WA Industrials: Subprime Finance

Hartleys

CCV.asx
Neutral

CASH CONVERTERS INT. LTD (CCV)

Loan book growth but at a cost

Cash Converters International Ltd (CCV) has delivered 1H19 net loss after tax of $5.2m. Statutory EBITDA of just $0.8m was well down on 1H18 ($21.2m) being impacted by one-off costs of $20m, including $16.4m settlement of the McKenzie class action and $2.5m of legal fees related to the class actions.

Gross loan book growth was strong, up 22% to $210m, from $172m at FY18. This growth however came at a cost with CCV noting a disproportionate increase in bad debt expenses during the period. Management notes that a number of new credit measures have been deployed during the period which are expected to have a positive impact on bad debt expense in 2H19.

Stronger 2H19 expected

CCV advises that it expects *"a stronger second half operating result"*. Our forecasts are reduced on the back of today's result, primarily due to the impact of the increased bad debt expenses. We now forecast normalised FY19 EBITDA of $46.4m, down 15% from $54.8m previously.

Class action update

During 1H19 the "McKenzie" class action was finalised with CCV settling the action through the payment of $16.4m. The second and final class action, the "Lynch" action, remains outstanding. The trial for the Lynch action was completed in November 2018 with a judgement being awaited. As outlined in our note of 29 October 2018 (*"Class action 2 – potential impact on funding"*) the ultimate outcome of the Lynch action could be a pivotal moment for CCV. A positive outcome (i.e. a win) would obviously be a good result for the business, while a material negative outcome could put a real dent in CCV's ability to fund ongoing loan book growth.

Senate Inquiry & SACC law review

The Senate Inquiry report into *"Credit and financial services targeted at Australians at risk of financial hardship"* is imminent. Recommendations from this inquiry may, or may not, impact on CCV's business. In regard to the SACC law review, CCV notes that two bills introduced to Parliament will, if passed, have the effect of writing into law the proposed changes under the SACC review. In CCV's words, implementation of these laws would mean *"many customers would no longer have access to cash from loans issued on or after 1 July 2020"*. CCV estimates that based on their current assumptions, such changes may result in a non-cash impairment to goodwill within the range of $45m - $60m.

Neutral; Price Target $0.34

On the back of our reduced estimates our price target reduces to $0.34 (from $0.42 previously). More importantly, there are two potentially major events looming for CCV (class action settlement, potential changes to lending laws). Given the associated uncertainty we maintain our Neutral recommendation pending greater clarity on these key issues.

	21 Feb 2019
Share Price:	$0.23
12mth price target:	$0.34

Brief Business Description:
MACC lending, SACC lending, consumer finance, car finance and pawn broking operations.

Hartleys Brief Investment Conclusion:
Earnings growth potential, though regulatory and legal risks remain high and may impact on funding capacity.

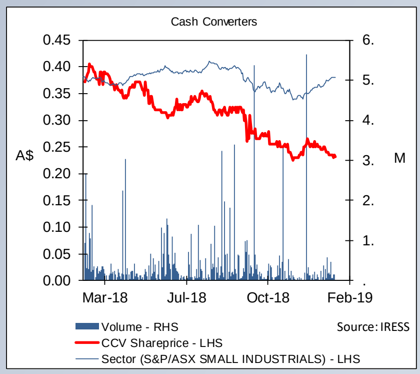
Chairman & CEO:
Stuart Grimshaw (Non-Exec. Chairman)
Martyn Jenkins (CFO)

Top Shareholders:	
EZCORP	34.7%
Perpetual Ltd	7.9%
Adam Smith AM	5.5%

Company Address:
Level 18, 37 St Georges Tce
Perth, WA, 6000

Issued Capital:			616.4m
- fully diluted			630.0m
Market Cap:			$141.8m
- fully diluted			$144.9m
Net Debt (1H19):			$49.5m
	FY18a	**FY19e**	**FY20e**
Revenue	259.6	272.9	278.6
NPAT (A$m) *	21.2	19.8	21.9
EPS ($, dil)*	4.2	3.1	3.5
P/E (basic)	5.1x	28.1x	6.5x
P/E (diluted)	5.5x	7.3x	6.6x
EV / EBITDA	4.1x	7.7x	4.0x
DPS (cps)	-	-	-
Franking	0%	0%	0%
Dividend Yield	0.0%	0.0%	0.0%
N.D. / equity	5.7%	15.3%	19.9%

Source: Hartleys Research. *normalised



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Hartleys was Lead Manager and Underwriter to an Entitlements Issue completed by Cash Converters International Limited ("CCV") in June 2018, for which it earned fees. Hartleys has also provided corporate advice within the past 12 months and continues to provide corporate advice to CCV for which it has earned fees and continue to earn fees.

SUMMARY MODEL

Cash Converters International (CCV)

Recommendation: Neutral

Company Information		
Date	21 Feb 2019	Level 18, 37 St Georges Tce
Share Price	$0.230	Perth, WA, 6000
52 Week High-Low	$0.415 - $0.22	Ph: (08) 9221 9011
Dil. Market Cap ($m)	$145	www.cashconverters.com.au
Enterprise Value ($m)	$194	
Ordinary Shares	616.4	
Fully Diluted Shares	630.0	
Price Target	$0.34	
Upside / Downside	46%	
Dividend Yield - FY19	0%	
Total Return	46%	

Price Target	
12 Month Price Target	$0.34
P/E (FY19) at price target - Reported EPS	41.2x
P/E (FY20) at price target - Reported EPS	9.6x
Div. Yld (FY19) at price target	0.0%
Div. Yld (FY20) at price target	0.0%

Multiples (S/price at $0.23)	6/17A	6/18A	6/19F	6/20F
P / E (basic, weighted)	5.5x	5.1x	28.1x	6.5x
P / E (norm, diluted, weighted)	5.6x	5.5x	7.3x	6.6x
Dividend Yield	0.0%	0.0%	0.0%	0.0%
EV/EBITDA multiple	4.4x	4.1x	7.7x	4.0x
EV/EBIT multiple	5.3x	4.8x	11.2x	4.7x
Price / Book Value	0.4x	0.4x	0.5x	0.4x
Price / NTA	0.9x	0.8x	0.8x	0.8x

Ratios	6/17A	6/18A	6/19F	6/20F
Return on Average Equity	8.2%	7.7%	1.6%	7.0%
Return on Assets	5.0%	5.0%	1.0%	4.6%
ND / ND + Equity	9.3%	5.4%	13.3%	16.6%
ND / Equity	10.2%	5.7%	15.3%	19.9%
Net Interest Cover (EBIT)	4.2x	4.0x	1.7x	4.0x
Revenue growth	-12%	-4%	5%	2%
EBIT growth	308%	9%	-57%	137%
NPAT growth	-491%	9%	-78%	334%
EPS (dil, wghtd) growth	-486%	8%	-82%	333%
EBIT Margin	14%	16%	6%	15%
Tax Rate	26.9%	28.8%	30.0%	29.0%

Cash Flow Analysis	6/17A	6/18A	6/19F	6/20F
Net Operating Cash Flow	39.0	34.9	22.0	37.1
+ Tax Paid	-5.3	6.4	8.8	2.2
+ Net Interest	7.6	8.0	10.1	10.2
Ungeared pre-tax cashflow	41.4	49.3	40.9	49.5
Reported EBITDA	44.3	48.0	25.3	49.1
Cash Conversion	**93%**	**103%**	**161%**	**101%**
Capex / D&A	1.0x	1.3x	0.9x	0.9x

Share Data	6/17A	6/18A	6/19F	6/20F
Ord Issued shares (m)	493.0	616.4	616.4	622.8
growth	1.7%	25.0%	0.0%	1.0%
Weighted ave shares (m)	490.3	494.5	616.4	622.8
growth	1.7%	0.8%	24.7%	1.0%
Diluted shares wgted (m)	501.2	508.4	631.3	633.2
growth	1.4%	1.4%	24.2%	0.3%

Directors & Senior Mgt	Substantial Shareholders	
Stuart Grimshaw (Non-Exec. Chairman)	EZCORP	34.7%
Peter Cumins (Exec. Deputy Chairman)	Perpetual Ltd	7.9%
Kevin Dundo (NED)	Adam Smith AM	5.5%
Lachlan Given (NED)		
Andrea Waters (NED)		
Sam Budiselik (Interim CEO)		
Martyn Jenkins (CFO)		

Profit & Loss ($m)	6/17A	6/18A	6/19F	6/20F
Operating Revenue	270.9	259.6	272.9	278.6
EBITDA	44.3	48.0	25.3	49.1
growth	*178.0%*	*8.2%*	*-47.1%*	*93.7%*
EBITDA / Revenue	16.4%	18.5%	9.3%	17.6%
Depn & Amort.	-7.3	-7.4	-8.0	-8.0
EBIT	**37.0**	**40.5**	**17.3**	**41.1**
Net Interest	-8.8	-10.1	-10.1	-10.2
PBT	**28.2**	**30.4**	**7.2**	**30.9**
Tax	-7.6	-8.8	-2.2	-9.0
Assoc. Cont	0.0	0.8	0.0	0.0
NPAT	**20.6**	**22.5**	**5.0**	**21.9**
Pre-tax Adjustments	0.0	-1.3	21.0	0.0
Adjusted EBITDA	**44.3**	**46.6**	**46.4**	**49.1**
Post-tax Adjustments	0.0	-1.3	14.7	0.0
Adjusted NPAT	**20.6**	**21.2**	**19.8**	**21.9**
Reported EPS (basic, wghtd)	**4.2**	**4.6**	**0.8**	**3.5**
Normalised EPS (dil, wghtd)	**4.1**	**4.2**	**3.1**	**3.5**
DPS (cps)	**0.0**	**0.0**	**0.0**	**0.0**
Franking	0%	0%	0%	0%
Payout Ratio	0.0%	0.0%	0.0%	0.0%

Cashflow Statement ($m)	6/17A	6/18A	6/19F	6/20F
EBITDA	44.3	48.0	25.3	49.1
Net Interest	-7.6	-8.0	-10.1	-10.2
Working Capital	6.5	1.3	15.6	0.4
Tax Paid	5.3	-6.4	-8.8	-2.2
Other	-9.4	0.0	0.0	0.0
Net Operating Cash Flow	**39.0**	**34.9**	**22.0**	**37.1**
Net loan funds advanced	4.5	-56.4	-43.1	-47.3
Operating Cash Flow	**43.5**	**-21.5**	**-21.1**	**-10.1**
Capital Expenditure	-7.4	-9.6	-7.0	-7.0
Acquisitions	0.0	0.0	0.0	0.0
Other (inc Investments, Asset sales etc)	1.0	1.4	0.0	0.0
Net Investing Cash Flow	**-6.4**	**-8.2**	**-7.0**	**-7.0**
Proceeds from Equity Issues	0.0	38.0	0.0	0.0
Net Change in Debt	-27.6	50.9	-38.4	23.6
Dividends Paid	-2.2	0.0	0.0	0.0
Other	0.0	0.0	0.0	0.0
Net Financing Cash Flow	**-29.8**	**88.9**	**-38.4**	**23.6**
Movement in Cash	7.3	59.1	-66.6	6.5

Balance Sheet ($m)	6/17A	6/18A	6/19F	6/20F
Cash	80.6	140.0	73.4	79.9
Loan Receivables	87.9	119.0	115.0	124.4
Receivables	7.6	22.7	6.7	6.7
Inventories	21.0	20.7	20.7	20.7
Other	5.5	6.8	6.8	6.8
Total Current Assets	**202.6**	**309.2**	**222.6**	**238.5**
Property, Plant & Equipment	10.2	9.1	8.7	7.7
Loan Receivables	14.0	32.8	64.4	96.6
Intangibles	134.0	137.1	137.1	137.1
Other	38.0	21.0	20.6	20.6
Total Non Current Assets	**196.2**	**200.0**	**230.8**	**262.0**
Total Assets	**398.8**	**509.1**	**453.4**	**500.5**
Accounts Payable	21.3	19.5	20.5	20.9
Interest Bearing Liabilities	46.3	139.4	90.0	90.0
Other	7.1	7.0	7.0	13.8
Total Current Liabilities	**74.7**	**165.9**	**117.5**	**124.7**
Interest Bearing Liabilities	60.9	19.0	29.9	53.5
Other	2.4	1.9	1.9	1.9
Total Non Current Liabilities	**63.4**	**20.8**	**31.8**	**55.4**
Total Liabilities	**138.0**	**186.7**	**149.2**	**180.1**
Net Assets	**260.8**	**322.4**	**304.2**	**320.4**
Net Asset Value / Share ($)	0.53	0.52	0.49	0.51
NTA / Share ($)	0.26	0.30	0.27	0.29
Net Debt (net cash)	26.7	18.4	46.5	63.6

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Phone: +61 8 9268 2879

Last Earnings Estimate Change:
21 February 2019

Sources: IRESS, Company Information, Hartleys Research

1H19 RESULT SUMMARY

Fig. 1: 1H19 result summary

CCV	1H18	1H19	Chg
Revenue	122.7	136.7	11.4%
Gross Profit	**80.9**	**78.0**	**-3.5%**
EBITDA	**21.2**	**0.8**	
D&A	-3.9	-3.9	
EBIT	**17.3**	**-3.1**	
Net Interest	-4.0	-4.6	
PBT	**13.3**	**-7.7**	
Tax	-4.0	2.4	
NPAT	**9.4**	**-5.2**	**-156%**
Adjustments:			
Class action settlement		16.4	
Class action legal costs	1.3	2.5	
Restructure costs		1.1	
Adjusted EBITDA	**22.5**	**20.8**	**-7.3%**
Reported EPS (basic)	**1.9c**	**-0.8c**	**-145%**
GP Margin	65.9%	57.1%	-8.9%
EBITDA Margin (Adj.)	17.3%	15.2%	-2.1%

Source: CCV, Hartleys

- CCV has reported a Net Loss After Tax of $5.2m.
- Adjusted EBITDA was $20.8m (we exclude interest income on cash balances), down 7.3% on 1H18.
- Adjustments to reported EBITDA ($0.8m), totalling $20.0m were comprised of:
    - $16.4m - class action settlement.
    - $2.5m – legal costs.
    - $1.1m - restructure costs, which relates predominantly to costs involved in the change of CEO over the period.
- CCV advises that initial adoption of accounting standard AASB9 impacted EBITDA by $3.4m, on a like for like basis versus 1H18.

Revenue growth was driven by strong growth in CCV's loan book, disappointingly this was offset by a disproportionate increase in bad debt expense (in short it seems that too many loans that shouldn't have been approved, were approved). This impacted on Gross Profit and flowed down to EBITDA, resulting in the adjusted EBITDA margin contracting from 17.3% to 15.2%.

In response, CCV notes that the business has begun to focus more on its credit risk assessment of applications, resulting in a fall in the overall approval rate to below 30%.

BALANCE SHEET & CASHFLOW

Fig. 2: Balance sheet

CCV - Balance Sheet	FY18a	1H19a	Comment
Cash	140.0	74.3	Reduced following repayment of FIIG bond $60m
Loan Receivables	151.7	171.8	Net loans outstanding
Inventories	20.7	20.8	Pre-owned goods held in store
Receivables	28.3	14.2	Net receipt of $12m from loan to associate
Goodwill	107.0	107.0	
Other Intangibles	30.2	31.1	Includes ~$20m allocated to software
Other	31.4	40.6	
Total Assets	**509.1**	**459.7**	
Payables	19.5	14.0	
Debt	158.3	123.8	$150m Fortress facility
Other	8.9	8.5	
Total Liabilities	**186.7**	**146.4**	
Total Equity	**322.4**	**313.3**	
Net Debt	18.4	49.5	
Net Debt / Equity	6%	16%	
Net debt / gross loans	11%	24%	
Net debt / net loans	12%	28%	
Net Tangible Assets	185	175	
NTA / share	$0.30	$0.28	

Source: CCV, Hartleys

- Operating cash flow was negative $41m, impacted by outflows due to the strong growth in net lending ($37m) along with payment of the McKenzie class action settlement ($16m).

- CCV received net cash inflow of $12m from the repayment of a loan by associates.

- Net debt rose during the period to ~$50m following the utilisation of cash reserves to repay the $60m FIIG bond in September 2018.

- CCV's sole financing vehicle is now the $150m facility (expiring November 2020) provided by Fortress.

We are unaware of any particular covenants around the Fortress facility other than noting that the initial announcement stated:

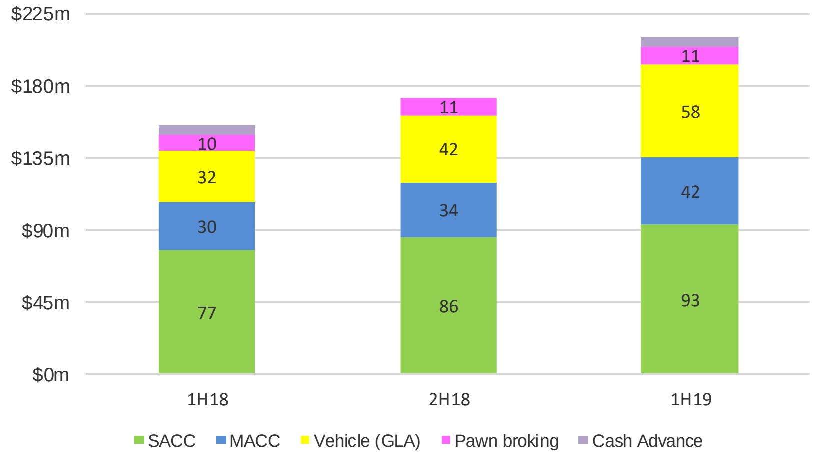
- No EBITDA or gearing ratio covenants.

- Fortress may suspend or cancel the facility if a change of control event occurs (in respect of CCV) or if CCV's ASX listing is suspended for more than 15 business days.

LOAN BOOK

CCV's gross loan book grew 22% from $172m at FY18 to $210m (Figure 3).

Fig. 3: *Loan book*



Source: CCV, Hartleys

- The net loan book increased by 13.2% from $152m at FY18 to $172m. The smaller increase in the net loan book is due to the increased bad debt expenses incurred during the period, coupled with initial adoption of AASB9.

FORECASTS

Fig. 4: Forecasts

CCV	FY18a	FY19 old	FY19 new	Chg	FY20 old	FY20 new	Chg
Loan Book - Gross	172	215	215	0%	262	262	0%
Revenue	259.6	270.4	272.9	1%	276.1	278.6	1%
Gross Profit	**164.9**	**172.4**	**162.6**	**-6%**	**176.6**	**170.3**	**-4%**
Expenses	-116.9	-134.1	-137.2		-120.1	-121.2	
EBITDA	**48.0**	**38.3**	**25.3**	**-34%**	**56.5**	**49.1**	**-13%**
D&A	-7.4	-8.0	-8.0		-8.0	-8.0	
EBIT	**40.5**	**30.3**	**17.3**	**-43%**	**48.5**	**41.1**	**-15%**
Net Interest	-10.1	-10.8	-10.1		-10.2	-10.2	
PBT	**30.4**	**19.5**	**7.2**	**-63%**	**38.2**	**30.9**	**-19%**
Tax	-8.8	-5.9	-2.2		-11.1	-9.0	
NPAT	**22.5**	**13.7**	**5.0**	**-63%**	**27.1**	**21.9**	**-19%**
Adjustments (pre-tax)	-2.6	16.5	21.0		0.0	0.0	
Adjusted EBITDA	**44.6**	**54.8**	**46.4**	**-15%**	**56.5**	**49.1**	**-13%**
Adjusted NPAT	17.8	25.2	19.8	-21%	27.1	21.9	-19%
EPS - Adjusted, dil	**4.2c**	**4.0c**	**3.1c**	**-21%**	**4.3c**	**3.5c**	**-19%**
Reported EPS (basic)	4.6c	2.2c	0.8c	-63%	4.4c	3.5c	-19%
GP Margin	63.5%	63.8%	59.6%	-4.2%	63.9%	61.1%	-2.8%
EBITDA Margin	17.2%	14.2%	9.3%	-4.9%	20.4%	17.6%	-2.8%

Source: CCV, Hartleys

- We maintain our gross loan book forecast, implying ~$5m gross loan book growth in 2H19, reflecting the tighter credit assessment criteria being undertaken by CCV. This quantum of growth is in line with that seen in 2H18.
- On an adjusted EBITDA basis our forecast reduces 15% to $46.4m, reflecting the weaker bad debt experience in 1H19, as shown by the reduced FY19 Gross and EBITDA margin assumptions.
- Our adjusted FY19 NPAT and EPS forecasts fall by 21%.
- Our FY20 forecasts reduce on the back of reduced margin assumptions; our preference being to await evidence of an improvement in the bad debt experience.
- We would expect some clarity around the class action and Senate Inquiry / SACC law review in coming months. There is a reasonable likelihood that outcomes around these issues could have a material impact on our forecasts.

We note that CCV has not provided specific earnings guidance, though the company states that it expects *"a stronger second half operating result"*.

VALUATION

Investors currently face two, potentially material, uncertainties when looking to derive a valuation for CCV; the Queensland class actions and the SACC law review / Senate Inquiry.

The outcomes of both these events are unknown, with the ultimate impact on CCV ranging from nil to materially negative.

At this stage, absent any real indication of the potential outcomes of these events, we consider a base valuation for CCV, utilising our underlying FY19 earnings forecasts.

We maintain a PE of 10.5x, in deriving a valuation of $0.34 / share, from $0.42 previously. CCV's implied valuation multiples based on our price target are shown in Figure 5.

Fig. 5: *CCV Valuation*

CCV	
FY19 EPS	3.2c
Target PER	10.5x
Valuation per share	**$0.34**

Implied Multiples at Price Target	FY18	FY19	FY20
EV/EBITDA	4.7x	4.9x	4.6x
EV/EBIT	5.6x	5.9x	5.5x
PER	7.4x	10.5x	9.6x

Source: Hartleys

We highlight that the outcomes of the class action and SACC law review / Senate Inquiry may have a material impact on our valuation going forward.

Key assumptions and risks for valuation

Assumption	Risk of not realising assumption	Downside risk to valuation if assumption is incorrect	Comment
Loan book growth.	Low	Medium	Our forecasts imply limited loan book growth into 2H19.
Bad debt expense.	Medium	High	CCV's bad debt expense has jumped in this period. Management has undertaken corrective action on this issue. If, however problems persist, this will likely have a further negative impact.
Conclusion	*We see the key risks to CCV being:*		

- *The potential for future regulatory reviews and / or proposed changes. Any activity in this regard could impact CCV's operations or may simply cause share price pressure due to the potential for additional investor uncertainty.*
- *Future disputes or litigation in the ordinary course of business.*
- *Action of franchisees. The majority of CCV's stores are run under franchise agreements. At present there is a particular focus on the franchisee industry with a Joint Parliamentary Inquiry currently underway. More generally, CCV faces the risk of non-compliance by franchisors to contractual arrangements which could result in damage to CCV's brand and reputation or require CCV to take steps to remedy non-compliance.*
- *Security of online databases. CCV maintains significant data and client account information online. The theft, loss or corruption of this data is a risk. We note that in November 2017 CCV announced that they had received a threat in relation to an unauthorised breach of customer data related to one of their UK websites.*
- *Ability to access and maintain funding sources. CCV relies in part on debt to fund its business operations. CCV currently has up to $150m of facilities in place with Fortress until November 2020, with options for a two-year extension.*
- *Stock illiquidity. CCV is a thinly traded stock, with little share market liquidity.*

Source: Hartleys

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Hartleys Recommendation Categories

Buy	Share price appreciation anticipated.
Accumulate	Share price appreciation anticipated but the risk/reward is not as attractive as a "Buy". Alternatively, for the share price to rise it may be contingent on the outcome of an uncertain or distant event. Analyst will often indicate a price level at which it may become a "Buy".
Neutral	Take no action. Upside & downside risk/reward is evenly balanced.
Reduce / Take profits	It is anticipated to be unlikely that there will be gains over the investment time horizon but there is a possibility of some price weakness over that period.
Sell	Significant price depreciation anticipated.
No Rating	No recommendation.
Speculative Buy	Share price could be volatile. While it is anticipated that, on a risk/reward basis, an investment is attractive, there is at least one identifiable risk that has a meaningful possibility of occurring, which, if it did occur, could lead to significant share price reduction. Consequently, the investment is considered high risk.

Institutional Sales

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