ENCORE CAPITAL GROUP INC
Form 10-Q
November 09, 2016
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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, 2016
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 and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post 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" and "smaller reporting company" in Rule 12b-2 of the Exchange Act. (Check one):
Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨ Smaller reporting company ¨
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 November 3, 2016
Common Stock, $0.01 par value	25,532,227 shares

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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, 2016	December 31, 2015
Assets		
Cash and cash equivalents	$ 157,672	$ 123,993
Investment in receivable portfolios, net	2,397,831	2,440,669
Property and equipment, net	66,703	72,546
Deferred court costs, net	57,089	75,239
Other assets	206,403	148,762
Goodwill	819,785	924,847
Assets associated with discontinued operations	—	388,763
Total assets	$ 3,705,483	$ 4,174,819
Liabilities and equity		
Liabilities:		
Accounts payable and accrued liabilities	$ 217,242	$ 290,608
Debt	2,848,443	2,944,063
Other liabilities	27,718	59,226
Liabilities associated with discontinued operations	—	232,434
Total liabilities	3,093,403	3,526,331
Commitments and contingencies		
Redeemable noncontrolling interest	33,755	38,624
Redeemable equity component of convertible senior notes	3,798	6,126
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, 25,532 shares and 25,288 shares issued and outstanding as of September 30, 2016 and December 31, 2015, respectively	255	253
Additional paid-in capital	83,521	110,533
Accumulated earnings	597,247	543,489
Accumulated other comprehensive loss	(103,320)	(57,822)
Total Encore Capital Group, Inc. stockholders' equity	577,703	596,453
Noncontrolling interest	(3,176)	7,285
Total equity	574,527	603,738
Total liabilities, redeemable equity and equity	$ 3,705,483	$ 4,174,819

The following table includes assets that can only be used to settle the liabilities of the Company's consolidated variable interest entities ("VIEs") and the creditors of the VIEs have no recourse to the Company. These assets and liabilities are included in the consolidated statements of financial condition above. See Note 11, "Variable Interest Entity" for additional information on the Company's VIE.

	September 30, 2016	December 31, 2015
Assets		
Cash and cash equivalents	$ 55,158	$ 50,483
Investment in receivable portfolios, net	1,038,119	1,197,513

Property and equipment, net	16,859	19,767
Deferred court costs, net	20,836	33,296
Other assets	58,146	31,679
Goodwill	616,859	706,812
Assets associated with discontinued operations	—	92,985
Liabilities		
Accounts payable and accrued liabilities	$ 89,056	$ 142,375
Debt	1,591,403	1,665,009
Other liabilities	770	839
Liabilities associated with discontinued operations	—	58,923

See accompanying notes to condensed consolidated financial statements

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,	
	2016	2015	2016	2015
Revenues				
Revenue from receivable portfolios, net	$159,534	$265,523	$697,080	$799,934
Other revenues	19,881	13,391	60,794	39,424
Total revenues	179,415	278,914	757,874	839,358
Operating expenses				
Salaries and employee benefits	67,783	62,995	212,924	194,116
Cost of legal collections	56,932	58,760	158,047	170,834
Other operating expenses	24,131	22,217	75,420	68,278
Collection agency commissions	8,848	9,381	28,242	28,532
General and administrative expenses	34,871	86,789	103,044	155,624
Depreciation and amortization	8,032	8,043	26,128	24,058
Total operating expenses	200,597	248,185	603,805	641,442
(Loss) income from operations	(21,182)	30,729	154,069	197,916
Other (expense) income				
Interest expense	(48,632)	(47,816)	(149,920)	(136,369)
Other income (expense)	4,100	(924)	14,358	1,588
Total other expense	(44,532)	(48,740)	(135,562)	(134,781)
(Loss) income before income taxes	(65,714)	(18,011)	18,507	63,135
Benefit (provision) for income taxes	13,768	6,361	(9,831)	(23,174)
(Loss) income from continuing operations	(51,946)	(11,650)	8,676	39,961
Income (loss) from discontinued operations, net of tax	—	2,286	(3,182)	5,827
Net (loss) income	(51,946)	(9,364)	5,494	45,788
Net loss (income) attributable to noncontrolling interest	50,422	(1,595)	48,264	335
Net (loss) income attributable to Encore Capital Group, Inc. stockholders	$(1,524)	$(10,959)	$53,758	$46,123
Amounts attributable to Encore Capital Group, Inc.:				
(Loss) income from continuing operations	$(1,524)	$(13,245)	$56,940	$40,296
Income (loss) from discontinued operations, net of tax	—	2,286	(3,182)	5,827
Net (loss) income	$(1,524)	$(10,959)	$53,758	$46,123
(Loss) earnings per share attributable to Encore Capital Group, Inc.:				
Basic (loss) earnings per share from:				
Continuing operations	$(0.06)	$(0.52)	$2.22	$1.56
Discontinued operations	$—	$0.09	$(0.13)	$0.23
Net basic (loss) earnings per share	$(0.06)	$(0.43)	$2.09	$1.79
Diluted (loss) earnings per share from:				
Continuing operations	$(0.06)	$(0.52)	$2.20	$1.50
Discontinued operations	$—	$0.09	$(0.12)	$0.21
Net diluted (loss) earnings per share	$(0.06)	$(0.43)	$2.08	$1.71
Weighted average shares outstanding:				
Basic	25,777	25,450	25,690	25,800

Diluted	25,777	25,450	25,885	26,912

See accompanying notes to condensed consolidated financial statements

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

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Net (loss) income	$(51,946)	$(9,364)	$5,494	$45,788
Other comprehensive income (loss), net of tax:				
Change in unrealized gains/losses on derivative instruments:				
Unrealized gain (loss) on derivative instruments	983	(615)	487	(26)
Income tax effect	(384)	242	(190)	2
Unrealized gain (loss) on derivative instruments, net of tax	599	(373)	297	(24)
Change in foreign currency translation:				
Unrealized loss on foreign currency translation	(11,456)	(13,995)	(47,221)	(26,854)
Income tax effect	73	(115)	1,426	(1,479)
Unrealized loss on foreign currency translation, net of tax	(11,383)	(14,110)	(45,795)	(28,333)
Other comprehensive loss, net of tax	(10,784)	(14,483)	(45,498)	(28,357)
Comprehensive (loss) income	(62,730)	(23,847)	(40,004)	17,431
Comprehensive loss (income) attributable to noncontrolling interest:				
Net loss (income)	50,422	(1,595)	48,264	335
Unrealized loss (gain) on foreign currency translation	115	2,308	(807)	2,960
Comprehensive loss attributable to noncontrolling interest	50,537	713	47,457	3,295
Comprehensive (loss) income attributable to Encore Capital Group, Inc. stockholders	$(12,193)	$(23,134)	$7,453	$20,726

See accompanying notes to condensed consolidated financial statements

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

	Nine Months Ended September 30,	
	2016	2015
Operating activities:		
Net income	$5,494	$45,788
Adjustments to reconcile net income to net cash provided by operating activities:		
Loss (income) from discontinued operations, net of income taxes	1,352	(5,827)
Depreciation and amortization	26,128	24,058
Non-cash interest expense, net	28,557	25,529
Stock-based compensation expense	9,502	17,259
Gain on derivative instruments, net	(10,885)	—
Deferred income taxes	(46,524)	(257)
Excess tax benefit from stock-based payment arrangements	—	(1,705)
Loss on sale of discontinued operations, net of tax	1,830	—
Provision for (reversal of) allowances on receivable portfolios, net	86,777	(3,958)
Changes in operating assets and liabilities		
Deferred court costs and other assets	7,572	(31,347)
Prepaid income tax and income taxes payable	(2,485)	(49,431)
Accounts payable, accrued liabilities and other liabilities	(24,146)	38,364
Net cash provided by operating activities from continuing operations	83,172	58,473
Net cash provided by operating activities from discontinued operations	2,096	4,908
Net cash provided by operating activities	85,268	63,381
Investing activities:		
Cash paid for acquisitions, net of cash acquired	(675)	(236,214)
Proceeds from divestiture of business, net of cash divested	106,041	—
Purchases of receivable portfolios, net of put-backs	(712,706)	(549,957)
Collections applied to investment in receivable portfolios, net	507,552	488,174
Purchases of property and equipment	(16,548)	(15,754)
Proceeds from derivative instruments, net	10,038	—
Net cash used in investing activities from continuing operations	(106,298)	(313,751)
Net cash provided by (used in) used in investing activities from discontinued operations	14,685	(41,154)
Net cash used in investing activities	(91,613)	(354,905)
Financing activities:		
Payment of loan costs	(3,750)	(7,316)
Proceeds from credit facilities	455,786	911,588
Repayment of credit facilities	(443,968)	(471,610)
Repayment of senior secured notes	(14,343)	(11,250)
Repayment of securitized notes	(935)	(32,324)
Repurchase of common stock	—	(33,185)
Taxes paid related to net share settlement of equity awards	(4,113)	(6,050)
Excess tax benefit from stock-based payment arrangements	—	1,705
Proceeds from other debt	35,080	—
Other, net	(10,070)	(5,703)
Net cash provided by financing activities	13,687	345,855
Net increase in cash and cash equivalents	7,342	54,331
Effect of exchange rate changes on cash and cash equivalents	(3,263)	(3,274)

Cash and cash equivalents, beginning of period	153,593	124,163
Cash and cash equivalents, end of period	157,672	175,220
Cash and cash equivalents of discontinued operations, end of period	—	31,825
Cash and cash equivalents of continuing operations, end of period	$ 157,672	$ 143,395

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 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.

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, 2015. 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 VIEs, 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 11, "Variable Interest Entity," 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. Transaction gains and losses are included in other income or expense.

Reclassifications

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

Recent Accounting Pronouncements

In August 2016, the Financial Accounting Standards Board (the "FASB") issued Accounting Standards Update ("ASU") 2016-15, Statement of Cash Flows (Topic 230): Classification of Certain Cash Receipts and Cash Payments ("ASU 2016-15"). The FASB issued ASU 2016-15 to decrease the diversity in practice in how certain cash receipts and cash payments are presented and classified in the statement of cash flows. The amendments in this update provide guidance on eight specific cash

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flow issues. ASU 2016-15 is effective for reporting periods beginning after December 15, 2017, with early adoption permitted, provided that all of the amendments are adopted in the same period. The guidance requires application using a retrospective transition method. The Company is currently assessing the impact that adopting this guidance will have 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. Most importantly, the standard eliminates the current accounting model for loans and debt securities acquired with deteriorated credit quality, 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, 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. 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 Company is currently assessing the impact that adopting this guidance will have on its consolidated financial statements.

In March 2016, the FASB issued ASU No. 2016-09, “Compensation - Stock Compensation (Topic 718): Improvements to Employee Share-Based Payment Accounting” (“ASU 2016-09”). ASU 2016-09 simplifies several aspects of the accounting for share-based payment transactions, including the income tax consequences, classification of awards as either equity or liabilities, and classification on the statement of cash flows. For public entities, ASU 2016-09 is effective for fiscal years beginning after December 15, 2016, and interim periods within those fiscal years. Early adoption is permitted. The Company is currently assessing the impact that adopting this guidance will have on its consolidated financial statements.

In March 2016, the FASB issued ASU 2016-05, Derivatives and Hedging (Topic 815): Effect of Derivative Contract Novations on Existing Hedge Accounting Relationships (“ASU 2016-05”) and ASU 2016-06, Derivatives and Hedging (Topic 815): Contingent Put and Call Options in Debt Instruments (“ASU 2016-06”). ASU 2016-05 clarifies that a change in the counterparty to a derivative instrument that has been designated as a hedging instrument does not, in and of itself, require dedesignation of that hedging relationship provided that all other hedge accounting criteria continue to be met. ASU 2016-06 clarifies the steps required to determine bifurcation of an embedded derivative. ASU 2016-05 and ASU 2016-06 are effective for fiscal years beginning after December 15, 2016, and interim periods within those years. Early adoption is permitted. The Company is currently assessing the impact that adopting this guidance will have on its consolidated financial statements.

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 all 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. ASU 2016-02 is effective for the Company in its first quarter of fiscal 2019 on a modified retrospective basis and earlier adoption is permitted. The Company is currently assessing the impact that adopting this guidance will have on its consolidated financial statements.

Change in Accounting Principle

In April 2015, the FASB issued ASU No. 2015-03, Interest—Imputation of Interest (Subtopic 835-30): Simplifying the Presentation of Debt Issuance Cost (“ASU 2015-03”). ASU 2015-03 requires that debt issuance costs related to a recognized debt liability be presented in the balance sheet as a direct deduction from the carrying amount of that debt liability, consistent with debt discounts. ASU 2015-03 was effective beginning January 1, 2016, with early adoption permitted. The update requires retrospective application and represents a change in accounting principle. The Company adopted ASU 2015-03 in the first quarter of 2016 and the retrospective application of this change in accounting principle on the consolidated balance sheet as of December 31, 2015 reclassified debt issuance costs of $41.7 million, which were previously presented as other assets, as a reduction to the carrying value of the debt by the same amount. The adoption did not have an impact on the Company's condensed consolidated statements of operations or statements of cash flows in any period.

Note 2: Discontinued Operations

On March 31, 2016, the Company completed its previously announced divestiture of its membership interests in Propel Acquisition LLC ("Propel") pursuant to the Securities Purchase Agreement (the "Purchase Agreement"), dated February 19,

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2016, among the Company and certain funds affiliated with Prophet Capital Asset Management LP. Pursuant to the Purchase Agreement, the application of the purchase price formula resulted in cash consideration paid to the Company at closing of $144.4 million (net proceeds were $106.0 million after divestiture of $38.4 million in cash), subject to customary post-closing adjustments.

During the three months ended March 31, 2016, the Company recognized a loss of $3.0 million related to the sale of Propel. Propel represented the Company's entire tax lien business reportable segment. Propel's operations are presented as discontinued operations in the Company's condensed consolidated statements of operations. Certain immaterial costs that may be eliminated as a result of the sale remained in continuing operations.

The following table presents the results of the discontinued operations during the periods presented (in thousands):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2016	2015	2016	2015
Revenue	$—	$8,882	$4,950	$24,457
Salaries and employee benefits	—	(1,981)	(2,860)	(6,153)
Other operating expenses	—	(1,736)	(1,473)	(3,924)
General and administrative expenses	—	(1,213)	(1,551)	(4,156)
Depreciation and amortization	—	(192)	(127)	(611)
Income (loss) from discontinued operations, before income taxes	—	3,760	(1,061)	9,613
Loss on sale of discontinued operations, before income taxes	—	—	(3,000)	—
Total income (loss) on discontinued operations, before income taxes	—	3,760	(4,061)	9,613
Income tax (provision) benefit	—	(1,474)	879	(3,786)
Total income (loss) from discontinued operations, net of tax	$—	$2,286	$(3,182)	$5,827

Note 3: Earnings (Loss) 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 on the basis of 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. In computing the diluted net loss per share for the three months ended September 30, 2016 and 2015, dilutive potential common shares are excluded from the diluted loss per share calculation because of their anti-dilutive effect.

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,	
	2016	2015	2016	2015
Weighted average common shares outstanding—basic	25,777	25,450	25,690	25,800
Dilutive effect of stock-based awards	—	—	195	265
Dilutive effect of convertible senior notes	—	—	—	847
Weighted average common shares outstanding—diluted	25,777	25,450	25,885	26,912

Anti-dilutive employee stock options outstanding were zero or negligible during the periods presented above.

Note 4: Business Combinations

dlc Acquisition

On June 1, 2015, Encore's U.K.-based subsidiary Cabot Credit Management Limited and its subsidiaries (collectively, "Cabot") acquired Hillesden Securities Ltd and its subsidiaries ("dlc"), a U.K.-based acquirer and collector of non-performing unsecured consumer debt for approximately £180.6 million (approximately $274.7 million), (the "dlc

Acquisition”).

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The dlc Acquisition was accounted for using the acquisition method of accounting and, accordingly, the tangible and intangible assets acquired and liabilities assumed were recorded at their estimated fair values as of the date of the acquisition. Fair value measurements have been applied based on assumptions that market participants would use in the pricing of the respective assets and liabilities.

The components of the purchase price allocation for the dlc Acquisition were as follows (in thousands):

Purchase price:	
Cash paid at acquisition	$268,391
Deferred consideration	6,306
Total purchase price	$274,697
Allocation of purchase price:	
Cash	$30,518
Investment in receivable portfolios	215,988
Deferred court costs	760
Property and equipment	1,327
Other assets	2,384
Liabilities assumed	(46,435)
Identifiable intangible assets	3,669
Goodwill	66,486
Total net assets acquired	$274,697

The goodwill recognized is primarily attributable to synergies that are expected to be achieved by combining dlc and Cabot's existing contingent collections operations. The entire goodwill of $66.5 million related to the dlc Acquisition is not deductible for income tax purposes.

Other Acquisitions

In addition to the dlc Acquisition discussed above, the Company, through its subsidiaries, completed certain other acquisitions in 2016 and 2015. These acquisitions were immaterial to the Company’s financial statements individually and in the aggregate.

Refer to Note 2, “Business Combinations” as disclosed in the Company’s Annual Report on Form 10-K for the year ended December 31, 2015, for a complete description of the Company’s acquisition activities in 2015.

Note 5: 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:

- 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.

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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, 2016			
	Level 1	Level 2	Level 3	Total
Assets				
Foreign currency exchange contracts	$—	$1,466	$ —	$1,466
Liabilities				
Foreign currency exchange contracts	—	(72)	—	(72)
Interest rate swap agreements	—	(199)	—	(199)
Temporary Equity				
Redeemable noncontrolling interests	—	—	(33,755)	(33,755)

	Fair Value Measurements as of December 31, 2015			
	Level 1	Level 2	Level 3	Total
Assets				
Foreign currency exchange contracts	$—	$718	$ —	$718
Liabilities				
Foreign currency exchange contracts	—	(601)	—	(601)
Interest rate swap agreements	—	(352)	—	(352)
Temporary Equity				
Redeemable noncontrolling interests	—	—	(38,624)	(38,624)

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.

Redeemable Noncontrolling Interests:

Some minority shareholders in certain subsidiaries of the Company have the right, at certain times, to require the Company to acquire their ownership interest in those entities at fair value and, in some cases, to force a sale of the subsidiary if the Company chooses not to purchase their interests at fair value. The noncontrolling interests subject to these arrangements are included in temporary equity as redeemable noncontrolling interests, and are adjusted to their estimated redemption amounts each reporting period with a corresponding adjustment to additional paid-in capital. Future reductions in the carrying amounts are subject to a “floor” amount that is equal to the fair value of the redeemable noncontrolling interests at the time they were originally recorded. The recorded value of the redeemable noncontrolling interests cannot go below the floor level. These adjustments do not affect the calculation of earnings per share.

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The components of the change in the redeemable noncontrolling interests for the periods ended September 30, 2016 and December 31, 2015 are presented in the following table (in thousands):

	Amount
Balance at December 31, 2014	$28,885
Addition to redeemable noncontrolling interest	9,409
Net income attributable to redeemable noncontrolling interests	1,371
Adjustment of the redeemable noncontrolling interests to fair value	2,349
Effect of foreign currency translation attributable to redeemable noncontrolling interests	(3,390)
Balance at December 31, 2015	38,624
Addition to redeemable noncontrolling interest	498
Net loss attributable to redeemable noncontrolling interests	(37,029)
Adjustment of the redeemable noncontrolling interests to fair value	32,470
Effect of foreign currency translation attributable to redeemable noncontrolling interests	(808)
Balance at September 30, 2016	$33,755

Financial Instruments Not Required To Be Carried At Fair Value

Investment in Receivable Portfolios:

The Company records its investment in receivable portfolios at cost, which represents a significant discount from the contractual receivable balances due. The Company computes the fair value of its investment in receivable portfolios using Level 3 inputs by discounting the estimated future cash flows generated by its proprietary forecasting models. The key inputs include the estimated future gross cash flow, average cost to collect, and discount rate. In accordance with authoritative guidance related to fair value measurements, the Company estimates the average cost to collect and discount rates based on its estimate of what a market participant might use in valuing these portfolios. The determination of such inputs requires significant judgment, including assessing the assumed market participant’s cost structure, its determination of whether to include fixed costs in its valuation, its collection strategies, and determining the appropriate weighted average cost of capital. The Company evaluates the use of these key inputs on an ongoing basis and refines the data as it continues to obtain better information from market participants in the debt recovery and purchasing business.

In the Company’s current analysis, the estimated blended market participant cost to collect and discount rate is approximately 50.3% and 10.5%, respectively, for U.S. portfolios, approximately 29.9% and 11.9%, respectively, for Europe portfolios and approximately 32.9% and 11.0%, respectively for other geographies. Using this method, the fair value of investment in receivable portfolios was approximately $2,165.0 million and $2,473.8 million as of September 30, 2016 and December 31, 2015, respectively, as compared to the carrying value of $2,397.83 million and $2,440.67 million as of September 30, 2016 and December 31, 2015, respectively. A 100 basis point fluctuation in the cost to collect and discount rate used would result in an increase or decrease in the fair value of U.S. and European portfolios by approximately $44.3 million and $58.6 million, respectively, as of September 30, 2016. This fair value calculation does not represent, and should not be construed to represent, the underlying value of the Company or the amount that could be realized if its investment in receivable portfolios were sold.

Deferred Court Costs:

The Company capitalizes deferred court costs and provides a reserve for those costs that it believes will ultimately be uncollectible. The carrying value of net deferred court costs approximates fair value.

Debt:

The majority of Encore and its subsidiaries’ borrowings are carried at historical amounts, adjusted for additional borrowings less principal repayments, which approximate fair value. These borrowings include Encore’s senior secured notes and borrowings under its revolving credit and term loan facilities, Cabot’s senior secured notes and borrowings under its revolving credit facility, and other borrowing under revolving credit facilities at certain of the Company’s subsidiaries.

Encore’s convertible senior notes are carried at historical cost, adjusted for the debt discount. The carrying value of the convertible senior notes was $414.0 million and $406.6 million as of September 30, 2016 and December 31, 2015, respectively. The fair value estimate for these convertible senior notes, which incorporates quoted market prices using

Level 2 inputs, was approximately $382.8 million and $372.2 million as of September 30, 2016 and December 31, 2015, respectively.

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Cabot's senior secured notes are carried at historical cost, adjusted for debt discount and debt premium. The carrying value of Cabot's senior secured notes was $1.3 billion and $1.4 billion, as of September 30, 2016 and December 31, 2015, respectively. The fair value estimate for these senior notes, which incorporates quoted market prices using Level 2 inputs, was $1.3 billion and $1.4 billion as of September 30, 2016 and December 31, 2015, respectively.

The Company's preferred equity certificates are legal obligations to the noncontrolling shareholders of certain subsidiaries. They are carried at the face amount, plus any accrued interest. The Company determined that the carrying value of these preferred equity certificates approximated fair value as of September 30, 2016 and December 31, 2015.

Note 6: Derivatives and Hedging Instruments

The Company may periodically enter into derivative financial instruments to manage risks related to interest rates and foreign currency. Certain of the Company's derivative financial instruments qualify for hedge accounting treatment under the authoritative guidance for derivatives and hedging.

The following table summarizes the fair value of derivative instruments as recorded in the Company's condensed consolidated statements of financial condition (in thousands):

	September 30, 2016		December 31, 2015	
	Balance Sheet Location	Fair Value	Balance Sheet Location	Fair Value
Derivatives designated as hedging instruments:				
Foreign currency exchange contracts	Other assets	$ 676	Other assets	$ 718
Foreign currency exchange contracts	Other liabilities	(72)	Other liabilities	(601)
Derivatives not designated as hedging instruments:				
Foreign currency exchange contracts	Other assets	790	Other assets	—
Interest rate swap agreements	Other liabilities	(199)	Other liabilities	(352)

The Company has operations in foreign countries, which expose the Company to foreign currency exchange rate fluctuations due to transactions denominated in foreign currencies. To mitigate a portion of this risk, the Company enters into derivative financial instruments, principally foreign currency forward contracts with financial counterparties. The Company adjusts the level and use of derivatives as soon as practicable after learning that an exposure has changed and reviews all exposures and derivative positions on an ongoing basis.

Derivatives Designated as Hedging Instruments

Certain of the foreign currency forward contracts are designated as cash flow hedging instruments and qualify for hedge accounting treatment. Gains and losses arising from the effective portion of such contracts are recorded as a component of accumulated other comprehensive income ("OCI") as gains and losses on derivative instruments, net of income taxes. The hedging gains and losses in OCI are subsequently reclassified into earnings in the same period in which the underlying transactions affect the Company's earnings. If all or a portion of the forecasted transaction is cancelled, this would render all or a portion of the cash flow hedge ineffective and the Company would reclassify the ineffective portion of the hedge into earnings. The Company generally does not experience ineffectiveness of the hedge relationship and the accompanying consolidated financial statements do not include any such gains or losses.

As of September 30, 2016, the total notional amount of the forward contracts that are designated as cash flow hedging instruments was $33.6 million. All of these outstanding contracts qualified for hedge accounting treatment. The Company estimates that approximately $0.2 million of net derivative gain included in OCI will be reclassified into earnings within the next 12 months. No gains or losses were reclassified from OCI into earnings as a result of forecasted transactions that failed to occur during the nine months ended September 30, 2016 and 2015.

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The following table summarizes the effects of derivatives in cash flow hedging relationships designated as hedging instruments on the Company's condensed consolidated statements of operations for the three and nine months ended September 30, 2016 and 2015 (in thousands):

Derivatives Designated as Hedging Instruments	Gain or (Loss) Recognized in OCI-Effective Portion	Location of Gain or (Loss) Reclassified from OCI into Income - Effective Portion	Gain or (Loss) Reclassified from OCI into Income - Effective Portion