Company Review

Ord Minnett Research Friday 7 January, 2011

Cash Converters

Update and results preview

- This note previews the upcoming 1H11 results for Cash Converters. Ord Minnett believes that the business continues to perform very well. Growth is expected to come from acquisitions, Quickdraw software and the growing financial services offering. The acquisition of the Scottish master franchise is a solid example of the acquisition strategy.
- OM toured three Victorian corporate Cash Converters stores in late 2010. Of the three, the larger refitted store lifted "deals done" per week from 280 per week to over 330. The refurbishment is adding 20–30% to the sales of the older stores. The payback appears to be very fast relative to the refurbishment cost and varies between one and two years.
- All stores sought to introduce financial services and move ("sell") transactions away from the retail shop front. All three shops now have a dedicated section focused on financial services and have specially trained staff in place.
- Ezcorp is also reporting good results in the US (33% ownership of CCV) demonstrating the resilience of this business. Albemarle and Bond, a large UK listed pawnbroker, also reported sound results at its November AGM.
- We believe that the business will continue to look to acquire more franchise stores to add to the corporate model. The focus is on struggling stores often starved of capital (and have no stock) and/or well-run larger stores. This gives the business the greatest return on incremental capital.
- We retain our Accumulate recommendation. We note that there is still uncertainty around the legislative environment. In the meantime the business is simply getting on with expansion and running its core business efficiently.

Key Financials

Year-end June (A$)	FY09A	FY10A	FY11E	FY12E
Revenue ($m)	94.4	126.6	171.6	198.9
EBITDA ($m)	25.5	33.7	41.8	46.4
Net profit after tax ($m)	16.1	21.6	28.9	31.3
EPS (¢)	6.6	6.6	7.6	8.3
P/E (x)	11.1	11.1	9.7	8.9
EV/EBITDA	7.3	7.2	6.6	6.0
Dividend (¢)	3.0	3.0	4.6	5.0
Net Yield (%)	4.1%	4.1%	6.2%	6.8%
Franking (%)	100%	100%	100%	100%
Normalised NPAT ($m)	16.1	21.6	28.9	31.3
Normalised EPS (¢)	6.6	6.6	7.6	8.3
EPS Growth (%)	3.1%	-0.4%	15.3%	8.6%
Normalised P/E (x)	11.1	11.1	9.7	8.9
Relative P/E (%)	71.6%	71.9%	62.3%	57.4%
Normalised ROE (%)	19.6%	13.3%	16.5%	16.8%

Source: Iress, Company Data, Ord Minnett Est. Share price: $ 0.735 Jan 07, 2011

CCV $0.735

Recommendation
Accumulate

Risk Assessment
High

Sector – consumer discretionary

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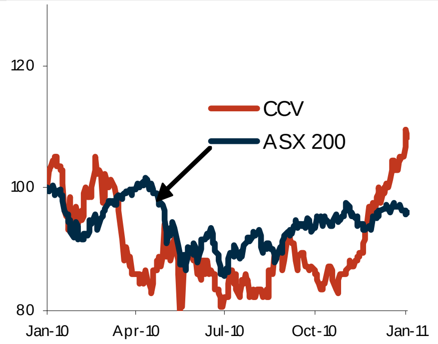
Cash Converters	
ASX Code	CCV
52 week range	A$0.5 - A$ 0.74
Market Cap	278.6
Shares Outstanding	379
Av Daily Turnover	254,200
ASX All Ordinaries	4,812
ASX200 Industrials	3,742
NTA FY11E (¢ per share)	22.7
Net Debt FY11E	-3.7

Relative price performance



Source: Iress

Consensus earnings

	FY11F	FY12F
NPAT (C)*	27-27.5m	n/a
NPAT (OM)	28.9	31.3
EPS (C)	n/a	n/a
EPS (OM)	7.6	8.3

Source: CCV guidance Nov 2010

1H11 results preview

We expect that Cash Converters will have a solid 1H11 but believe the 2H11 will be better again, driven by a full contribution from corporate stores acquired in 1H11. Cash Converters ended the FY10 year with 58 corporate stores and has since added a further 14 during 1H11. It now has a total of 72 corporate stores.

14 extra corporate stores

Table 1: Preview 1H11 Cash Converters result

Item	1H10A	1H11F	% change
Revenue (total)*	59.3	84.7	+42.8%
EBITDA	15.9	19.5	+22.6%
EBIT	15.3	18.9	+23.5%
NPAT reported	10.1	13.4	+32.7%
NPAT normalised	10.1	13.4	+32.7%
EPS reported	3.5	3.55	+1.4%
EPS normalised	3.5	3.55	+1.4%
DPS total	1.5	2.0	33.3%
Corporate stores	44	72	63.6%

Source: Company data, OM

2H11 will be driven by a full contribution from acquired stores

Major issues to look for in the result will include:

1. An update on any further corporate store additions.
2. News around possible further expansion offshore or structural change in the business.
3. The tough retail environment which may have slowed sales of second-hand goods. The lack of government stimulus payments may have assisted in the financial services side of the business in the run up to Christmas.
4. Further refurbishment programs, the progress of the financial services business and evidence of further rollouts.
5. News around federal and state government regulation of interest rate caps. After careful consideration OM believes the threat of adverse legislation probably always remains for Cash Converters and that this is substantially priced in

OM remains above guidance with NPAT of $27.5m for the full year due to the distinct potential for further accretive bolt-on acquisitions such as the recent acquisition in Scotland.

Other news

Cash Converters held its AGM in late November and reiterated NPAT guidance of between $27–27.5m for FY1. Cash Converters also reported trading for the first four months has been in line with expectations. Given the relatively tough consumer backdrop in Australia we believe this is a sound outcome though we would note that the business is less cyclical than many other retailers.

AGM positive

Growth is expected to come from:

1. Acquisitions – with 13 stores acquired in the first quarter of FY11.
2. Quickdraw software – fully acquired in May 2010 and expected to add $1.3m in EBIT annualised to the business.
3. Growing financial services offering including the Safrock loan book and the growth of financial services in the UK that was launched in October 2009.

Therefore with more stores rolled out and a full year's contribution this initiative should add to earnings in FY11.

Cash Converters has also set up a five-year plan with corporate goals which include diversification, growth via acquisition (mainly corporate stores), maintaining a conservative debt to equity ratio, a stable franchise network and growth via new stores, new markets and new products.

Store tour field notes

Ord Minnett toured three Victorian corporate Cash Converters stores late last year. We viewed an older style, small store in Prahran, a larger suburban store in Parkdale with a slightly older fit out, and finally a larger, fully refitted store in Fountaingate.

The quality of the fittings and look of the refurbished store is far more attractive than the older-style stores. In particular, the jewellery counter looked professional.

Refurbishment lifting growth rates

The upshot is that the larger refitted store lifted "deals done" in the week from 280 per week to over 330. The refurbishment is adding 20–30% to the sales of the older stores. The payback appears to be very fast relative to the refurbishment costs, and can vary from less than one year to over two years.

There is often minimal competition. Competition is often from older stores fitted with bars which are very consumer unfriendly. Management prefers to have some parking nearby to accommodate heavy transactions (bikes, TVs etc). Ideally an off-strip location near a major shopping centre is the best value location.

All stores sought to separate financial services and "sell" transactions from the retail shop front. All stores are now focused on financial services and have staff and a section of stores dedicated to this business.

We believe the business will continue to look to acquire more franchise stores to add to the corporate model. The focus is on either struggling stores often starved of capital (and have no stock) and well-run larger stores. This gives the business the greatest return on incremental capital.

The business is still keen to acquire either capital-starved, poorly run stores or large, well-run winners to the portfolio.

Decent store managers who can buy and lend well is critical. Store managers earn decent money at around $70k and some earn capped bonuses of around 10k.

The modernisation of the corporate store portfolio is set to remain a major driver of growth going forward.

Ezcorp results

Offshore players reporting good results

Ezcorp, Inc. (Nasdaq: EZPW) a provider of specialty financial services and pawn broking, is a 33% shareholder and is a strategic partner of Cash Converters. Ezcorp announced strong results for its fourth fiscal quarter and 2010 fiscal year ended 30 September 2010. While this is some time ago now, it shows ongoing strength in the business.

EZCORP's net income for the quarter increased 33% to $27.9m ($0.56 per share) compared to $20.9m ($0.42 per share) for the prior year quarter. Total revenues for the quarter increased 20% over the prior year period to $198.2m.

Ezcorp noted better margin mix and operating leverage from growth (from a fixed cost base). The business continues to grow and expand its store base. The company expects EPS to grow at 20% pa for fiscal 2011.

This again suggests that in a very tough US retailing environment, pawn brokers and alternative finance businesses with scale have not missed a beat and continue to pump out strong results. All major lines of business grew in the previous corresponding period (pcp) including merchandise, jewellery scrapping, pawn fees, auto loans and alternative services.

Albemarle and Bond results

Albemarle and Bond (ABN.LN) at its November 2011 AGM reported that demand for small flexible loans has continued to be strong and store rollouts continue. Pawn broking has continued to record double digit like-for-like growth driven in part by higher loan sizes. Gold buying also remains strong and financial services remains positive.

This business reported EPS growth of 34% in the fiscal year to June 2010.

Stock catalysts

We believe there are a number of catalysts for Cash Converters:

1. Continued store expansion and acquisitions appear in place given the large bank of franchised stores available and the current slate of acquisition opportunities. News around store acquisitions is a positive for the business.

2. In recent times Cash Converters has been re-examining the international business's position. OM believes that the focus will be on acquiring the larger franchised chains.

   Cash Converters announced in December that it will seek to acquire the master franchise for the Scottish operations. This enables a much faster expansion of the business into Scotland and also saves on fees being leaked out to another party. Cash Converters paid £420K or 3.2x EBIT for this sub master franchise.

   Cash Converters estimates that Scotland could support up to 60 stores.

3. New products are being piloted and rolled out in new geographies is a positive for the business, and loan books have strong momentum.

4. Lifting the growth rates in the cash advance lending business helped by new store pilots and ongoing growth of the corporate store business.

Recommendation – Accumulate

OM remains positive on the business. We would prefer to retain our above-guidance estimates in case the business is able to acquire further stores for the duration for FY11.

The recent Scottish sub master franchise buyback is an example of why we prefer to remain ahead of guidance, adding 1% to EPS and also paving the way for further expansion.

Regulatory issues, however, remain but appear to be priced into the stock at current levels. Ultimately the federal government is committed to making some sort of decision regarding interest rate caps by June 2012. A tough regulatory environment might just remain a long-term factor for the business. Investors will have to be resigned to a lack of a short-term resolution.

Further international growth over time will assist the business in mitigating this risk.

Risk factors

OM believes that the largest outstanding risk is an adverse resolution of the attempt by the federal government to **regulate interest rates** the Australian industry can charge. Any positive news around this would re-rate the stock.

Management of the **bad debt cycle** of the loan books remains important given Cash Converters' recent growth. The loans turn over fairly rapidly, reducing the risk of underestimation of bad debts.

Operational failure – system problems.

Increased competition.

Gold prices – a decline would be problematic for the scrap market and loan values.

Business description

Cash Converters is one the largest corporate second hand goods dealers, pawn brokers and providers of alternative credit in the world (albeit in a highly fragmented industry) with over 600 outlets (528 franchisee and 72 corporate stores). It has four divisions:

1. Australia – including growing corporate store presence
2. UK – including a growing corporate store presence
3. Finance – alternative finance and/or micro credit
4. Franchisee operations (rest of world) – tiny percentage of revenue despite large footprint.

Financial statements

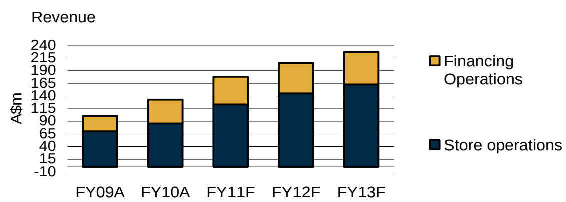
Cash Converters

Accumulate

Profit & Loss Statement (A$m)	FY09A	FY10A	FY11F	FY12F	FY13F
Revenue	94.4	126.6	171.6	198.9	220.9
Operating Costs	0.0	0.0	0.0	0.0	0.0
EBITDA	**25.5**	**33.7**	**41.8**	**46.4**	**51.4**
Depreciation & amortisation	-1.1	-1.5	-1.1	-1.3	-1.4
EBIT	**24.4**	**32.2**	**40.7**	**45.1**	**50.0**
Net Interest	-1.1	-1.0	0.5	-0.4	-0.5
PBT pre-unusual items	**23.3**	**31.2**	**41.2**	**44.8**	**49.6**
Unusual non-operating items	0.0	0.0	0.0	0.0	0.0
NPBT	**23.3**	**31.2**	**41.2**	**44.8**	**49.6**
Income Tax Expense	-7.2	-9.6	-12.4	-13.4	-14.9
NPAT pre-OEI	**16.1**	**21.6**	**28.9**	**31.3**	**34.7**
Minority interest	0.0	0.0	0.0	0.0	0.0
NPAT	16.1	21.6	28.9	31.3	34.7
Abnormals / convertible dist.	0.0	0.0	0.0	0.0	0.0
Reported NPAT	**16.1**	**21.6**	**28.9**	**31.3**	**34.7**
Normalised NPAT	**16.1**	**21.6**	**28.9**	**31.3**	**34.7**
Effective Tax Rate	30.9%	30.8%	30.0%	30.0%	30.0%
Reported - diluted EPS	6.6	6.6	7.6	8.3	9.2
Normalised (diluted) EPS	6.6	6.6	7.6	8.3	9.2
DPS (cps)	3.0	3.0	4.6	5.0	6.4
Dividend Yield (%)	4.1%	4.1%	6.2%	6.8%	8.7%
Payout Ratio	44%	45%	60%	60%	70%
Franking	100%	100%	100%	100%	100%
Free cash flow (cps)	5.6	3.5	0.6	5.0	6.4
FCF Yield (%)	7.7%	4.7%	0.8%	6.8%	8.8%

Cash Flow Statement (A$m)	FY09A	FY10A	FY11F	FY12F	FY13F
Gross cashflow	8.6	7.4	24.1	35.7	42.7
Net Interest (paid)/received	-0.6	0.4	0.5	-0.4	-0.5
Tax Paid	-6.6	-7.3	-12.4	-13.4	-14.9
Other Operating Items	13.9	16.0	0.0	0.0	0.0
Operating Cash Flow	**15.3**	**16.5**	**12.2**	**21.9**	**27.4**
Capex	-1.5	-3.4	-10.0	-3.0	-3.0
Net Acquisitions and Investments	-18.5	-23.9	-18.0	-5.0	0.0
Other investing items	0.3	-1.9	0.0	0.0	0.0
Investing Cash Flow	**-19.7**	**-29.2**	**-28.0**	**-8.0**	**-3.0**
Inc/(Dec) in Equity	0.0	68.3	0.0	0.0	0.0
Inc/(Dec) in Borrowings	4.0	-2.3	0.0	0.0	0.0
Dividends Paid	-7.3	-9.2	-17.3	-18.8	-24.3
Other Financing Items	-0.5	0.1	0.0	0.0	0.0
Financing Cash Flow	**-3.8**	**56.9**	**-17.3**	**-18.8**	**-24.3**
Net Inc/(Dec) in Cash (ex-FX)	**-8.2**	**44.2**	**-33.1**	**-4.9**	**0.1**

Balance Sheet (A$m)	FY09A	FY10A	FY11F	FY12F	FY13F
Cash and Cash Equivalents	7.0	50.7	17.6	12.6	12.8
Current Receivables	31.8	49.8	67.5	78.2	86.9
Other Current Assets -Inv	7.7	12.1	15.9	18.2	20.1
PP & E	4.6	6.8	15.7	17.4	19.0
Intangibles	60.3	70.6	88.6	93.6	93.6
Other Non Current Assets	3.2	7.1	7.1	7.1	7.1
Total Assets	**114.6**	**197.1**	**212.4**	**227.2**	**239.4**
Short term Debt	3.9	3.3	3.3	3.3	3.3
Current Payables	8.4	10.5	14.2	16.5	18.3
Other Current Liabilities	5.8	8.5	8.5	8.5	8.5
Long term Debt	12.9	10.6	10.6	10.6	10.6
Other Non Current Liabilities	1.3	1.3	1.3	1.3	1.3
Total Liabilities	**32.3**	**34.2**	**37.9**	**40.2**	**42.0**
Total Equity	**82.3**	**162.9**	**174.4**	**187.0**	**197.4**
Net Debt/(cash)	9.8	-36.8	-3.7	1.3	1.1



Divisions (A$m)	FY09A	FY10A	FY11F	FY12F	FY13F
Revenue					
Store operations	70.1	85.4	123.3	145.1	162.3
Financing Operations	30.1	47.4	54.5	60.0	64.8
Intersegment	-5.8	-6.2	-6.2	-6.2	-6.2
Total	**94.4**	**126.6**	**171.6**	**198.9**	**220.9**
Drivers					
Corporate stores	37	58	75	84	92
Comp sales		0.0%	1.0%	1.0%	2.0%
Financing book Y/E $m	21.4	38.7			

Operational Metrics (%)	FY09A	FY10A	FY11F	FY12F	FY13F
Revenue growth	27.1%	34.1%	35.5%	15.9%	11.1%
EBITDA margin	27.0%	26.6%	24.4%	23.4%	23.3%
EBITDA growth	9.0%	32.2%	24.1%	11.0%	10.8%
EBIT margin	25.8%	25.4%	23.7%	22.7%	22.7%
EBIT growth	4.6%	32.0%	26.5%	10.8%	10.8%
Normalised EPS growth	3.1%	-0.4%	15.3%	8.6%	10.7%
Return on asset	14.7%	11.3%	13.4%	13.9%	14.6%
Normalised ROE	19.6%	13.3%	16.5%	16.8%	17.6%

Valuation Ratios (x)	FY09A	FY10A	FY11F	FY12F	FY13F
Reported P/E	11.1	11.1	9.7	8.9	8.0
Normalised P/E	11.1	11.1	9.7	8.9	8.0
Price To Free Cash Flow	13.1	21.3	126.9	14.8	11.4
EV / EBITDA	7.3	7.2	6.6	6.0	5.4
EV / EBIT	7.6	7.5	6.7	6.2	5.6

Leverage	FY09A	FY10A	FY11F	FY12F	FY13F
Net Debt / Equity	12%	-23%	-2%	1%	1%
Net Debt / (ND + Equity)	11%	-29%	-2%	1%	1%
Net Debt / Total Assets	9%	-19%	-2%	1%	0%
EBITDA Interest Cover (x)	23.2	n.m	n.m	n.m	n.m
EBIT Interest Cover (x)	22.2	n.m	n.m	n.m	n.m

Substantial Shareholders	m	%
Ezcorp	124.4	32.8%
Staff	21.0	5.5%
Rand Holdings	14.9	3.9%

Valuation		
WACC (%)		12.2%
Fully Diluted Number of shares (m)		379.0
Cost of Equity		13.6%
D/EV		20.0%
Risk Free Rate		5.5%
	A$m	**A$**
Operational NPV (5 year Forecast)	72.6	0.19
Terminal Value	175.1	0.46
Less Net Debt	36.8	0.10
Franking Credits Value (50% weight)	16.6	0.04
Group NPV	284.5	**0.79**
Current Share Price		0.74
NPV Discount to Share Price		**7.5%**

Sensitivity Analysis

		WACC				
		11.2%	11.7%	12.2%	12.7%	13.2%
	1.6%	$0.85	$0.81	$0.78	$0.74	$0.72
Terminal	1.8%	$0.86	$0.82	$0.78	$0.75	$0.72
Growth	2.0%	$0.87	$0.83	$0.79	$0.76	$0.73
Rate	2.2%	$0.88	$0.84	$0.80	$0.77	$0.74
	2.4%	$0.90	$0.85	$0.81	$0.78	$0.75

		β				
		1.1	1.2	1.3	1.3	1.4
Equity	5.2%	$0.95	$0.92	$0.90	$0.87	$0.85
Risk	5.9%	$0.89	$0.87	$0.84	$0.82	$0.80
Premium	6.5%	$0.84	$0.82	$0.79	$0.77	$0.75
	7.2%	$0.80	$0.77	$0.75	$0.73	$0.71
	7.8%	$0.76	$0.74	$0.72	$0.69	$0.68

Source: Ord Minnett, Company Data.

Please contact your Ord Minnett Adviser for further information on our document.

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Guide to Ord Minnett Recommendations

BUY	The stock's total return (nominal dividend yield plus capital appreciation) is expected to exceed 15% over 12 months.
ACCUMULATE	The stock's total return is expected to be between 5% and 15%. Investors may add to existing holdings, or initiate holdings on share price weakness.
HOLD	The stock is fairly priced, and its total return is expected to be between 0% and 5%.
LIGHTEN	The stock's total return is expected to be less than 0% and possibly down 15%. Investors should consider selling into share price strength.
SELL	The stock's total return is expected to lose 15% or more.
RISK ASSESSMENT	Classified as High, Medium or Low, denotes the relative assessment of an individual stock's risk based on an appraisal of its disclosed financial information, volatility, nature of its operations and other relevant quantitative and qualitative criteria.