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Research Update:

Arrow Global Group PLC 'BB-' Rating Affirmed Following Completion Of Asset-Backed Facility; Outlook Stable

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Overview

- U.K.-based debt collection company Arrow Global Group PLC has completed on its new private asset-backed facility, which it will use to refinance existing drawings on its revolving credit facility (RCF).
- Because we do not expect this to erode Arrow's financial metrics, we are affirming our 'BB-' long-term issuer credit rating on Arrow Global Group PLC.
- At the same time, we are affirming our 'BB' issue level ratings on Arrow's senior secured bonds.
- The stable outlook reflects our expectation that Arrow's increasingly diversified earnings will support a reduction in what we regard as relatively high leverage, when considering the current rating level, over the next 12 months.

Rating Action

On May 9, 2019, S&P Global Ratings affirmed its 'BB-' long-term issuer credit rating on U.K.-based debt collection company Arrow Global Group PLC (Arrow). The outlook is stable.

We also affirmed our 'BB' issue rating on the senior secured bonds issued by Arrow. The '2' recovery rating is unchanged, indicating recovery prospects of approximately 70% in the event of a default. Following the transaction, the metrics are now approaching a level where any further deterioration could lead us to lower the rating on the senior secured instruments.

Rationale

We affirmed the ratings because we forecast that Arrow's credit metrics will improve during the next year and do not expect the transaction to impede that improvement. We expect the new asset-backed facility will be used to refinance existing drawings on the group's RCF, and that the group will then make further drawings on the RCF over 2019. As such, following the transaction, our expectations for Arrow's credit metrics remain broadly unchanged.

Under our updated base case, we expect the reduction in leverage to gather pace in 2019, with debt metrics at year-end 2018 high for the rating level. However, if, contrary to our expectations, group leverage fails to improve to below 4x in 2019--precipitated by operational underperformance or by debt-financed portfolio growth beyond our base case--we could see negative pressure on the rating by end-2019.

Arrow grew rapidly in 2018. Cash EBITDA grew by £60 million to £285 million as the group continued to expand its servicing business and invested heavily in profitable, specialized nonperforming loans (NPLs) in core geographies. However, much of this growth was debt-funded. Leverage stood at 4.2x at year-end 2018, in line with 2017, and above our previous forecast level. Nevertheless, we expect Arrow's metrics to be sustainably lower by the end of 2019 as economies of scale and profitable diversification begin to feed through into improved credit metrics. Under this base case we expect 2019 metrics of:

- Debt to adjusted EBITDA of 3.5x-4x;
- Funds from operations to gross debt of 20%-25%; and
- S&P Global Ratings-adjusted EBITDA to interest expense of 5x-6x.

Our forecasts incorporate modest growth in portfolio purchases in 2019, with a plateau thereafter. Growth should be increasingly covered by operating cash flow generation. We expect management's dividend policy to remain progressive through 2019, at 40%-45% of annual net income. Overall, our forecasted metrics are built from:

- Continued income growth from rapid expansion in asset management and servicing (AMS) income streams, with more moderated growth in traditional investment activities as this business line enters a more steady state.
- Modest deterioration in EBITDA margins as Arrow moves into the AMS business, where margins have historically sat around the 20% mark. On a consolidated basis, we expect concerted cost-control efforts to offset this somewhat, although in total the effect will be a fall of around 4-6 percentage points in terms of cash EBITDA margin over 2019-2020.
- No bond issuance expected in 2019, with net debt affected by further drawing on the RCF and the securitization facility.

Our rating also incorporates Arrow's relatively narrow geographic diversification compared with larger industry players, offset by Arrow's solid competitive position across its five core geographies, all of which have large, diverse NPL supplies. The rating is supported by the group's continued move into AMS, from which we expect to see most of its top-line growth over the next 24 months.

Our 'BB-' rating includes a one-notch downward adjustment to reflect Arrow's recent track record of rapid debt-funded growth as it has looked to gain scale, diversify its asset base, and build its asset management capabilities.

Liquidity

Based on Arrow's likely sources and uses of cash over the next 12 months, we view the company as having adequate liquidity. We expect sources of liquidity will exceed uses by at least 1.2x in the coming 12 months.

The group's principal liquidity sources under our base case will be:

- Headroom in the RCF of approximately £150 million for 2019 under our base case following the asset-backed facility transaction; and
- Cash generation from the group's investment and AMS businesses.

The group's principal liquidity uses under our base case will be:

- Portfolio purchases of above £250 million; and
- Management's progressive dividend, which we expect the group to pay even under a period of moderate stress.

Outlook

The stable outlook reflects our view that Arrow's credit metrics will improve over our 12-month outlook horizon, with adjusted debt to EBITDA falling below 4x on a sustainable basis.

Downside scenario

We could lower the ratings if our measure of the group's leverage remains above 4x in 2019, precipitated by operational underperformance or by debt-financed portfolio growth beyond our base-case expectations. In our view, a reduction in leverage is required if the rating is to remain at its current level, not least because the current position is the second-highest in our covered universe.

Upside scenario

We currently regard a positive rating action as unlikely. However, material growth in operating cash flow to support the replenishment and growth of the business' investment portfolio, while maintaining coverage of management's progressive dividend policy, could support the rating in the medium term.

Ratings Score Snapshot

Issuer Credit Rating: BB-/Stable/--

Business risk: Fair

- Country risk: Low
- Industry risk: Moderately high
- Competitive position: Fair

Financial risk: Significant

- Cash flow/Leverage: Significant

Anchor: bb

Modifiers

- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Liquidity: Adequate (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Fair (no impact)
- Comparable rating analysis: Negative (-1)

Stand-alone credit profile: bb-

Issue Ratings--Recovery Analysis

Key analytical factors

- The issue rating on Arrow's senior secured notes is 'BB', one notch above the issuer credit rating. The recovery rating of '2' is supported by the company's asset base, its growing third-party debt servicing capabilities, and our view of the U.K. as a relatively favorable jurisdiction for senior secured creditors.
- There is little headroom in the recovery rating and a similar asset-backed transaction, underperformance in the AMS business, or an expansion of priority or senior secured claims in the waterfall, would cause us to lower the issue credit and recovery ratings for the senior secured bonds, all else remaining equal.
- Our simulated default scenario contemplates a default in 2023, reflecting a significant decline in cash flow as a result of adverse operational issues; lost clients; difficult collection conditions; or greater competitive pressures, leading to mispricing of portfolio purchases.
- We calculate a combined enterprise value, taking into consideration the different business segments and assuming that Arrow's portfolio of debt receivables would find a potential acquirer. We apply a haircut of 25% to the book value of the debt portfolios. In calculating the assets available to the group's enterprise value, we deduct the assets pledged to the asset-based facility from our estimate of the net portfolio. We assume this is 100% drawn at the point of default.
- In addition, we assume earnings from its third-party servicing businesses will decline and apply a valuation using a 4.0x EBITDA multiple. We assess it on a going-concern basis, given its long-term contracts and established relationships with customers.

Simulated default assumptions

Year of default: 2023

Jurisdiction: U.K.

Simplified waterfall

Net enterprise value (1) on liquidation: £910 million

Priority claims (2): £245 million

Collateral value available to secured creditors: £665 million

Senior secured claims (2): £946

Recovery expectation: 2 (rounded estimate: 70%)

(1)This figure is net of a 5% administrative expense charge. (2)Includes 6 months of prepetition interest expense.

Related Criteria

- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Recovery Rating Criteria For Speculative-Grade Corporate Issuers, Dec. 7, 2016
- General Criteria: Guarantee Criteria, Oct. 21, 2016
- Criteria | Corporates | Recovery: Methodology: Jurisdiction Ranking Assessments, Jan. 20, 2016
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Financial Institutions | Finance Companies: Key Credit Factors For Financial Services Finance Companies, Dec. 9, 2014
- Criteria | Financial Institutions | General: Issue Credit Rating Methodology For Nonbank Financial Institutions And Nonbank Financial Services Companies, Dec. 9, 2014
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Related Research

- Europe's Debt Collection Companies Are Looking To Pay Down Their Own Debt In 2019, Feb. 4, 2019

Ratings List

Ratings Affirmed	
Arrow Global Group PLC	
Issuer Credit Rating	BB-/Stable/--

Ratings Affirmed

Arrow Global Finance PLC	
Senior Secured	BB
Recovery Rating	2(70%)