,404	$ 4,490,712
Liabilities and Equity		
Liabilities:		
Accounts payable and accrued liabilities	$ 274,213	$ 284,774
Debt, net	3,561,467	3,446,876
Other liabilities	33,279	35,151
Total liabilities	3,868,959	3,766,801
Commitments and contingencies		
Redeemable noncontrolling interest	1,231	151,978
Equity:		
Convertible preferred stock, $.01 par value, 5,000 shares authorized, no shares issued and outstanding	—	—
Common stock, $.01 par value, 50,000 shares authorized, 30,852 shares and 25,801 shares issued and outstanding as of September 30, 2018 and December 31, 2017, respectively	309	258
Additional paid-in capital	207,985	42,646
Accumulated earnings	673,153	616,314
Accumulated other comprehensive loss	(103,394)	(77,356)
Total Encore Capital Group, Inc. stockholders' equity	778,053	581,862
Noncontrolling interest	(839)	(9,929)
Total equity	777,214	571,933
Total liabilities, redeemable equity and equity	$ 4,647,404	$ 4,490,712

The following table presents certain assets and liabilities of consolidated variable interest entities ("VIEs") included in the consolidated statements of financial condition above. Most assets in the table below include those assets that can only be used to settle obligations of consolidated VIEs. The liabilities exclude amounts where creditors or beneficial interest holders have recourse to the general credit of the Company. See Note 10, "Variable Interest Entities" for additional information on the Company's VIEs.

	September 30, 2018	December 31, 2017
Assets		
Cash and cash equivalents	$ 471	$ 88,902
Investment in receivable portfolios, net	444,503	1,342,300
Deferred court costs, net	—	26,482
Property and equipment, net	—	23,138

Other assets	8,212	122,263
Goodwill	—	724,054
Liabilities		
Accounts payable and accrued liabilities	$ 3,514	$ 151,208
Debt, net	390,690	2,014,202
Other liabilities	—	1,494

See accompanying notes to condensed consolidated financial statements

3

Table of Contents

ENCORE CAPITAL GROUP, INC.
Condensed Consolidated Statements of Operations
(In Thousands, Except Per Share Amounts)
(Unaudited)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Revenues				
Revenue from receivable portfolios	$295,357	$264,024	$869,028	$777,269
Other revenues	37,388	23,111	112,809	61,763
Total revenues	332,745	287,135	981,837	839,032
Allowance reversals on receivable portfolios, net	4,029	19,564	31,472	30,525
Total revenues, adjusted by net allowances	336,774	306,699	1,013,309	869,557
Operating expenses				
Salaries and employee benefits	95,634	77,232	275,853	221,296
Cost of legal collections	50,473	48,094	155,583	149,460
Other operating expenses	30,691	25,859	103,478	76,249
Collection agency commissions	10,682	10,622	34,587	33,678
General and administrative expenses	41,893	32,500	123,163	102,750
Depreciation and amortization	9,873	8,522	31,232	25,819
Total operating expenses	239,246	202,829	723,896	609,252
Income from operations	97,528	103,870	289,413	260,305
Other (expense) income				
Interest expense	(65,094)	(52,755)	(183,092)	(152,469)
Other (expense) income	(2,539)	8,873	(4,961)	12,004
Total other expense	(67,633)	(43,882)	(188,053)	(140,465)
Income from continuing operations before income taxes	29,895	59,988	101,360	119,840
Provision for income taxes	(16,879)	(17,844)	(37,657)	(43,442)
Income from continuing operations	13,016	42,144	63,703	76,398
Loss from discontinued operations, net of tax	—	—	—	(199)
Net income	13,016	42,144	63,703	76,199
Net loss (income) attributable to noncontrolling interest	7,709	(13,950)	5,147	(5,652)
Net income attributable to Encore Capital Group, Inc. stockholders	$20,725	$28,194	$68,850	$70,547
Amounts attributable to Encore Capital Group, Inc.:				
Income from continuing operations	$20,725	$28,194	$68,850	$70,746
Loss from discontinued operations, net of tax	—	—	—	(199)
Net income	$20,725	$28,194	$68,850	$70,547
Earnings (loss) per share attributable to Encore Capital Group, Inc.:				
Basic earnings (loss) per share from:				
Continuing operations	$0.69	$1.08	$2.52	$2.73
Discontinued operations	—	—	—	(0.01)
Net basic earnings per share	$0.69	$1.08	$2.52	$2.72
Diluted earnings (loss) per share from:				
Continuing operations	$0.69	$1.05	$2.49	$2.68
Discontinued operations	—	—	—	(0.01)
Net diluted earnings per share	$0.69	$1.05	$2.49	$2.67
Weighted average shares outstanding:				

Basic	29,867	26,011	27,372	25,957
Diluted	30,121	26,736	27,663	26,406

See accompanying notes to condensed consolidated financial statements

Table of Contents

ENCORE CAPITAL GROUP, INC.
Condensed Consolidated Statements of Comprehensive Income
(Unaudited, In Thousands)

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Net income	$13,016	$42,144	$63,703	$76,199
Other comprehensive (loss) income, net of tax:				
Change in unrealized gains/losses on derivative instruments:				
Unrealized (loss) gain on derivative instruments	(1,152)	(264)	(3,306)	1,170
Income tax effect	284	103	823	(409)
Unrealized (loss) gain on derivative instruments, net of tax	(868)	(161)	(2,483)	761
Change in foreign currency translation:				
Unrealized (loss) gain on foreign currency translation	(6,919)	9,712	(23,436)	32,000
Other comprehensive (loss) income, net of tax	(7,787)	9,551	(25,919)	32,761
Comprehensive income	5,229	51,695	37,784	108,960
Comprehensive (income) loss attributable to noncontrolling interest:				
Net loss (income)	7,709	(13,950)	5,147	(5,652)
Unrealized loss (gain) on foreign currency translation	1,293	(594)	(119)	(2,003)
Comprehensive loss (income) attributable to noncontrolling interest	9,002	(14,544)	5,028	(7,655)
Comprehensive income attributable to Encore Capital Group, Inc. stockholders	$14,231	$37,151	$42,812	$101,305

See accompanying notes to condensed consolidated financial statements

5

Table of Contents

ENCORE CAPITAL GROUP, INC.
Condensed Consolidated Statement of Equity
(In Thousands)

	Common Stock		Additional Paid-In Capital	Accumulated Earnings	Accumulated Other Comprehensive Loss	Noncontrolling Interest	Total Equity
	Shares	Par					
Balance at December 31, 2017	25,801	$ 258	$ 42,646	$ 616,314	$ (77,356)	$ (9,929)	$ 571,933
Net income (loss)	—	—	—	68,850	—	(969)	67,881
Other comprehensive (loss) gain, net of tax	—	—	—	—	(26,038)	433	(25,605)
Change in fair value of redeemable noncontrolling interest	—	—	19,430	(12,011)	—	—	7,419
Purchase of noncontrolling interest	—	—	—	—	—	9,626	9,626
Exercise of stock options and issuance of share-based awards, net of shares withheld for employee taxes	132	2	(1,934)	—	—	—	(1,932)
Issuance of common stock	4,920	49	181,138	—	—	—	181,187
Stock-based compensation	—	—	10,452	—	—	—	10,452
Issuance of exchangeable notes	—	—	14,009	—	—	—	14,009
Exchangeable notes hedge transactions	—	—	(17,785)	—	—	—	(17,785)
Net equity adjustment on Cabot Transaction	—	—	(43,097)	—	—	—	(43,097)
Other	—	—	3,126	—	—	—	3,126
Balance at September 30, 2018	30,853	$ 309	$ 207,985	$ 673,153	$ (103,394)	$ (839)	$ 777,214

Table of Contents

ENCORE CAPITAL GROUP, INC.
Condensed Consolidated Statements of Cash Flows
(Unaudited, In Thousands)

	Nine Months Ended September 30,	
	2018	2017
Operating activities:		
Net income	$63,703	$76,199
Adjustments to reconcile net income to net cash provided by operating activities:		
Loss from discontinued operations, net of income taxes	—	199
Depreciation and amortization	31,232	25,819
Other non-cash expense, net	30,453	24,768
Stock-based compensation expense	10,452	7,041
Loss (gain) on derivative instruments, net	10,648	(2,714)
Deferred income taxes	18,733	(5,396)
Allowance reversals on receivable portfolios, net	(31,472)	(30,525)
Other, net	(9,690)	330
Changes in operating assets and liabilities		
Deferred court costs and other assets	(19,537)	(20,094)
Prepaid income tax and income taxes payable	21,419	15,565
Accounts payable, accrued liabilities and other liabilities	(5,919)	(9,501)
Net cash provided by operating activities	120,022	81,691
Investing activities:		
Cash paid for acquisitions, net of cash acquired	—	(5,623)
Purchases of receivable portfolios, net of put-backs	(881,789)	(739,478)
Collections applied to investment in receivable portfolios, net	615,010	549,544
Purchases of property and equipment	(37,436)	(20,518)
(Payment) proceeds from derivative instruments, net	(28,656)	6,140
Other, net	6,800	2,155
Net cash used in investing activities	(326,071)	(207,780)
Financing activities:		
Payment of loan costs	(6,440)	(19,910)
Proceeds from credit facilities	766,471	928,141
Repayment of credit facilities	(465,666)	(972,453)
Proceeds from senior secured notes	—	325,000
Repayment of senior secured notes	(1,029)	(203,212)
Proceeds from issuance of convertible senior notes	172,500	150,000
Repayment of convertible senior notes	—	(60,406)
Proceeds from convertible hedge instruments	—	5,580
Proceeds from other debt	9,090	8,318
Repayment of other debt	(23,450)	(4,309)
Payment for the purchase of PECs and noncontrolling interest	(234,101)	—
Payment of direct and incremental costs relating to Cabot Transaction	(8,622)	—
Other, net	(3,826)	(1,440)
Net cash provided by financing activities	$204,927	155,309
Net (decrease) increase in cash and cash equivalents	(1,122)	29,220
Effect of exchange rate changes on cash and cash equivalents	(6,368)	9,261
Cash and cash equivalents, beginning of period	212,139	149,765
Cash and cash equivalents, end of period	$204,649	$188,246

See accompanying notes to condensed consolidated financial statements

ENCORE CAPITAL GROUP, INC.
Notes to Condensed Consolidated Financial Statements (Unaudited)
Note 1: Ownership, Description of Business, and Summary of Significant Accounting Policies
Encore Capital Group, Inc. ("Encore"), through its subsidiaries (collectively with Encore, the "Company"), is an international specialty finance company providing debt recovery solutions and other related services for consumers across a broad range of financial assets. The Company purchases portfolios of defaulted consumer receivables at deep discounts to face value and manages them by working with individuals as they repay their obligations and work toward financial recovery. Defaulted receivables are consumers' unpaid financial commitments to credit originators, including banks, credit unions, consumer finance companies, commercial retailers, and telecommunication companies. Defaulted receivables may also include receivables subject to bankruptcy proceedings.
Encore's subsidiary Midland Credit Management (together with its subsidiaries and domestic affiliates, "Midland") is a market leader in portfolio purchasing and recovery in the United States, including Puerto Rico. Cabot Credit Management plc (together with its subsidiaries, "Cabot"), Encore's largest international subsidiary, is one of the largest credit management services providers in Europe and is a market leader in the United Kingdom and Ireland. Previously, Encore controlled Cabot via its majority ownership interest in the indirect holding company of Cabot, Janus Holdings S.a r.l. ("Janus Holdings"). On July 24, 2018, the Company completed the purchase of all the outstanding interests of Cabot not owned by the Company. As a result, Cabot became a wholly owned subsidiary of Encore. These are the Company's primary operations.
Financial Statement Preparation and Presentation
The accompanying interim condensed consolidated financial statements have been prepared by the Company, without audit, in accordance with the instructions to the Quarterly Report on Form 10-Q, and Rule 10-01 of Regulation S-X promulgated by the United States Securities and Exchange Commission (the "SEC") and, therefore, do not include all information and footnotes necessary for a fair presentation of its consolidated financial position, results of operations and cash flows in accordance with accounting principles generally accepted in the United States ("GAAP").
In the opinion of management, the unaudited financial information for the interim periods presented reflects all adjustments, consisting of only normal and recurring adjustments, necessary for a fair presentation of the Company's consolidated financial position, results of operations, and cash flows. These condensed consolidated financial statements should be read in conjunction with the consolidated financial statements included in the Company's Annual Report on Form 10-K for the fiscal year ended December 31, 2017. Operating results for interim periods are not necessarily indicative of operating results for an entire fiscal year.
The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts and the disclosure of contingent amounts in the Company's financial statements and the accompanying notes. Actual results could materially differ from those estimates.
Basis of Consolidation
The condensed consolidated financial statements have been prepared in conformity with GAAP and reflect the accounts and operations of the Company and those of its subsidiaries in which the Company has a controlling financial interest. The Company also consolidates variable interest entities ("VIE"s), for which it is the primary beneficiary. The primary beneficiary has both (a) the power to direct the activities of the VIE that most significantly affect the entity's economic performance, and (b) either the obligation to absorb losses or the right to receive benefits. Refer to Note 10, "Variable Interest Entities," for further details. All intercompany transactions and balances have been eliminated in consolidation.
Translation of Foreign Currencies
The financial statements of certain of the Company's foreign subsidiaries are measured using their local currency as the functional currency. Assets and liabilities of foreign operations are translated into U.S. dollars using period-end exchange rates, and revenues and expenses are translated into U.S. dollars using average exchange rates in effect during each period. The resulting translation adjustments are recorded as a component of other comprehensive income or loss. Equity accounts are translated at historical rates, except for the change in retained earnings during the year which is the result of the income statement translation process. Intercompany transaction gains or losses at each period end arising from subsequent measurement of balances for which settlement is not planned or anticipated in the

foreseeable future are included as translation adjustments and recorded within other comprehensive income or loss. Translation gains or losses are the material components of accumulated other comprehensive income or loss. Transaction gains and losses are included in other income or expense.

Table of Contents

Reclassifications

Certain immaterial reclassifications have been made to the condensed consolidated financial statements to conform to the current year's presentation.

Change in Accounting Principle

In May 2014, the Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update ("ASU") 2014-09, Revenue from Contracts with Customers ("Topic 606" or "ASU 2014-09"). The objective of ASU 2014-09 is to establish a single comprehensive model for entities to use in accounting for revenue arising from contracts with customers. ASU 2014-09 supersedes most of the existing revenue recognition guidance, including industry-specific guidance. The core principle is that an entity should recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. ASU 2014-09 applies to all contracts with customers except those that are within the scope of other topics in the FASB's Accounting Standards Codification ("ASC"). Under the prior accounting standard, the Company recognized revenue when there was persuasive evidence of an arrangement, the sales price was fixed or determinable, the services had been performed and collectability was reasonably assured.

The Company's investment in receivable portfolios is outside of the scope of Topic 606 since it is accounted for in accordance with ASC 310-30. Certain of the Company's international subsidiaries earn fee-based income by providing portfolio management services to credit originators for non-performing loans. Performance obligations for this revenue stream under the new standard primarily arise from debt collection and management activities. These performance obligations are typically satisfied when services are performed, or debt is collected. Consideration is typically variable based on indeterminate volumes or collection activity. Under the new accounting standard, revenue is recognized over time as a series of single performance obligations when the Company is entitled to a percentage of collections received, since the customer simultaneously receives and consumes the benefits provided by the Company's performance of debt collection and management. The method for measuring progress towards satisfying a performance obligation is based on transaction volumes or debt collected, depending on whether the contract is based on services performed or based on commissions. Costs to fulfill a contract are expensed when incurred.

The Company adopted the requirements of Topic 606 as of January 1, 2018, utilizing the modified retrospective method of transition and elected to apply the revenue standard only to contracts that were not completed as of the adoption date. Prior periods were not restated. The cumulative effect of adopting this new standard had no impact to retained earnings. The impact of adopting Topic 606 on the Company's revenue is not material to any of the periods presented. Fee-based income is included in "Other Revenues" in the Company's consolidated statements of operations.

In August 2017, the FASB issued ASU 2017-12, Targeted Improvements to Accounting for Hedging Activities—Derivatives and Hedging ("Topic 815" or "ASU 2017-12") which amends the hedge accounting recognition and presentation requirements in ASC 815. ASU 2017-12 improves Topic 815 by simplifying and expanding the eligible hedging strategies for financial and nonfinancial risks by more closely aligning hedge accounting with a company's risk management activities, and also simplifies its application through targeted improvements in key practice areas. This includes expanding the list of items eligible to be hedged and amending the methods used to measure the effectiveness of hedging relationships. In addition, ASU 2017-12 prescribes how hedging results should be presented and requires incremental disclosures. These changes are intended to allow preparers more flexibility and to enhance the transparency of how hedging results are presented and disclosed. Further, the new standard provides partial relief on the timing of certain aspects of hedge documentation and eliminates the requirement to recognize hedge ineffectiveness separately in earnings in the current period. For public entities, ASU 2017-12 is effective for fiscal years, including interim periods within those fiscal years, beginning after December 15, 2018, with early adoption permitted in any interim period or fiscal year. The Company early adopted ASU 2017-12 as of the second quarter of 2018 retroactive to January 1, 2018. The adoption of the new standard did not have a material effect on the Company's financial position, results of operations, or required presentations.

Recent Accounting Pronouncements

Other than the adoption of the standards discussed above, there have been no new accounting pronouncements made effective during the three and nine months ended September 30, 2018 that have significance, or potential significance, to the Company's consolidated financial statements.

Recent Accounting Pronouncements Not Yet Effective

In January 2017, the FASB issued ASU 2017-04, Intangibles - Goodwill and Other (Topic 350). The amendments in this update simplify the test for goodwill impairment by eliminating Step 2 from the impairment test, which required the entity to perform procedures to determine the fair value at the impairment testing date of its assets and liabilities following the procedure

that would be required in determining fair value of assets acquired and liabilities assumed in a business combination. The amendments in this update are effective for public companies for annual or any interim goodwill impairments tests in fiscal years beginning after December 15, 2019. Early adoption is permitted for interim or annual goodwill impairment tests performed on testing dates after January 1, 2017. The Company did not early adopt this guidance for its annual goodwill impairment testing and does not expect the adoption of ASU 2017-04 to have a material impact on its consolidated financial statements.

In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments ("ASU 2016-13"). ASU 2016-13 applies a current expected credit loss model which is a new impairment model based on expected losses rather than incurred losses. Under this model, an entity would recognize an impairment allowance equal to its current estimate of all contractual cash flows that the entity does not expect to collect from financial assets measured at amortized cost. The estimate of expected credit losses should consider historical information, current information, as well as reasonable and supportable forecasts, including estimates of prepayments. The expected credit losses, and subsequent adjustments to such losses, will be recorded through an allowance account that is deducted from the amortized cost basis of the financial asset, with the net carrying value of the financial asset presented on the consolidated balance sheet at the amount expected to be collected. ASU 2016-13 eliminates the current accounting model for loans and debt securities acquired with deteriorated credit quality under ASC 310-30, which provides authoritative guidance for the accounting of the Company's investment in receivable portfolios. Under this new standard, entities will gross up the initial amortized cost for the purchased financial assets with credit deterioration ("PCD assets"), the initial amortized cost will be the sum of (1) the purchase price and (2) the estimate of credit losses as of the date of acquisition. After initial recognition of PCD assets and the related allowance, any change in estimated cash flows (favorable or unfavorable) will be immediately recognized in the income statement because the yield on PCD assets would be locked. ASU 2016-13 is effective for reporting periods beginning after December 15, 2019 with early adoption permitted for reporting periods beginning after December 15, 2018. The guidance will be applied on a modified retrospective basis through a cumulative-effect adjustment to retained earnings as of the beginning of the period in which ASU 2016-13 is adopted. However, the FASB has determined that financial assets for which the guidance in Subtopic 310-30, Receivables-Loans and Debt Securities Acquired with Deteriorated Credit Quality, has previously been applied should prospectively apply the guidance in ASU 2016-13 for PCD assets. A prospective transition approach should be used for PCD assets where upon adoption, the amortized cost basis should be adjusted to reflect the addition of the allowance for credit losses. This transition relief will avoid the need for a reporting entity to reassess its purchased financial assets that exist as of the date of adoption to determine whether they would have met at acquisition the new criteria of more-than insignificant credit deterioration since origination. The transition relief also will allow an entity to accrete the remaining noncredit discount (based on the revised amortized cost basis) into interest income at the effective interest rate at the adoption date of ASU 2016-13. The same transition requirements should be applied to beneficial interests that previously applied Subtopic 310-30 or have a significant difference between contractual cash flows and expected cash flows. The Company is in the process of determining the effects the adoption of ASU 2016-13 will have on its consolidated financial statements. The Company expects ASU 2016-13 could have a significant impact on how it measures and records income recognized on its receivable portfolios. The Company has established a project management team and is in the process of developing its accounting policy, evaluating the impact of this pronouncement and researching software resources that could assist with the implementation.

In February 2016, the FASB issued ASU 2016-02, Leases (Topic 842) ("ASU 2016-02"). ASU 2016-02 changes accounting for leases and requires lessees to recognize the assets and liabilities arising from most leases, including those classified as operating leases under previous accounting guidance, on the balance sheet and requires disclosure of key information about leasing arrangements to increase transparency and comparability among organizations. In July 2018, the FASB issued ASU 2018-10, Codification Improvements to Topic 842, which provides narrow amendments to clarify how to apply certain aspects of the new lease standard. In July 2018, ASU 2018-11, Leases: Targeted Improvements, was issued to provide relief to companies from restating comparative periods. Pursuant to ASU 2018-11, in the period of adoption, the Company will not restate comparative periods presented in its financial statements. The new guidance will be effective for the Company starting in the first quarter of fiscal year 2019. Early

adoption is permitted; however, the Company does not intend to early adopt. The Company is developing an inventory of all leases, accumulating the lease data necessary to apply the amended guidance and is in the process of determining the effects the adoption will have on its consolidated financial statements, systems and processes. The Company has selected a software to assist with implementation to the standard.

With the exception of the updated standards discussed above, there have been no new accounting pronouncements not yet effective that have significance, or potential significance, to the Company's consolidated financial statements.

Table of Contents

Note 2: Earnings Per Share

Basic earnings or loss per share is calculated by dividing net earnings or loss attributable to Encore by the weighted average number of shares of common stock outstanding during the period. Diluted earnings per share is calculated based on the weighted average number of shares of common stock plus the effect of dilutive potential common shares outstanding during the period using the treasury stock method. Dilutive potential common shares include outstanding stock options, restricted stock, and the dilutive effect of the convertible senior notes, if applicable.

A reconciliation of shares used in calculating earnings per basic and diluted shares follows (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2018	2017	2018	2017
Weighted average common shares outstanding—basic	29,867	26,011	27,372	25,957
Dilutive effect of stock-based awards	254	271	291	214
Dilutive effect of convertible senior notes	—	454	—	235
Weighted average common shares outstanding—diluted	30,121	26,736	27,663	26,406

Anti-dilutive employee stock options outstanding were approximately 13,000 during each of the three and nine months ended September 30, 2018. Anti-dilutive employee stock options outstanding were approximately 13,000 and 138,000 during the three and nine months ended September 30, 2017, respectively.

Note 3: Cabot Transaction

On July 24, 2018, the Company completed the purchase of all the outstanding interests of Cabot not owned by the Company (the "Cabot Transaction"). As a result, Cabot became a wholly owned subsidiary of Encore. The acquisition of the remaining interest was accounted for as an equity transaction and no gain or loss was recognized in the Company's consolidated statements of operations but was reflected as a component of additional paid-in capital in the consolidated statement of equity. Additionally, in accordance with authoritative guidance and the Company's policy, the direct and incremental costs associated with the Cabot Transaction were accounted for as part of the equity transaction. Total consideration transferred was approximately $414.7 million, which consisted of cash of $234.1 million and the equivalent of $180.6 million of Encore common stock based on the last reported sale price of Encore common stock per share of $36.80 on July 24, 2018.

	(in thousands)
Cash consideration	$ 234,101
Stock consideration	180,559
Total consideration transferred	414,660
Less: Preferred equity certificates acquired	(262,512)
Consideration transferred to acquire remaining equity interest	152,148
Less: Carrying value of redeemable noncontrolling interest	(127,299)
Less: Carrying value of noncontrolling interest	9,626
Net loss directly recorded in equity	34,475
Direct and incremental transaction costs	8,622
Total reduction in additional paid-in capital	$ 43,097

Note 4: Fair Value Measurements

The authoritative guidance for fair value measurements defines fair value as the price that would be received upon sale of an asset or the price paid to transfer a liability, in an orderly transaction between market participants at the measurement date (i.e., the "exit price"). The guidance utilizes a fair value hierarchy that prioritizes the inputs used in valuation techniques to measure fair value into three broad levels. The following is a brief description of each level:

Table of Contents

- Level 1: Observable inputs such as quoted prices (unadjusted) in active markets for identical assets or liabilities.
- Level 2: Inputs other than quoted prices that are observable for the asset or liability, either directly or indirectly. These include quoted prices for similar assets or liabilities in active markets and quoted prices for identical or similar assets or liabilities in markets that are not active.
- Level 3: Unobservable inputs, including inputs that reflect the reporting entity's own assumptions.

Financial Instruments Required To Be Carried At Fair Value

Financial assets and liabilities measured at fair value on a recurring basis are summarized below (in thousands):

	Fair Value Measurements as of September 30, 2018			
	Level 1	Level 2	Level 3	Total
Assets				
Interest rate swap agreements	$ —	$ 5	$ —	$ 5
Interest rate cap contracts	—	2,445	—	2,445
Liabilities				
Foreign currency exchange contracts	—	(1,408)	—	(1,408)
Contingent consideration	—	—	(7,417)	(7,417)
Temporary Equity				
Redeemable noncontrolling interest	—	—	(1,231)	(1,231)

	Fair Value Measurements as of December 31, 2017			
	Level 1	Level 2	Level 3	Total
Assets				
Foreign currency exchange contracts	$ —	$ 1,912	$ —	$ 1,912
Interest rate cap contracts	—	3,922	—	3,922
Liabilities				
Foreign currency exchange contracts	—	(1,110)	—	(1,110)
Interest rate swap agreements	—	(7)	—	(7)
Contingent consideration	—	—	(10,612)	(10,612)
Temporary Equity				
Redeemable noncontrolling interest	—	—	(151,978)	(151,978)

Derivative Contracts:

The Company uses derivative instruments to manage its exposure to fluctuations in interest rates and foreign currency exchange rates. Fair values of these derivative instruments are estimated using industry standard valuation models. These models project future cash flows and discount the future amounts to a present value using market-based observable inputs, including interest rate curves, foreign currency exchange rates, and forward and spot prices for currencies.

Contingent Consideration:

The Company carries certain contingent liabilities resulting from its mergers and acquisition activities. Certain sellers of the Company's acquired entities could earn additional earn-out payments in cash based on the entities' subsequent operating performance. The Company recorded the acquisition date fair values of these contingent liabilities, based on the likelihood of contingent earn-out payments, as part of the consideration transferred. The earn-out payments are subsequently remeasured to fair value at each reporting date. The Company reviewed the earn-out analysis during the three and nine months ended September 30, 2018 and determined that, based on actual and forecasted operating performance, the expected future earn-out payments would remain the same and be reduced by approximately $4.7 million, respectively. As of September 30, 2018, the aggregated fair value of the contingent consideration was approximately $7.4 million.

Table of Contents

The following table provides a roll forward of the fair value of contingent consideration for the periods ended September 30, 2018 and December 31, 2017 (in thousands):

	Amount
Balance at December 31, 2016	$2,531
Issuance of contingent consideration in connection with acquisition	10,808
Change in fair value of contingent consideration	(2,465)
Payment of contingent consideration	(781)
Effect of foreign currency translation	519
Balance at December 31, 2017	10,612