

# ClearDebt

July 2006

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**Sector: Financial services**

## Key points

- Fast-growing market
- Demand exceeds supply, so attractive returns available
- Innovative approach, leading to high-quality, lower-cost
- Resulting in exceptional rate of growth
- Potential to dominate the market for smaller IVAs

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# ClearDebt



## ClearDebt

### CLEA

<b>Date:</b>	<b>17.7.06</b>
<b>Share price p</b>	<b>2.125</b>
52 week High/Low p	5/2.125
<b>Issued share cap</b>	<b>257.1m</b>
Market cap £m	5.5

<b>Index/sector statistics</b>	<b>Index</b>	<b>PER</b>	<b>Yield</b>
AIM	1069.3	>80	0.58%
General Financial	5934.64	13.13	2.42%

NB all share prices and index levels taken as of market close 14th July

#### Next event

Prelims September 2006

ClearDebt offers debt resolution services to insolvent individuals, using a state-of-the-art web-based system for initial contact and individual supervision of all the later stages in the process, resulting in a higher success rate and lower overall costs than its competitors.

**ClearDebt is a small, fast-growing company operating in a specialist niche of the financial services sector that is itself growing at a frightening pace. From a start-up in 2005, we expect ClearDebt's turnover to exceed £0.5m per month before the end of 2007.**

The debt relief sector is a new sub-category of financial services, a consequence of social change and New Labour's economic policies. It is growing at a phenomenal rate: the number of insolvencies handled by the half-dozen quoted companies in the sector is widely expected to double in 2006 compared to 2005.

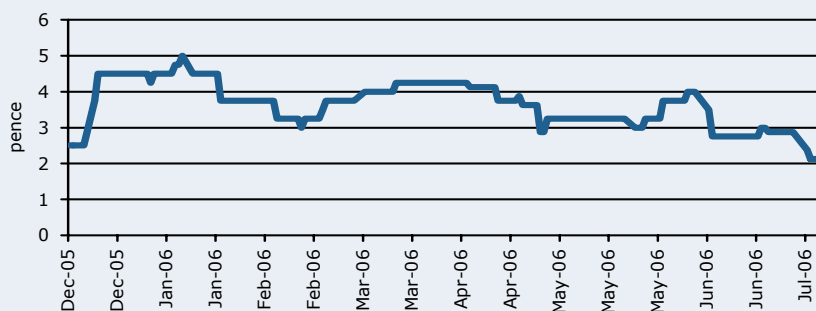
We expect growth to continue strongly in 2007 and 2008, with over-indebted homeowners forming a growing minority of those insolvent. As demand currently overwhelms capacity (and will do so for the immediate future), there is ample scope for profitable growth by all of the quoted companies: in fact this writer is far from happy at the profits that certain other companies extract from desperate debtors and hapless creditors.

ClearDebt has set itself up to be the most efficient and lowest-cost operator in the sector. It expects to win a significant market share, and can also handle Individual Voluntary Arrangement ("IVA") cases that are too small to meet the criteria of its largest competitors.

We think that recent claims by Accuma and Debt Free Direct ("DFD") that they make profits of 80% (or more) of turnover on supervisory fees, which equates to a profit margin of 400% on costs, will spur the major lenders to tighten up on the fees that they will class as acceptable, which should benefit ClearDebt as the lowest-cost operator.

We also think that, at this stage in its development, any profits forecast would be guilty of spurious precision. On the other hand, we do not see why ClearDebt should not reach at least half the *current* turnover and profit (£16.2m and £4.8m) of DFD, the present market leader, by 2007/8, despite charging less. To do so ClearDebt would only need to take 5% of the large IVA market and 20% of the small one, in which DFD and Accuma cannot compete. The latest data (see p.3) suggest this is well within its capabilities. DFD has grown to become capitalised at **£185m** after only five years, which illustrates the potential for ClearDebt.

**Figure 1: Price Performance**



ADVFN

#### Equity Development contact

**Andy Edmond**

020 7405 7777

andy@equitydevelopment.co.uk

## THE COMPANY

Earlier this year, Carrwood plc (an AIM-listed shell) acquired ClearDebt Ltd and changed its name to ClearDebt plc. ClearDebt Ltd was set up last year by Hodgsons, a firm of chartered accountants of which David Mond, the CEO of ClearDebt, is senior partner. The acquisition was accompanied by a share placing to raise £1.2m to fund the working capital required during its planned expansion.

The working capital is needed because the business model of debt resolution companies and insolvency practitioners involves doing some 90% of the work before receiving the first payment; from then on each individual case is cash-flow positive, but it takes almost a year to recoup the initial costs.

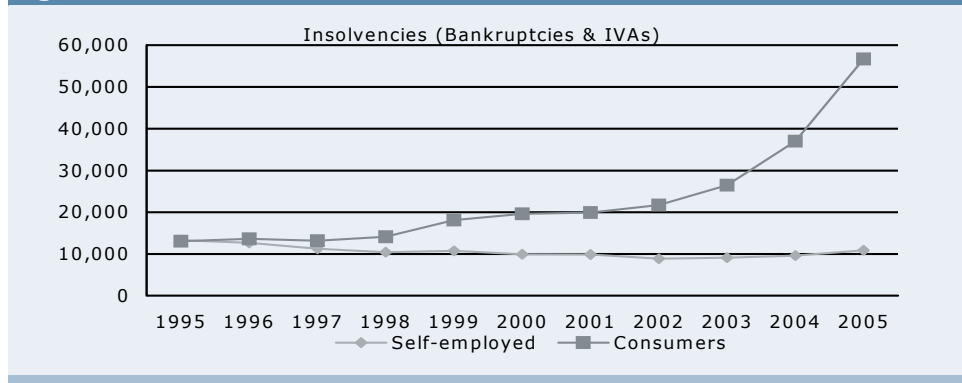
ClearDebt’s objective is to provide a high-quality, lower-cost service for individuals who find themselves unable to repay their debts in full. It does this through using sophisticated computer systems, web-based marketing and, most importantly a team inspired by a group ethos of trying to do the best job possible.

Their policy of continuously trying to improve systems and performance (now referred to as “kaizen”) means that every problem is met, not just by a solution, but also by an attempt to prevent a similar problem happening in future. In their first seven months they had six “failures” (less than 10% of total) where either the creditors’ meeting did not approve the proposal or, even rarer, the debtor failed to keep up the monthly payments. In their second seven months they have had **no** “failures”, although a handful of clients are behind in their contributions which might lead to a couple of current failures. Their largest competitor expects a significant percentage of failures, to the extent that it includes part of it in its definition of turnover. In consequence ClearDebt are now capable of handling 15 IVA cases per month per member of staff in contrast to their largest competitors that deal with just fewer than two per month per employee.

ClearDebt has chosen to earn an honest penny (instead of making a fast buck) from helping individuals who cannot cope with their debts.

This is a category that is growing at a worrying speed – since New Labour came to power in 1997, consumer insolvencies have more than quadrupled and, since the number admitting insolvency lags the trend in those losing control of indebtedness, its growth is expected to continue. There are several forecasts that it will double again this year.

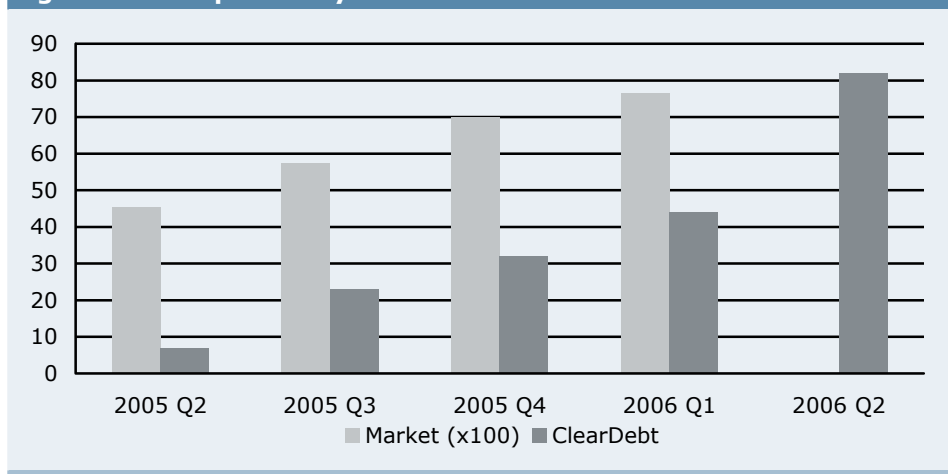
**Figure 2: Growth in insolvencies 1995-2005**



Source:DTI

ClearDebt is growing even faster than the market. It has just released data that show that the number of IVAs completed in the second quarter of 2006 was 86% higher than in the first quarter and more than 10 times that in the same quarter of 2005. Of course growth rates are highest in the early stages of development, and the market itself is expected to double this year, but even so this is a remarkable performance. The market has responded favourably to the news by raising ClearDebt's share price above the 2.125p that we show (to ensure comparability all our share price and index data is correct as at Friday's close).

**Figure 3: IVAs passed by ClearDebt and 1% of the total market**



Source: Insolvency service and ClearDebt plc

ClearDebt's market share has grown from 0.15% in the second quarter of 2005 to something close to 1% (data for the total market will be published in 4 week's time). This supports my view that ClearDebt can achieve a 5% market share within the next two years: for the market-leaders, it only becomes worth cutting prices to fend off ClearDebt's competition when it has achieved a market share of more than 20%.

Pegler's seminal paper on the Principles of Investment set guidelines for actuaries that led insurance companies and pension funds to outperform by so much that within a generation they had come to dominate UK investment. His fourth principle of investment, after seeking to maximise returns, reduce risk by diversification, and take account of future trends, was to orient investment policy to economically and socially desirable ends, since, apart from the intrinsic virtue of such a policy, one could expect the government to influence the environment to favour those actions of which it approved.

ClearDebt is not anticipating any help from government, although it has set itself up to meet or exceed the standards that a regulator might impose if one were created. So it does not expect to suffer from any further government regulation. (The company and its two Insolvency Practitioners are already regulated by their professional bodies). It does, however, expect to reap some benefit from the self-interest of the major lenders who benefit from their cheaper and more efficient service and may therefore redirect some clients to them.

## “Half a loaf” - the Debt Resolution Market

When someone is unable to repay his/her debts, even by liquidating all his/her assets, then he/she is insolvent.

There are ways out of insolvency – the most common one, for which I obviously have no numbers, is to spend less than you earn for a long enough period to pay down your debts. This should work for most newly-employed graduates, who have been accustomed to living on a lot less than their salary.

Any other solution involves the creditors, in aggregate, losing some of the money to which they are entitled.

Formerly this normally meant bankruptcy, which involved an agent for the creditors taking possession of and selling all the debtor’s assets except necessities of life and tools, and distributing the net proceeds among creditors, according to a set of rules governed by law with no regard to fairness.

Bankruptcy law is not intended to deal with individuals who deliberately set out to avoid paying their debts – these are covered by laws on theft and fraud. Originally it only covered traders, and was designed to share the misery equitably among the creditors of failed businesses if, for instance, the workshop or warehouse burned. Until the 19<sup>th</sup> century, individuals who incurred debts other than through unprofitable trading were not covered by bankruptcy laws.

An informal deed of arrangement was an agreement between an insolvent debtor and his creditors on how he should repay them all or part of what he owed, sometimes by instalments, without going through formal bankruptcy procedures. It had two main advantages: it could be done more quickly, and it avoided lawyer’s fees (which are quite capable of absorbing any assets the debtor has left by the time he is forced to admit that he is insolvent). In theory deeds of arrangement can still be made but the introduction of IVAs, which combine being legally binding with most of their advantages, has made them mostly redundant.

An IVA is not an easy option; it takes up to five years of self-discipline and a degree of sacrifice, curbing spendthrift habits and tastes for luxuries. Under new laws the bankrupt can be discharged after only one year.

The advantage of an IVA is that the debtor is not formally bankrupted, so the various disqualifications do not apply; secondly, there is no attachment of earnings so the employer does not have to be informed; thirdly, interest on the debts are frozen; fourthly, the IVA allows the debtor to retain enough of his/her income to live decently but without any luxuries, fripperies etc. Some creditors will even accept a budget that includes going out for a pint – but definitely not three or four – on a Friday night, while others will not. Also the legislation governing IVAs binds all creditors to accept the terms of the IVA if it is approved by 75% (by value) of creditors voting at a special meeting to consider it. The terms of an IVA are proposed by the debtor, while those of a bankruptcy are imposed by the court, so the IVA imposes terms that the debtor thinks are achievable. On the other hand it needs to offer the creditors more than they would get from a bankruptcy: otherwise why should they accept it?

The Scottish equivalent, the Protected Trust Deed (“PTD”) lasts three years. They have grown even faster than IVAs south of the border because a higher percentage of Scots become insolvent and the PTD terms are less onerous than those of an IVA.

IVAs are expensive, partly because each has to be supervised by a qualified Insolvency Practitioner (“IP”). IPs are relatively rare and the more-than-quadrupling of consumer insolvencies since 1997 has ensured that supply cannot

keep up with demand. So the price of an IP's time is measured in £ per minute. For instance, Begbies Traynor published a scale of charges in 2004 with the charge-out rate for a partner set at £295 per hour.

Most of ClearDebt's competitors charge more than £4,000 per case

DebtMatters is one of the lower-cost of ClearDebt's competitors and it typically charges an initial £1,750 plus a monthly charge averaging £42, which amounts to £4,270 over the five-year life of a successful IVA.

Accuma's subsidiary AIP charges half as much again £2,500 to £3,000 plus monthly fee averaging £78, say £7,500 overall. On January 25<sup>th</sup> 2006 it said that supervisory fees had an average gross profit margin of 80%; DFD said in June that its supervisory fees had a gross margin of 86%: even allowing for the inevitable preponderance of staff costs in the supervision of instalment payments, this seems more than adequate and, if I was a "worthless" HSBC analyst, I should suggest to a banking colleague that fees could be reduced.

Debt Free Direct did not publish its scale of charges in their prospectus but comments to analysts imply that their charges are slightly higher than AIP's

So, if a debtor owes less than £15,000 and is sufficiently out of his depth to recognise that he is insolvent, either company's charges would absorb more than half the funds available.

What often happens is that the unfortunate debtor is directed to a Debt Management Organisation ("DMO") until his debts are large enough to justify the expense of an IVA. DebtMatters set a threshold of £15,000, below which it considers the costs of an IVA outweigh the benefits. Debt Free Direct refer anyone with debts of less than £20,000 to the Consumer Credit Counselling Service ("CCCS") or a DMO. A significant number of ClearDebt's clients have been clients of a DMO, and are now insolvent.

There are two reasons for the high charges of an IVA – one is the scarcity and high price of IPs, the other is the marketing cost. The latter is a slightly circular argument – they only spend so much money on marketing because the fees are so high and the fees are so high because marketing is the largest part of the costs. This is where a government-sponsored or charitable organisation, with low marketing costs because it relied on recommendations rather than "hard sell" should provide an alternative.

The Official Receiver will act in the case of bankruptcies but not IVAs, and it would be difficult to fit helping with IVAs into the definitions of charitable purposes.<sup>1</sup>

### **ClearDebt intends to fill the gap.**

In the case of DMOs, both such exist: the Citizens' Advice Bureaux ("CAB") helps where local volunteers staff have the relevant expertise; CCCS is registered as a charity, allegedly funded by lending organisations – its last set of accounts filed with the Charity Commission (for 2004: those for calendar year 2005 are still awaited) showed that it was actually making so much money from the fees it charged that they covered all its expenditure and left a surplus. Donations from

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<sup>1</sup> *The Official Receiver may (at his discretion) act in the case of a Fast Track Voluntary Arrangement ("FTVA"). A FTVA is only available to those who have already been declared bankrupt; only the Official Receiver may act as Nominee and Supervisor; it only applies to simple cases, and he will reject any proposal that does not provide creditors a return significantly better than they would have received from bankruptcy. If a FTVA proposal is accepted by creditors the bankruptcy is annulled. As only simple cases are accepted the OR's fees are lower than an IP's in an IVA*

the public-spirited lenders amounted to less than 0.1% of the fees it charged. In contrast Credit Action, which only provides advice and not debt management "services", collects nothing from debtors, being funded from donations, legacies and grants; trading income from the sale of books and income from speaking engagements covers only 11% of its costs.

If a County Court is asked to make an Administration Order in respect of debts amounting to less than £5,000 it is allowed to deduct 10% of each payment by the debtor to contribute towards its costs.

CCCS, which deals with moderate-sized cases, deducts 10%, which covered all its expenses with a modest surplus in 2004 – with the growth in insolvencies since then, the surplus is presumably no longer modest. Baines & Ernst, the leading DMO, takes much more: the whole of the first monthly payment and 17.625% (up to a maximum of £90 per month) of every subsequent one.

To put CCCS in context, several DMOs charge fees that are close to double those of CCCS. Loans.co.uk, a loans broker, paid salaries in 2004/5 to its two controlling shareholders of £11.37m, over one-sixth of turnover, [at the year-end, the group's net tangible assets were just under £2m]. Debtmatters has just acquired an intermediary, Loanmakers, which collects a commission from lenders of 10% of the value of each loan it sources for them: I shudder to think what sort of margin the lenders expect. When people are desperate, they will pay almost any rate of interest, which is why we used to have laws against usury.

It is not a formal requirement of an IVA that it should provide a better return to creditors than bankruptcy, but it is a general rule of thumb, since there is no reason for the creditors to vote in favour if it does not; the creditors are not usually inclined to think that they owe the debtor any favours.

## THE IVA MARKET

There are two separate markets, one in England and Wales and another in Scotland because the laws applying to insolvent debtors differ.

ClearDebt earns almost all of its income by handling IVAs; it occasionally helps a debtor through an application for bankruptcy when that is a preferable solution, or by advising him/her to re-mortgage to replace both the original mortgage and the unsecured consumer debt with a new mortgage at better interest rates. The market for IVAs is restricted to England and Wales.

Scotland has a comparable, but necessarily smaller market for Protected Trust Deeds ("PTDs"). Nevertheless, since the terms of Protected Trust Deeds are more favourable to debtors than those of IVAs, the proportion of Scots choosing PTDs in preference to sequestration is far higher than the proportion of those based south of the border choosing IVAs instead of bankruptcy. The number of PTDs last year was less than one-third of IVAs since the population of Scotland is less than one-tenth of that of England and Wales.

The proportion of the Scottish population entering insolvency has been even higher than south of the border: the population of Scotland is only 8.4% of that of England & Wales but overall Scottish insolvencies are around one-sixth of the number in England and Wales.

**Table 1: Regional Breakdown**

	Total individual insolvencies	ENGLAND & WALES		SCOTLAND		Total UK individual insolvencies
		Bankruptcies	Individual Voluntary Arrangements	Sequestrations	Protected Trust Deeds	
1997	24441	19892	4549	2,534	532	27,507
1998	24549	19647	4902	2,701	890	28140
1999	28806	21611	7195	3,110	1,574	33,490
2000	29528	21550	7978	3,185	2,353	35,066
2001	29775	23477	6298	2,943	2,946	35,664
2002	30,587	25,292	6,295	3,193	4,011	37,791
2003	35,604	28,021	7,583	3,228	5,363	44,195
2004	46,650	35,898	10,752	3,309	5,669	55,628
2005	67,584	47,291	20,293	4,965	6,141	78,690

Source: DTI

Excluding ClearDebt, there are three quoted companies specialising in IVAs (Debt Free Direct, Accumu, and Debtmatters), whose claims to market share add up to 45% of the IVA market, and debts.co.uk which is involved in IVAs as well as debt management and consolidation loans; also Begbies Traynor, a specialist in corporate insolvencies, has a small share of the IVA market; half-a-dozen unquoted companies have small but significant shares of the market; one of these, Blair Endersby with approaching 5% of the market, is closely linked to Bains & Ernst, the leading DMO. In Scotland there is one quoted PTD specialist, Invocas that claims 14% of the PTD market.

DFD claims a 19.8% market share, but I suspect that this is overstated since it compares the number of cases where it has given advice to the debtor with the number of completed cases registered by the Insolvency Service in the same period. The gap must now be more than three weeks and is often eight to ten weeks. If the market was static this might be fair, but with market growth of 155% in a year this is not measuring market share accurately. It has easily the largest market share, more than 15%, anyhow.

**Table 2: Participants**

	Price p	Market Cap £m
Debt Free Direct	495.25	185.2
Accuma	292.5	75.3
Debtmatters	360	88.6
Invocas	190	54.3
Begbies Traynor	172	128.8
ClearDebt	2.125	5.5

Source: LSE

On a number of occasions we make comparisons with DFD – not because it is the worst, but because it plausibly holds itself out to be the *best* in the market as well as the largest, so is the most apposite comparator for a company that aims to combine efficiency with ethical standards.

The FSA reckons two million households are living on a financial knife-edge, at risk of being unable to cope if anything went wrong (we might cite as examples illness or injury, redundancy, an unplanned pregnancy, or uninsured losses).

Reports by the charity Credit Action are more worrying – 2 million workers are overdrawn immediately after their salaries are paid and some 3.5 million people are permanently overdrawn, while another 10 million rely on their overdraft to get through the month. UK credit card debt, £56bn at the end of April 2006, is twice

as much as that in all the rest of the European Union. Unsecured borrowing overall rose in April to £199bn, an average of £7,754 per household, but since many have no unsecured debt apart from the current month's credit card utilisation, the average for the 3.5m with debt worries is probably well over £20,000. The CAB dealt with over 1 million debt enquiries last year, with average debt equivalent to over 17 months' income. National Debt Line reported that 105,000 called it in the first four months of 2006, which "inundated" it so it managed only to deal with just 32,000 of them.

For the last eight years, Britons, in aggregate have been spending more than they earn resulting in a gradual build up to a vast number of individual crises.

Part of the fall in the savings ratio since 1997 can be attributed to Brown's attack on pensions, as it no longer makes sense for men with moderate earnings to save up for a pension (Adair Turner had to blatantly fudge the figures to pretend that it did), but most is due to consumer spending boosted by the offers of easy credit.

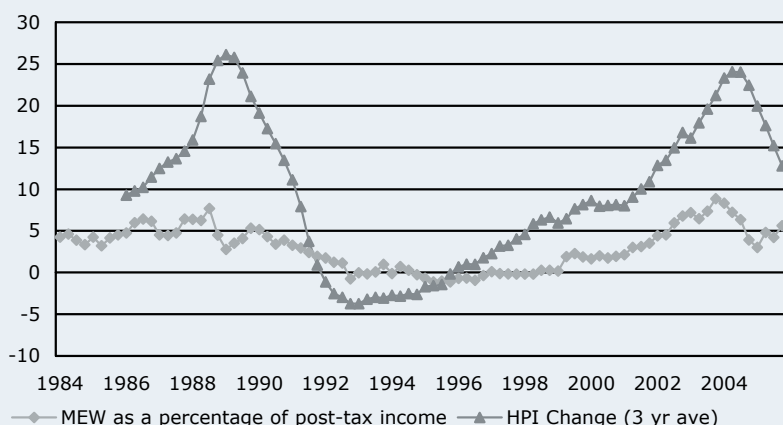
During the three months before Christmas 2005, credit card companies sent out 100 million unsolicited credit card application packs to the 40 million adults living in the UK, plus the occasional child and dog (but, apparently, no cats).

The Bank of England appears complacent about consumer debt because it is not a threat to the banking system; banks are reporting massive profits that dwarf their bad debt provisions. The banking system as a whole is collecting around £548million per month in interest on credit card balances, which is more than adequate to cover its losses from defaults. This may explain why a survey by uSwitch found that, when issuing cards, credit card issuers did not bother to check the applicant's income in 88% of cases nor, in 95% of cases, whether the cardholder could afford to repay the debt incurred.

A substantial amount of consumer expenditure/debt has been financed by Mortgage Equity Withdrawal ("MEW") either increasing the size of the mortgage by more than the house-price when moving house, or re-mortgaging houses whose market price has risen. One thinks of MEW in terms of releasing cash to pay for a new kitchen or a new car, but it appears that most of it in recent years has been to pay off debts: as interest rates on mortgages are generally much lower than on consumer finance, burdensome debts can become manageable overnight – of course they still need to be repaid eventually, but quartering the monthly interest charge leaves some cash available to do so gradually.

The actual amount of consumer debt refinanced by second mortgages is not known but Mortgages plc, owned by Merrill Lynch, has estimated that sub-prime mortgage lending was between £25bn and £30bn last year, compared to total MEW of £36bn. Some of this will so reduce the interest burden that the debtors can start to pay down their borrowings, but for those with poor credit records who have to pay 19% on debts increased by £3,000 or so by "broker's fees" and lender's fees, it merely postpones the crunch while increasing the actual level of indebtedness.

It is therefore welcome news that the FSA has identified the sub-prime mortgage market as a 'priority area' of concern.

**Figure 4: The rise in house prices and Mortgage Equity Withdrawal**


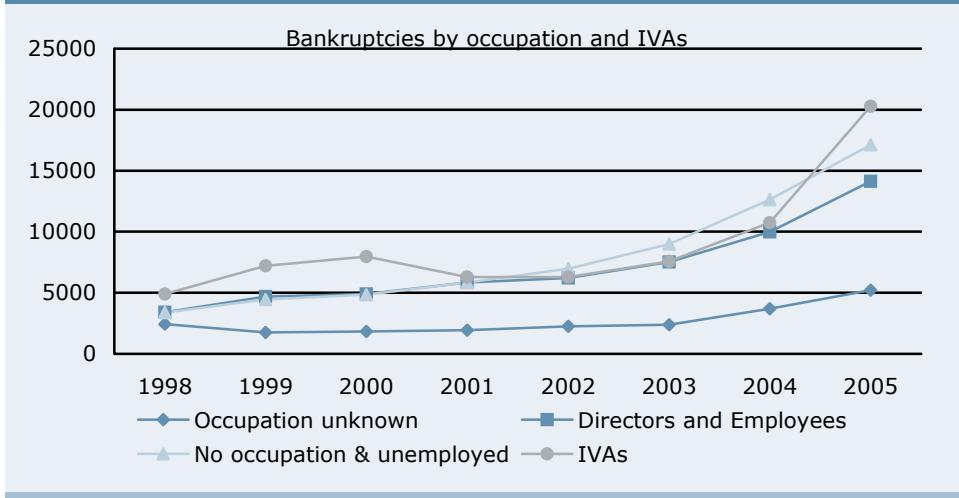
Data from the Halifax House Price Index has been used with the kind permission of HBOS plc:

As long as house prices continue to rise, most indebted homeowners can continue to stave off insolvency by drawing on the windfall “equity” in their homes. However house prices are now at historically high levels relative to average earnings that I do not believe are sustainable if real interest rates revert to their historic norm, so I do not believe that this can continue indefinitely without a descent into rampant inflation. A continuation of current economic and fiscal policies for another decade is likely to lead to a vast number of homeowners becoming insolvent, but this does not form part of my argument.

Personal insolvencies are currently concentrated among the minority that live in rented accommodation, so cannot use the re-mortgage escape route and are disproportionately among the unemployed and non-employed.

Excluding the “occupation unknown category”, those un/non-employed have gone up from 49% of bankruptcies (excluding self-employed) in 1998 to 55% in 2005. We assume they are a very small proportion of IVAs, since the latter almost invariably involve regular payments out of future income but, even if one assumes that 100% of IVAs are for employees (a moderate number are for self-employed individuals with relatively predictable incomes), the number of insolvencies for those un/non-employed are at least half as many as those for employees. This contrasts with a headline “claimant count” of less than 1 million (the ILO definition of unemployed, including those who cannot claim because they have been out of work for more than six months, gives 1.5 million, and a more realistic estimate, including those claiming disability benefit because it is more generous than unemployment benefit – over half of those disabled have no job - gives 4m) out of 47m adults, compared to 26m employees. Even using the worst, and most realistic, estimate, the unemployed are still less than 10% of the adult population.

**Figure 5: Bankruptcies by occupational category**



Source: DTI

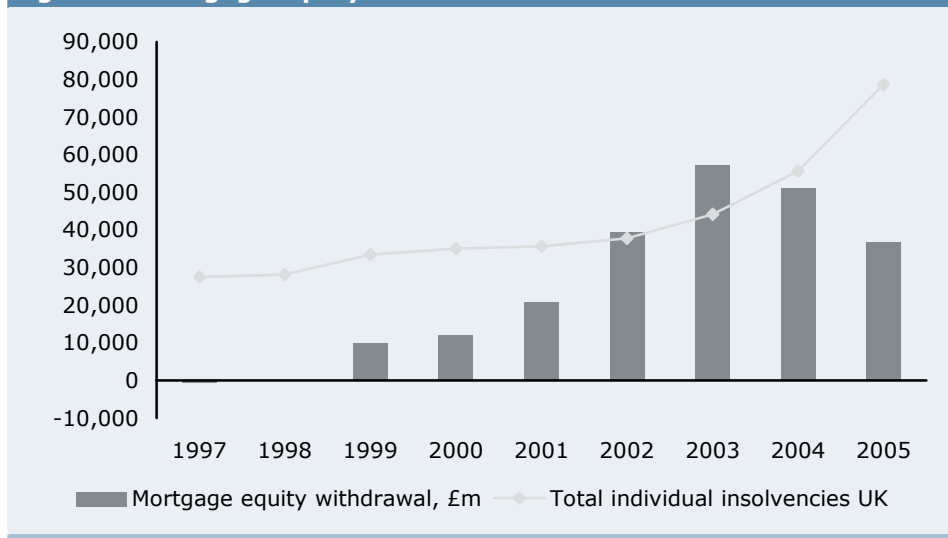
This gives credence to anecdotal evidence that a large proportion of insolvencies are due to an individual with substantial but apparently manageable debts falling sick and/or losing his/her job and being unable to meet payments out of a reduced or non-existent income.

The “feel good factor” under New Labour has been enhanced and prolonged by individuals and the country as a whole living on borrowed money. Brown’s financial policy has created record budget and trade deficits - in excess of those suffered during either World War. The reckoning always comes later so if Blair had retired after two terms, it would have become the problem of the next Chancellor.

Grant Thornton are rightly concerned that the level of unsecured personal debt has risen to £191bn. The situation is far worse than it looks as that ignores £227bn of mortgage equity withdrawal (i.e. borrowing for consumption or to pay moving expenses secured against the debtor’s home) during the seven years 1999-2005. The estimate by Mortgages plc above suggests that of £1 trillion mortgage debt, about one-fifth was to finance consumption rather than the purchase of homes. There was an earlier, significantly lesser<sup>2</sup>, bout of MEW during the 1980s house-price boom, but much of that should have been repaid by now.

In 2003, MEW reached £57,267m, some £900 for every man woman and child in the country, before declining to £51,189m in 2004 and £36,768m in 2005 as house price inflation slowed. The decline in MEW was accompanied by a sharp rise in insolvencies.

<sup>2</sup>MEW in the peak year under Lawson was 10% greater than in the peak *quarter* under Brown

**Figure 6: Mortgage Equity Withdrawal and insolvencies**

Source:HMG

## BARRIERS TO ENTRY

You need an Insolvency Practitioner to supervise, or at least to accept personal responsibility, for each case. Secondly you need a million pounds to spend on advertising.

The first restriction is more important than the latter since there is a shortage of IPs which is becoming steadily more acute as the numbers sinking into insolvency increase faster than new IPs qualify.

The second is a result of the legislation governing IVAs: each is the result of an approach by an individual debtor to his/her creditors, so the IP has to be chosen by and approached by the debtor – the only way for the debtor to know of an IP's existence (until David Beckham sponsors one) is through advertising.

While the CAB gives free advice and sometimes help; relatively few CAB clients go through an IVA because they do not have enough income to justify the cost of one.

**Table 3: Client Profile**

	CAB	CCCS	DFD calls	DFD IVAs
Average Income	£9,997	£16,500	£19,657	£20,020
Average debt	£13,153	£30,167	£27,859	£46,294

Debt Free Direct

Assuming a maximum 40% of realisations going to the debt resolution company, Accuma is only interested in debtors who can repay more than £20,000, rather than one who cannot repay £13,000; DFD's cut-off point is similar, so the level of indebtedness of its IVA clients is significantly higher than those who call DFD but are not led through to an IVA. ClearDebt's lower costs mean that it can help those with much lower levels of debt.

ClearDebt charges its fees to the IVA pot and hence Creditors are paying instead of the debtors. The money received by creditors is equal to the amount that the debtor pays less the amount paid to/retained by the debt resolution company. So,

in simple cash terms, *for a given level of fees* it makes no difference whether the debt resolution company collects a fee from the debtor and the debtor pays the rest of the money to the creditors or the debtor pays all the money to the debt resolution company and the latter then pays the creditors after deducting its fees.

The real significance is that ClearDebt claims its fee from the financially sophisticated party, which has a strong bargaining position and is able to compare its fees to those of competitors, instead of the debtor who knows that he/she is in a mess, is financially unsophisticated, usually has no means of judging the reasonability of the fee and would not feel able to reject a proposal whose main beneficiary is the DMO.

Mr Mond does not regard this as fashioning a rod for his own back: rather he believes that he is setting a standard for the sector and that eventually the banks and credit card issuers will put pressure on his more expensive rivals to conform to his standards.

Several other firms adopt the same policy for marketing purposes – there is no charge to the debtor which makes a welcome change from the loan consolidation companies which charge exorbitant fees.

ClearDebt is designed to be a low-cost high-quality operation. It is not the lowest possible cost because it is willing to pay a little extra for security and to ensure the quality of service, but it can process more than five times as many IVAs per member of staff than its rivals. It estimates that its staff can process, on average 15 cases per month whereas DFD and Accuma average fewer than 2 per employee per month. This enables it to charge lower fees to the benefit of the creditors.

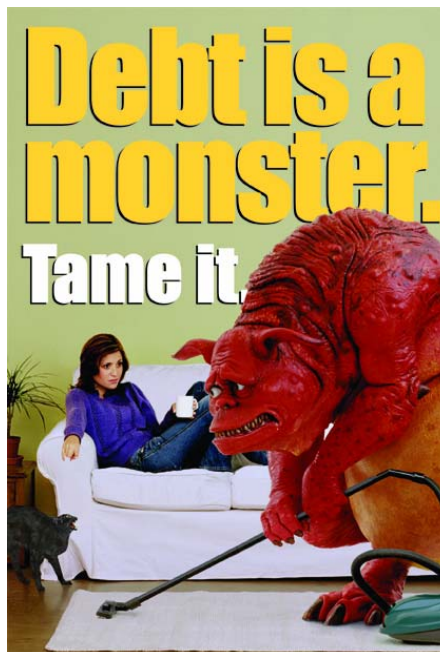
A ClearDebt case including costs is typically less than £5,000 whereas Accuma is £7,000 excluding costs; Debt Free Direct does not publish its scale of fees but the data it does publish shows that its average fees amount to around £7,500 over the five-year life of a successful IVA, so it sends debtors whose total debt is less than £20,000 to CCCS. DFD does this because it believes that it is “best advice”, which may or may not be true – there is a prima facie case for supposing that Payplan, which is supported by Boots, John Lewis, and Marks & Spencer, among others, does a better job for debtors than CCCS, which is supported by the credit card companies.

The third major competitor, Debtmatters, charges significantly lower fees than Accuma and is growing much faster. We do not think that this is a coincidence. Although the creditors have not yet started to collaborate to direct debtors to low-cost IPs, they are said to have chosen an informal limit of 40% on the proportion of the monies recovered that they are willing to give to the IPs. Debtmatters’ lower costs means that it can handle smaller cases than Accuma so it has a higher “conversion rate” – the ratio of IVAs to initial enquiries – in fact it is double that for Accuma or DFD, so I presume that there are other factors besides cost.

The culture of continuous improvement – always looking for ways to do things better or better ways of doing the same thing – is the key factor, with the web-based marketing and first-stage checking instead of telesales being the most obvious outcome. ClearDebt also uses its IPs much more efficiently by supplying them with all the relevant information on each case in a simple clear concise format, enabling them to make decisions in less than one-quarter of the time taken by IPs employed by competitors, with near-perfect precision, whereas DFD, with all the benefits it enjoys as market leader, expects one in four of the IVAs for which it gets approval to fail within the five year term.

Why is ClearDebt so much cheaper than its rivals? There are two principal reasons: it is more efficient at processing and it uses a web-based system for handling initial enquiries. Secondary reasons are lower marketing costs and that it is willing to accept less profit per case.

ClearDebt's marketing aims to be encouraging rather than judgemental. It will take a major effort for anyone to work his/her way through a five-year IVA, so negative criticism is unhelpful. Its advertising campaign is now designed around the slogan "Debt is a monster. Tame it" and features Debtby, a tamed monster (see picture). Debtby was originally tried as an experiment: following a lot of positive feedback they have adopted him as the focus of their campaign.



The continuous improvement philosophy has led ClearDebt to measure the effectiveness of different advertising media on a continuous basis. Largely as a result, it has improved the cost-effectiveness of advertising (the numbers of IVA per £ of advertising spend) six-fold. A little of this is due to the growth in the market – DFD has improved its by 56%; rather more to the cumulative effect of advertising on name-recognition; nevertheless, it is clear that the targeting of advertising where it is most effective has significantly reduced overall costs. ClearDebt reckon that its advertising spend per IVA successfully processed will ultimately be much less than half that of the market leader.

ClearDebt's online "Debt Analyser" on its website is set up to be easy to use by an enquirer: it genuinely takes only two minutes to complete; the website handles the first two stages of an enquiry automatically before any human needs to get involved.

This is a major cost-saving, although it may encourage a lot more casual enquiries from those unsure if they need help or from the merely curious. Only one in three of those completing the first stage go on to the second stage, and only one in three of those goes on to actually speaking to a member of staff.

This narrows the field down to serious enquirers. The drop-out rate at each subsequent stage is only about one in five. As the next step in its continuous improvement programme, ClearDebt plans to send a representative to visit those debtors to whom it has sent out a pack or proposal who have not replied. It has contracted with a firm employing a network of retired police officers spread around the country, who can both help the debtor complete the forms, if they have any difficulty with them, and simultaneously carry out the checks required under anti-money-laundering legislation.

ClearDebt has one further stage in its process than most of its rivals: it includes a face-to-face interview with every applicant for whom an IVA proposal has been prepared, before submitting it to creditors. To achieve this it has built up a network of over 100 IPs around the country so that it has one within a reasonable distance of every debtor. This interview tends to weed out the handful whom DFD later classify as drop-outs because they make no, or hardly any, monthly

payments after the IVA has been approved, wasting everyone's time and money, although they may appear fine on paper.

ClearDebt's superior systems include tailoring the terms of the IVA to meet the requirements of each principal creditor, so that it has not had a single IVA proposal rejected by a creditors' meeting in the last six months. In contrast, DFD told analysts that it has to re-submit 20% of its proposals.

We think that the reason why ClearDebt's conversion rate of initial enquiries to IVAs is lower than its rivals is that its "Debt Analyser" is much easier and less daunting than 'phoning telesales staff at one of its competitors, so it is used by a greater number of worried, but solvent debtors.

Conversion rate (IVAs completed as a percentage of initial enquiries):

- DFD 4.5% Accuma 4% Debtmatters 10% ClearDebt 2%
- ClearDebt as percentage of those to whom staff speaks 17%

ClearDebt has found that more enquirers can be helped by the MEW route than need IVAs, so it has come to an arrangement with John Charcol, the leading mortgage broker, that it will refer to them enquirers for whom re-mortgaging appears the best solution and that John Charcol will charge the debtors no fees (normally it would take a commission from the lender and charge a fee to the borrower).

This may help to explain the very low conversion rates for the sector as a whole: most enquirers are not actually insolvent.

This may not look special but sub-prime borrowers looking for a mortgage to refinance their unsecured credit card debt frequently face fees (which are added to the loan) of more than £2,000, sometimes more than £3,000, so initially they are even deeper in debt.

DFD has a policy of referring creditors below £20k to CCCS; ClearDebt finds a large percentage of its clients have been through a DMO and ended up deeper in debt so while it will encourage those who are not yet insolvent to manage and repay their debts, it does not refer them to a DMO or loan consolidation company.

Sub-prime secured lending is now a big and very profitable business in the UK. Rates charged for loans secured on the debtor's home are, on average, nearly three times bank base rate or the best offered to house-buyers (although if the loan is limited to 60% of valuation, so that the lender's risk is reduced from small to infinitesimal, the rate might be less than twice base rate).

The FSA has recently announced that it needs to investigate the sub-prime mortgage market, which may lead to some improvements to forestall the threat of regulation.

## ACCOUNTING POLICIES

I am happier with ClearDebt's accounting policy than those of a majority of its quoted competitors. ClearDebt recognises turnover when the proposed IVA has been accepted by the Creditors' meeting, after which there are merely formalities.

DFD recognises income when it has prepared proposals to be submitted to a Creditors' meeting and sent them to the debtor, but then applies a % discount recognising that not all proposals are approved. This is acceptable under UK GAAP if the approval rate is sufficiently uniform for past approval rates to be an adequate guide to future ones. I, on the other hand, prefer to finish a job before sending an invoice, and would prefer to recognise it as "Work-in-progress" at that stage. Accuma, until recently the next-largest, has followed DFD's example.

In fact, since DFD don't recognise work-in-progress, they probably *understate* their turnover. They are also conservative in their assumptions about conversion rates, using a 16% discount when in practice they have been achieving a 90% conversion rate.

The big difference is in recognition of profit, as work-in-progress is valued at cost, but only the cost applicable to that particular case. DFD has reduced its advertising cost per IVA from £1252 to £807 – in terms of cost per response that is from £56 to £36. So, in addition to their 30% reported profit:turnover ratio DFD added £1196/£771 to the value of each case that was approaching completion – enough to make the difference between reporting a surplus and deficit of assets when it was a young company. DFD are now comfortably solvent on any plausible accounting basis.

**Table 4: The relationship of reported profit to cash flow**

	Turnover	Reported Profit	Operating Cash Flow
Debt-free Direct 2004/5	8.422	1.543	-1.617
Debt-free Direct 2005/6	16.23	4.819	0.565
Accuma	2.85	-0.473	-1.529
Debtmatters	7.794	2.839	-1.012

Source: Company accounts

Gregory Pennington, an unquoted competitor, goes to the other extreme, by only recognising fees when received, although it does recognise commission from third parties as it is earned.

Debtmatters follows the same accounting policy as ClearDebt and charges significantly lower fees than DFD or Accuma. Personally, I quite liked what I read of Debtmatters until it purchased Loanmakers.

The difference between reported profit and cash flow is not solely a result of the accounting policy. As fees are deducted from the debtors' payments, they will in any case trickle in over a period of months.

If a debtor agrees to repay £24,000 of his debts over a period of 5 years, i.e. £400 per month, it will take 4.4 months to pay Debtmatters' initial fee or 10.6 months to pay Accuma's (in the latter case the creditors would not receive a penny until the fourteenth instalment as the accumulated monthly fees would absorb the balance of the eleventh, and the twelfth and thirteenth). In a static market, the run-down of prior year debtors would balance the growth in new

debtors but in a rapidly expanding one, the level of trade debtors will grow in line with the level of turnover over the last four or ten months.

Despite earning profits, Accuma has had to rely on external finance to fund its expansion. At end-July 2005 it had £2.04m cash, but still raised £5m (£4.75m net) in January 2006.

## HISTORY

Carrwood had been AIM-listed since 1998, at which time it was a textile company called Downtex, controlled by the Mond family. Initially it thrived but like almost all UK textile companies Downtex suffered from competition from cheaper imports, sinking into heavy losses in 2002, and had to close its manufacturing plants in 2003.

At the end of 2003, the group was in danger of itself becoming insolvent: David Mond and his brother did a MBO of Downtex's business in a rescue attempt, leaving Downtex plc, renamed Carrwood as a shell with £50,000 which they had paid for the business, whose net asset value was nil. The rescue attempt that temporarily saved a few jobs was eventually unsuccessful as the business, after a further name change, went into administration owing David Mond £0.67m, so he lost more than five times as much as all other creditors combined. His brother now runs a small part of the former Downtex that he hopes can be made viable.

By 2006 the £50,000 which the brothers had given Carrwood was nearly exhausted, so its only asset was its status as an AIM-listed company. The directors had sought for two years to make an acquisition on terms that were fair to both sides, but the flood of shell companies listing on AIM made it difficult to make an acquisition on terms that were attractive to existing shareholders. The need for ClearDebt to raise external finance to fund the second stage of its growth made it a natural fit.

From 2003 until the acquisition of ClearDebt, the group had been a cash shell, so it had no turnover and reported a modest loss of £22,353 for its last full year. ClearDebt Ltd has only published one set of annual accounts - for the 54 weeks to end-June 2005, which are only of academic interest since they include 10 months of preparation and less than three months of actual trading so total turnover amounted to £8,630, and it recorded a very modest loss of £12,997. The principal asset on the group's balance sheet is the £1.2m raised in the share placing that accompanied the group's acquisition of ClearDebt Ltd.

Naturally some investors will worry that the CEO was a director of both the acquiring and the acquired company. As he owned 100% of the equity of ClearDebt, and his family trusts owned a majority of Carrwood, whose only remaining asset, since it ran out of cash, was its status as an AIM-listed company, no-one except Mr Mond himself can have suffered if the terms were unfair.

I certify that this report represents my own opinions  
John Borgars, Senior Analyst  
020 7405 7777  
john@equitydevelopment.co.uk

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[www.equitydevelopment.co.uk](http://www.equitydevelopment.co.uk)

**Equity Development**

91 Farringdon Road

London

EC1M 3LN

**Telephone** 020 7405 7777

**Facsimile** 020 7405 7773

**Email** [mail@equitydevelopment.co.uk](mailto:mail@equitydevelopment.co.uk)