

If it's your money and you need it now – you should call J.G. Wentworth. If it's your money and you want more of it later - you should invest in JG Wentworth.

Following a confusing quarterly call, investors rushed for the exits on May 14th and sent shares down more than 25% during the day. Analysts decided to extrapolate the recent results and fixate on issues that will largely be gone over the longer term. None of these issues matter over a long enough period because JG Wentworth is the 800 pound gorilla in the structured settlements space and enjoys numerous advantages that other smaller players do not.

The opportunity exists due to short-term confusion and long-term pessimism. With a share price of \$11.30 as of June 27, 2014, the bad news is more than baked in. Over the next few quarters I expect JG Wentworth to continue doing what it does best, purchase structured settlements at rates that cannot be beat by competitors. As this happens and the pessimism potentially abates, investors will find a company that generates more than \$45 million in excess cash which compares favorably to a market capitalization of \$294 million. Based on their industry leading position and robust cash flows, I believe that the fair value for JG Wentworth is greater than \$19.00 per share without accounting for accretive acquisitions, debt repayment, or share repurchases.

Business Overview

As anyone who has watched television outside of primetime knows, JG Wentworth provides you cash when you need it, preferably NOW. Let's use a hypothetical example to explain how the business works.

John Doe is a worker in the United States of America. John gets injured on work, at no fault of his, and as a result is awarded a [structured settlement](#). His structured settlement will provide him with a reliable income for a period of time. This income is paid for by a large insurance company.

Some period of time after he is awarded the structured settlement, John needs cash. Perhaps he wants to go to school or he wants to buy a house. John will call up a group (like JG Wentworth) that can purchase his structured settlement (either all or just a portion) at a discount to face value. If John thinks it makes sense the group and John schedule a date to go to court and have a judge decide if this transaction is in the best interest of John. If the judge rules for the transaction, John receives cash and the group will collect the cash from John's settlement over time. The group's return is the discount rate applied to the cash flows less any expenses.

JG Wentworth performs these transactions thousands of times per year and is the leader in the space. Since 1995 they have purchased over \$9.6 billion of structured settlement payment streams. Their main competitors include Stone Street Capital, DRB Capital, Woodbridge, Symetra Financial and a few others. In [2011](#) JG Wentworth performed an estimated 5,000 transactions. Since then, JG Wentworth acquired Peachtree and the two names do more than 8,500 transactions per year. It is [estimated](#) that JG Wentworth and Peachtree account for 80% of the industry profits.

JG Wentworth is able to capture that much industry profit because they can securitize their purchased payment streams. This creates a distinct advantage for JG Wentworth compared to other players. When other groups purchase payment streams they need to put up cash upfront and then wait for that payment stream to pay them back creating a multi-year lag for working capital needs. By securitizing these assets JG Wentworth can get a significant portion of cash upfront.

As an illustrative example, let's look at a settlement with the following characteristics.

Table 1. Hypothetical settlement to be purchased by JG Wentworth

Original Settlement Length (Years)	25
Remaining Settlement (Years)	15
Original Settlement Value	\$100,000
Yearly Payments	\$4,000
Remaining Settlement Value	\$60,000

The remaining settlement value is referred to as Total Receivables Balance (TRB). JG Wentworth will go out and purchase the remaining payments in a court ordered transaction, securitize the future payments, and collect cash from investors. They make money by securitizing assets at lower discount rates than they originally purchased the receivables at. The spread economics are shown on the table below.

Table 2. Spread economics for JG Wentworth Source: Author's calculations, JGW financial reports

Total Receivables Balance	\$60,000	15 years, \$4,000/yr
JGW Purchases this at...	(\$28,763)	11% Discount Rate
JGW Securitizes this at...	\$42,958	4.5% Discount Rate
JGW holds a Residual Interest of...	(\$2,900)	6.75% of the Securitization
Net Proceeds to JGW	\$11,295	
Spread Over TRB	18.8%	

The net proceeds, relative to TRB, are quite attractive. While attractive, the whole mechanism depends on ample access to warehouse financing. Without this financing JG Wentworth's model begins to fall apart. This is exactly what happened in 2009 and caused their bankruptcy.

Bankruptcy

I believe part of the reason JG Wentworth is so undervalued is their tainted history. In 2009 the company filed for [bankruptcy](#) protection and emerged shortly thereafter. The [primary](#) cause for the bankruptcy was a lack of available financing in the securitization market. When your business depends on plentiful financing, and that financing dries up, you're in trouble. Leading up to the bankruptcy JG Wentworth had a single funding facility from Deutsche Bank and only a few investors that would purchase the bundled payment plans. That didn't work out well in 2009.

To avoid these issues in the future, JG Wentworth has opened up facilities with a number of other groups and adjusted the terms. If trouble pops up for JG Wentworth in the future it will not be for the same reasons that caused 2009's bankruptcy.

Once the company received more capital from their private equity sponsor, JLL Partners, the group rebuilt the brand and tried to sell the company. These attempts did not go that well so the firm launched an IPO. Given the pessimism surrounding the consumer financing market, particularly a [low-growth](#) one that JG Wentworth operates

in, it wasn't [surprising](#) that JG Wentworth had a poor IPO. Regardless, on November 14, 2014 the company was able to sell 11.21 million Class A shares for net proceeds of \$141.4 million ([pg 4](#) Sept 30, 2013 10Q).

Going Forward as a Public Company

The primary purpose of the IPO was to pay down the term loan, which had a balance of \$556 million as of September 30, 2014. The term loan was originally taken out to pay a dividend to the private equity owners. The composition of the enterprise value for the consolidated company can be found below. It is important to note that a considerable portion of debt is non-recourse to the company.

Table 2. Enterprise value calculation: Source: JGW Financials, Author's calculations

Add	(\$Millions)	Notes
Recourse Debt	\$434.93	
Class A Shares:	\$136.02	12.037M shares outstanding
Class B Shares	\$158.21	14.0M shares outstanding
Current Market Cap	\$294.23	26.03M shares combined
Subtract Cash	-\$39.06	
Enterprise Value	\$690.10	

Most investors would love to take the enterprise value and compare this to some simple calculation of profitability, such as EBITDA or standard calculated free cash flow. This will inevitably lead to frustration and confusion. I believe it is appropriate to use management guided Adjusted Net Income (ANI). Reconciliation from GAAP net income to Adjusted Net Income can be found below.

Table 4. Adjusted Net Income reconciliation Source: April 1, 2014 8-K [Exhibit 99.1](#)

In Millions	2013	2012
GAAP Net Income	\$61.82	\$116.74
Elimination of unrealized gain(loss) on receivables due to interest rates	(\$42.36)	(\$51.60)
Elimination of Interest Income from Securitized Receivables	(\$150.95)	(\$149.88)
Interest Income from Retained Interests in Finance Receivables	\$18.71	\$16.37
Servicing Income on Securitized Finance Receivables	\$5.55	\$5.95
Elimination of Interest Expense on LT Debt related to securitization	\$128.23	\$126.65
Professional Fees related to Securitizations	\$6.20	\$5.34
Share Based Compensation	\$1.45	\$2.39
Income tax/provision	\$2.55	(\$0.23)
Severance, M&A and Consulting expenses	\$5.42	\$4.36
Other Non-recurring expenses	\$10.00	\$0.30
Adjusted Net Income	\$46.61	\$76.40

Thanks to securitization and variable interest entity (VIE) accounting, an analyst has a series of hoops to jump through before they understand the true earnings power of the business. It is important to note that the above figures are simply taken from the company. Like all calculations, simply adding together numbers tells you little about the business and it is necessary to adjust accordingly. However, I believe that the numbers above present a good proxy for earnings power, but there are certainly things that will change each year depending on interest rates, refinancing of non-recourse debt, executives leaving/joining, etc.

The key driver to ANI is Total Receivables Balance (TRB), where more receivables purchased will lead to a higher ANI. The table below shows the purchases of TRB, ANI, and ANI as a percent of TRB. There were several reasons for the drop in ANI from 2012 to 2013. In the Q4 2013 conference call, management noted that 2013 interest expense increased by \$33.5 million, due to the term loan. If there was no term loan, ANI would have come in at \$80.1 million in 2013. Hypothetical scenarios aside, JG Wentworth consistently generates robust cash flows.

Table 5. TRB purchases and ANI for JG Wentworth Source: Company Financials

Year	2011	2012	2013
TRB Purchases	\$810	\$1,070	\$1,125
Adjusted Net Income	\$36.6	\$76.4	\$46.6
ANI/TRB	4.5%	7.1%	4.1%

I believe that JG Wentworth has a competitive advantage to other groups (explained in more detail later) and previous levels of TRB purchasing will continue at historical averages. In 2014, I expect ANI to be roughly the same, except for one thing; there will be less interest expense. Following the IPO, JG Wentworth used the proceeds to pay down a portion of the term loan. Going into the IPO the term loan had a balance of \$557 million and after the IPO the term loan was \$434 million, a reduction of \$123 million. The term loan carries an interest rate of 8.75% and I estimate that the prepayment will increase ANI by approximately \$9 million. All of this depends on TRB purchases remaining the same.

Like any business, there can be short term hiccups that look like structural issues. More often than not, these structural issues are simply short-term issues extrapolated into the longer term. In the Q1 2013 conference call it appeared that some analysts were very concerned about these short term issues. As one analyst said

“I guess one of the things that I struggle with right now is, it seems like the overall profitability of the industry is under pressure. Regulatory scrutiny is on the rise, as are interest rates. Overall, things look less attractive, at least from an outsider’s perspective than they did, say two or three quarters ago. Yet despite that, competition has increased.” –David Furtado, Jefferies

Mr. Furtado was hardly the only analyst to be concerned. Several other analysts questioned the company about short-term issues such as TRB purchases and increased competition. I believe the issues discussed during the conference call will prove to be simple bumps in the road. JG Wentworth has defended itself from competition before and exhibits a robust competitive advantage.

Competitive Advantage

At a basic level, it seems like anyone could start a settlement purchasing business. Theoretically a group could buy some advertising, get some capital to purchase settlements, and become familiar with the court system. In practice this is not the case. There are a few reasons for this.

First, JG Wentworth has a customer database of more than 121,960 (as of Dec 31, 2013) former, current, and prospective customers. With such a large database JG Wentworth has an incredible marketing advantage. The company also notes in their [S-1](#) "Of the total structured settlement customers we have served since 1995, the average customer has completed two separate transactions with us." While it may seem odd that a customer would do multiple transactions, it is rare that customers sell off their entire settlement in one transaction. Generally a customer will sell a portion of their settlement to pay for education, medical, or housing costs. A few years later if the customer needs money for a different purpose, who are they going to call?

The second advantage is their brand. JG Wentworth believes they have the number 1 or number 2 brands within the structured settlement space. Without fact based numbers or references, this is tough to verify. However, I encourage readers to explore various advertising channels. JG Wentworth dominates all media platforms and has a presence like no other company. An executive at a competitor said it best "we don't even bother advertising, there's no point competing with them over ad dollars, we'd rather go other routes."

The executive interviewed is probably justified in avoiding out-marketing JG Wentworth. In the Q1 2014 conference call CEO David Miller discussed the impact of price competition.

"In the past, we've seeing [sic] competitors ramp up their marketing spend only to subsequently reduce their spend as their marketing results fail to produce the anticipated volume. In the long term, we've been able to maintain our market share and profitability."

Based on publicly available [information](#) it was clear that purchasing adwords common to the structured settlement space is very expensive. Top words commanded more than \$200 per click and that doesn't even guarantee a sale! Companies that increase ad spend had better be able to convert leads to sales efficiently or any incremental profit will be taken away. This is one reason I expect JG Wentworth's advantage to grow over time.

These advantages listed above all stem from one source: JG Wentworth's lowest cost of funding. As a matter of due diligence I received quotes from several of the top structured settlement companies. Not a single group could match the rate that JG Wentworth quoted me. With a robust warehouse line and active securitization program, JG Wentworth can offer customers a better deal than other providers, if those customers shop around. This lowest cost of funding will help shield the company from increased regulatory scrutiny.

Regulatory Concerns

Like many things that Dichotomy Capital invests in, structured settlement purchasing isn't exactly a loved industry. There are many bad actors here and, given the (typically) stressed situation of the customer, there are many opportunities for poor behavior. In an effort to stem that behavior some states have investigated various [protection](#) measures. North Carolina already caps [discount rates](#) at prime plus 5% and there was even some discussion of capping discount rates in the [House of Representatives](#). This can't be good for JG Wentworth right?

The answer is more complicated than a simple yes or no. Management at JG Wentworth has said the discount rate cap in North Carolina limits their ability to write business. Instead of going after many smaller deals, JG Wentworth

prefers to purchase a very large portion of the claimant's payment stream. This allows JG Wentworth to achieve their return goals.

Competitors have not fared as well. One competitor told me that they had only performed two transactions in North Carolina since the law was passed. JG Wentworth's scale gives them an incredible advantage in increased regulatory environments. One executive even told me that he "feared" more regulation because he thought JG Wentworth would just capture all business.

The other regulatory concern is a lack of comparison shopping. The hope is that with more quotes, discount rates would come down. I believe that this would be a positive for JG Wentworth. It has been clearly established that they have the lowest cost of funding. In a head-to-head quote comparison JG Wentworth would win every time, or could drop their rate to beat the competitor. I am of the opinion, while regulatory risk is concerning, it will disproportionately impact smaller competitors more than JG Wentworth. The biggest concern is interest rates rising rapidly.

Interest Rate Environment and Other Risks

With interest rates near multi-decade lows, most investors expect rates to rise. I believe that is a fair assumption, although I have no clue what the timing of such a rise would be. For JG Wentworth, a rise would be a headwind to near-term earnings. There are a few reasons higher interest rates impact the company.

Due to simple discounted cash flow math, JG Wentworth's assets and liabilities will shift. On page 51 of their 2013 10K, JG Wentworth shows the impact of rising/falling interest rates to the fair values of their interest rate sensitive assets/liabilities. This isn't that concerning in my opinion, because JG Wentworth has no intention of selling off these assets. Therefore the adjustments are simply mark-to-market gains/losses and have little impact on the true cash generating ability.

The bigger risk is rapidly rising interest rates in between any securitization period. When a customer is given a quote it is done so with a presumed interest rate in mind. If rates rise quickly between the purchasing of the settlement and the securitization of said settlement, investors will demand a higher interest rate. This directly impacts JG Wentworth's spread that they collect. This impact will be temporary though and JG Wentworth will simply adjust their discount rate when purchasing future payment streams.

I believe that other risks include continued delays for judgments (discussed in the Q1 2014 conference call), increased competition, and headline risk from increased regulation laws. These seem to be temporary in nature though. I would also point out that smart money and insiders must believe that these risks are minimal. The table below shows top holders.

Some of these holders are also long-term holders of Imperial Holdings, another company profiled in my research. If these groups are owners, they clearly think the value of the company is higher than current prices. So what's the company worth?

Table 6. Insider Holdings Source: 2014 [Proxy Statement](#)

Holder	Class A Shares	Class B Shares
JLL Holders/Paul Levy		9,345,175
Waddell & Reed Financial	1,054,900	
Indaba Capital Fund	1,050,000	
Kerrisdale Partners Master Fund	682,630	
Citadel Advisors	644,250	
Candlewood Special Situations Fund		791,974
Blackrock	612,021	

Valuation

By now it should be clear that I believe JG Wentworth operates in a niche business, has a defensible moat, and generates plenty of cash. Despite the temporary headwinds, the business is materially undervalued in my opinion. The table below shows my range of valuations. For the Bear scenario, I dropped ANI as a % of TRB by 0.6% to account for interest rate headwinds. I also dropped TRB purchases by 10% to provide another level of conservatism. The base scenario is simply 2013's numbers and a 10X multiple, a multiple I think is applicable to stable businesses. Finally for the Bull scenario, I assumed a modest 5% increase in TRB purchases and a 0.4% increase to ANI as a % of TRB, to provide for better scale and lower interest expense. The 12X multiple is to account for a quality brand, industry leading position, and improved financing vehicles.

The scenarios below are hardly a lesson in analytical precision. However, it should be clear that the company is undervalued, and unless you think the business is going the way of the horse carriage or buggy whip, shares should trade higher. By all accounts structured settlements are a stable, albeit low-growth, industry. It seems reasonable to believe that JG Wentworth could be valued in excess of \$17/share under most environments even after considering interest rate and regulatory risks.

Table 6. Potential valuation scenarios: Authors Calculations

	Bear	Base	Bull
TRB Purchases	\$1,013	\$1,125	\$1,181
ANI/TRB	3.50%	4.10%	4.50%
Adjusted Net Income	\$35.44	\$46.13	\$53.16
ANI/Share	\$1.36	\$1.77	\$2.04
<i>Multiple</i>	<i>7X</i>	<i>10X</i>	<i>12X</i>
Value/Share	\$9.54	\$17.74	\$24.53
Upside/Downside	-15.6%	57.0%	117.1%

There are three sources of upside as well. Management has spoken about completing small bolt-on transactions that could enhance net income by \$5-\$20 million. Given the uncertainties surrounding these acquisitions, I have made no provision for that upside and will consider it a pleasant surprise if/when it happens. Another source of upside is share buybacks, a \$15 million repurchase program was [announced](#) in June. Finally, the company could redeem the term loan, driving interest expense down, which would increase ANI directly. There are a number of

levers that management could pull to generate shareholder value and that flexibility should reward long-term investors.

Conclusion

The May 2014 sell-off of JG Wentworth shares was largely overdone and represented an investor base that didn't understand the quality of the business. Comments on the conference call indicated that analysts were reading into quarterly numbers and extrapolating them *ad infinitum*. Hidden in all that carnage is a business that consistently generates cash flows and operates in a valuable niche.

Part of the pessimism relates to the groups 2009 bankruptcy and obfuscated financials. The issues that caused the bankruptcy are gone thanks to diverse warehouse facilities and committed lenders. The issues with financials will slowly go away as investors become more comfortable with management guided Adjusted Net Income. While there are some issues to an investment here, I believe that investors are more than compensated and should see a greater than 60% upside to shares at current prices.