

WHITE PAPER

Debt sale: a viable option for dealing with non-performing assets in the utility sector

Utility companies in the UK have traditionally relied on internal processes and contingent agents to collect outstanding payments from customers who have accounts in arrears. Tax and regulatory changes have however, created a new option for utility firms that many of the leading financial services organisations have been utilising for the last five years. The new tool available for utility companies is asset sale which, in its simplest form, can enable a company to sell accounts where all traditional methods have failed to yield a result. More complex strategies, where organisations sell strategically at a range of points in the arrears process for different types of debt with an overall objective of maximising long term value, could also be used.

Debt sale in the utilities space takes exactly the same form as in the financial services industry with specialist purchasers making an upfront cash payment for the defaulted accounts. The price paid is typically heavily discounted from the face value of the assets and reflects the purchasers' views around future potential liquidation. The debt sale process for utilities debt is almost exactly the same as for financial services debt which means that the utilities sector should be able to benefit from the more advanced approaches developed over recent years in the financial services space. The key drivers of a successful debt sale are:

- Quality account level data – cleansed, verified and enhanced appropriately;
- Market based segmentation of debt to match potential purchasers with their specialist areas;
- A dynamic panel of interested purchasers;
- An understanding of the overall market to determine optimum sale timing;
- A clearly defined sale process including price maximising bidding process;
- A generic purchaser contract that can be a platform for a full agreement that fits the needs of both the creditor and purchaser.

The key point with all of these activities is that purchasers typically discount prices for uncertainty around what they are buying. The majority of the activities above are designed to improve purchaser confidence and this is always reflected in the eventual price.

The change in VAT regulations now means that any reclaimed VAT on written off accounts is not repayable on transfer of the assets to a third party. In the past, the standard VAT rate would have been charged on the full face value of the assets on transfer of ownership, meaning that any sale price below the VAT rate would generate a P&L loss. This has now changed and has allowed debt sale to become a viable option for dealing with non-performing assets. This is only applicable for organisations who account for VAT on an invoice basis.

The financial services sector has benefited greatly through the process of debt sale, largely because of the structural differences that exist between sellers and buyers that create prices at which both can realise value from these assets.

Typically purchasers take a longer term view of their assets and consequently assign a higher overall value to the accounts. This is usually because sellers rely on small number of short term contingent placements of around six months after which they assign limited value to the assets. By contrast, purchasers will look at liquidation across a much longer period, usually between five and seven years.

For the sellers, in addition to bringing forward cash flows, sale also removes any uncertainty around future liquidation as this risk is now borne by the purchaser. In addition, the sale of non-performing assets also allows the seller to remove operational capability in the recoveries space and refocus on core capabilities. This is a key benefit around debt sale for most utilities organisations, as managing accounts in arrears does not usually constitute a core activity.

Sellers typically have two structural approaches to debt sale; they can rely on a number of spot sales that meet their requirements at specific points in time, or they can sign up to a forward flow arrangement that effectively ties a creditor into selling a proportion of defaulted accounts each month at a fixed price. Both options have their advantages and disadvantages with the key trade off being around flexibility and certainty of future revenue streams.

One of the key barriers to the wider use of debt sale amongst utilities has been the perceived reputational risk that exists around selling the ownership of debt to a third party. Whilst this is a justifiable concern, the modern approach to collection taken by purchasers and the rise of organisations such as the Debt Buyers and Sellers Group (DBSG) and the Credit Services Authority (CSA) has mitigated these concerns amongst many current sellers. With the vast majority of the leading financial services organisations now utilising debt sale, the industry has become increasingly focused on its reputation and so many of the original concerns have been mitigated.

The next year is likely to be characterised by utilities organisations analysing their recoveries portfolios and looking to sell those older debts to which they assign little or no value. As the warehouse debt is cleared, it is anticipated that each organisation will begin to look at selling fresher debt and will become increasingly focused on the disposal of a flow of debt at a particular point in the recoveries cycle. As the market develops further in the utilities sector, sellers will eventually move to a strategic approach to sale where a decision to sell specific segments of debt is based around maximising long term value and shaping the balance sheet.

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March 2008**

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