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companyREPORT

Cash Converters Intl.

18th January 2012

GICS: Diversified Financials – Consumer Finance

Converting the Brand…

COMPANY DESCRIPTION

Cash Converters [ASX:CCV] is engaged in the franchising of second hand goods and financial services stores. The Company provides both secured and unsecured personal loans, pawn broking loans and cash advances. It is also the operator of a number of corporate stores operating under the Cash Converters brand.

INITIATING COVERAGE

Events

- **FY11 Results:** NPAT rose 27.5% to $27.6m on the back of a 47.6% jump in sales to $186.1m. A final dividend of 1.75c was declared taking the full year payout to 3.5c, representing a payout ratio of 48%.
- **UK business ramping up:** Strong FY11 result follows the continued expansion of financial services products into UK stores and store acquisitions.
- **Credit reforms review:** The Australian government have put forward proposals for interest rate and fee caps on payday loans. Legislative changes are likely to be in place around 2013.

Our view

- **Credit reforms likely to be scaled back:** We believe the recent parliamentary committee's findings into the proposed credit reforms and further industry consultation will see a 'watered-down' version of the interest caps introduced around calendar year 2013.
- **Store rollout to shield regulatory impacts:** We expect continued store rollouts and acquisitions in both the UK and Australian markets. This along with the introduction of financial services products into all UK stores should offset most of the negative earnings impacts of the proposed credit reforms.

Valuation | Recommendation

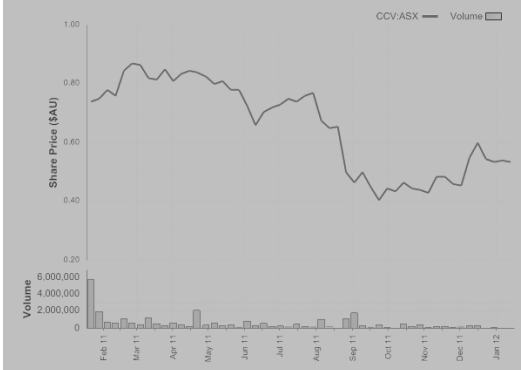
We initiate coverage with a STRONG BUY recommendation and a price target of $0.78, a 50% premium over the last traded price of $0.52. Despite the recent run up in the share price following the parliamentary committee recommendations on credit reforms, the longer-term outlook for the company remains sound. The defensive nature of the business in tough economic conditions and the fact it currently trades at a significant discount to its global peers justifies our recommendation.

CCV | **STRONG BUY**

Price Objective: **$0.78**

Last traded	A$	$0.52
Market Cap	A$'m	197.5
Nº of Shares	m	379.8
2011A EPS	¢	7.2
2012F EPS	¢	8.5
2012F PE	x	6.1
2012F EV/EBITDA	x	3.8
2012F DPS	¢	4.0
Forecast Div Yield	%	7.7
Sales 2011A	m	186.1
Sales 2012F	m	241.5
EBITDA 2011A	m	41.7
EBITDA 2012F	m	51.2
NPAT 2011A	m	27.6
NPAT 2012F	m	32.2

Share Price | 12month



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COMPANY PROFILE

Background

Cash Converters International's [ASX:CCV] main business is the provision of consumer finance, pawn broking services and second hand goods retailing. Since 2005, CCV has been working on enhancing their business model, and at present time has been increasingly active in the lending services sector, which has been becoming a substantial part of CCV's revenue. CCV's operations have also grown due to store rollout and acquisition of established franchise stores. CCV currently operates a total of 97 corporate owned stores and 522 franchise stores, located in Australia, United Kingdom and internationally. Further store expansions and franchise store acquisitions are expected.

BOARD OF DIRECTORS

Reginald Webb | Non-Executive Chairman

Mr Webb was appointed Chairman in January 2006 after serving as a non-executive director for many years. He is a Fellow of the Institute of Chartered Accountants of Australia and was for many years a Partner of PwC. In that position, he worked in North America and Europe as well as Australia. He was a partner for 20 years and served on the Policy Board of that firm. He is currently a Director of D'Orsogna Limited.

Peter Cumins | Managing Director

Mr Cumins joined the group in August 1990 as Finance and Administration Manager when the Company had just 23 stores, becoming General Manager in March 1992. He became Group Managing Director in April 1995. Mr Cumins is a qualified accountant, and has overseen the major growth in the number of franchisees in Australia as well as the international development of the Cash Converters franchise system. His experience in the management of large organizations has included senior executive positions in the government health sector, specifically with the Fremantle Hospital Group, where he was Finance and Human Resources Manager.

John Yeudall | Non-Executive Director

Mr Yeudall is a Chartered Engineer and member of the Australian Institute of Company Directors. He was founder of the IKEA franchise in Western Australia. Mr Yeudall was previously Australia's senior Trade Commissioner in the Middle East and Consul General for Dubai. He joined the board in 2002.

William Love | Non-Executive Director

Mr Love has served as an independent director of EZCORP since October 2008 and has served as chairman of the Audit Committee of the EZCORP board of directors since November 2009. He joined the board of Cash Converters International Limited in 2009. Mr Love is a licensed Certified Public Accountant and a Certified Valuation Analyst, and since January 1993 has practised public accounting in the Austin, Texas based William C Love accounting firm. From 1972 to 1993, Mr Love worked with the accounting firm KPMG Peat Marwick and its predecessors, including appointments as Partner in Charge of Audit, Partner in Charge of Tax and Managing Partner of its Austin, Texas office.

Joseph Beal | Non-Executive Director

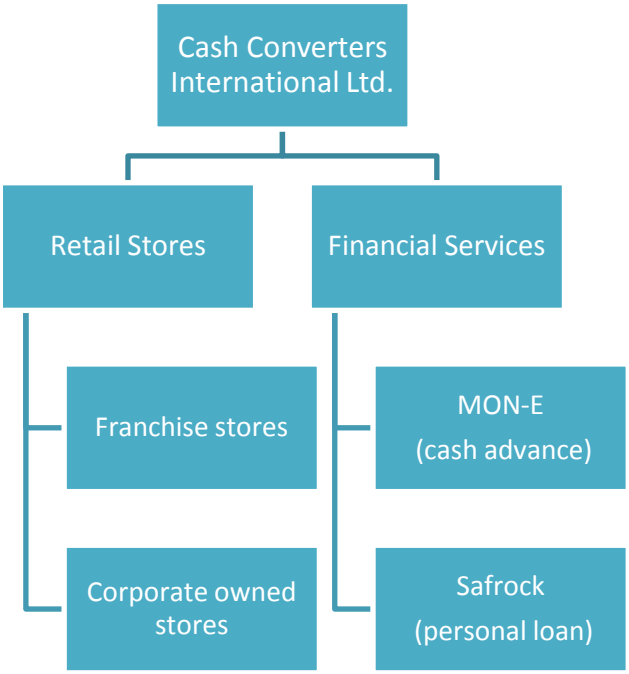
Mr Beal has served as an independent director of EZCORP since August 2009 and serves on the Compensation Committee. Mr Beal also joined the Cash Converters International Limited Board in 2009. Until his retirement in January 2008, Mr Beal was the General Manager and Chief Executive Officer of the Lower Colorado River Authority, a Texas conservation and reclamation district with over $1 billion in annual revenues, over $3 billion in assets and more than 2,200 employees. Mr Beal joined LCRA in 1995 to lead its Water Services Division and was appointed by the LCRA board in January 2000 to become its eighth General Manager and Chief Executive Officer. Before joining LCRA, Mr Beal was Senior Vice President and Chief Operating Officer at Espey Huston & Associates, an international engineering and environmental consulting firm based on Austin.

BUSINESS DESCRIPTION

Cash Converters operates two main business units, store operations and financial services (consumer credit). The store operations have historically been the core focus of the company as a legacy second-hand goods retailing business. However, management has shifted focus from a franchise based retailing operation to utilising the store network as a distribution channel for consumer credit products. The finance division of the company has now become a significant operation of CCV, contributing circa 71% of profit before tax in FY11.

Management have expanded into financial services products, which now account for the majority of profit before tax.

Figure 1: **Cash Converters divisional structure**



Source: Company data

Australia

The Australian operations consist of around 148 stores with 43 corporate owned stores and 105 franchise stores. Stores are represented in most states with the largest number in QLD. NSW is under-represented with only 17 stores. Further store expansion in NSW presents a lucrative opportunity going forward due to the greater population concentration. The overall strategy for Cash Converters is to acquire well-established and profitable franchise stores going forward. Product mix can be changed and stronger promotion of finance products will enhance store profitability.

Store numbers are under-represented in NSW providing future expansion opportunities.

UK

The UK operations include circa 208 stores of which 54 are corporate owned and 154 franchise stores. Management expects to continue acquiring well-established and profitable franchise stores, consistent with the domestic acquisition strategy.

Financial Services

Cash Converters also provides micro-lending, short-term lending (payday lending) and pawn broking services. This is an alternative source of credit for subprime borrowers. CCV has continued to grow its loan book as banks tighten up on their lending after the global financial crisis.

International

CCV has expanded its franchise operations internationally with 276 stores. Despite the large number of stores, revenue contribution is only minimal with operators given sub-franchisee licenses in return for a passive royalty revenue stream. We believe this could still be a key growth driver for CCV in the longer term with potential acquisition of some franchises as they become more established and profitable. We like CCV's model of transferring the risk of store expansion onto franchisees, reducing the risk of large upfront capex investment. Management have previously noted parts of Europe as potential regions to acquire well-run and profitable franchises. One key risk for the group is the negative impacts on the CCV brand if international franchisees fail to uphold the high standards expected by the Cash Converters management.

Figure 2: **Cash Converter's financial products**

	MON-E	Safrock (secured)	Safrock (unsecured)	Pawn broking
Type	Pay day loan	Personal loan	Personal loan	Pawn broking loan
Security	Unsecured	Secured	Unsecured	Secured
Average size of loan	Australia: $304 UK: £104	$2000-$5000	Average $1500	Average $90
Average length of loan	4 weeks	12-24 months	7 months	-

Source: Company data, Microequities estimates

Pawn Broking

Pawn broking involves taking personal items such as jewellery as collateral for small amount loans. A high percentage interest rate is charged on the loans to reflect the administrative costs in the provisioning of small nominal value. Personal items taken as security are normally sold if the customer defaults on the loan. Loan terms are typically one to three months in Australian stores and 6months in UK stores.

Retail Store Operations

Franchisees pay between $50,000 upfront to CCV to establish the business with weekly fees and charges. Cash Converters franchisees pay a fixed weekly amount (irrespective of turnover) in addition to a fixed contracted amount on every anniversary of the store opening. The Company also generates revenue via royalty payments from sub-franchisors, franchise renewal fee and support service fees from its franchisee network. There are currently around 613 Cash Converter stores in 18 countries with around 97 corporate owned stores in Australia (43) and the UK (54). FY11 turnover from franchise operations was $27.4m, contributing circa 13.8% of total revenue (FY10: 18.2%).

Figure 3: **Cash Converter's retail store comparison**

	UK store operations	Australian store operations
No. of franchise stores	154	105
No. of corporate owned stores	54	43
Store rollout plans	• 1 franchise store per month • 2 corporate stores per month	• 10 franchise stores per annum • 4 corporate stores expected in FY12 annum

Source: Company data, Microequities estimates

A franchise system was adopted to allow the Group to expand internationally and manage cultural and commercial differences around the world. Under the franchise agreement, Cash Converters provides each franchisee with the right to use the Cash Converters trademark, training system and business systems including inventory management, finance and advertising.

Australian franchise stores trade in second hand household goods, jewellery and personal items. It also provides pawn broking loans, cash advances personal unsecured and secured loans. UK franchise stores also trades in second hand goods, provides pawn broking loans, salary advance loans and cheque cashing services.

In the recent years, CCV has been acquiring established and profitable franchisee stores, and concentrated on increasing operating margin. Going forward, CCV has indicated further store acquisitions and potentially expanding its corporate owned store network into other international regions such as parts of Europe.

Key strategies include:

- Expanding the Cash Converter brand into new geographies and in existing markets
- Continuing acquisition of franchised stores and increasing funding capacity of cash advance and personal loan products

We expect CCV to continue its store acquisition program and expanding the rollout of financial services products.

Financial Services

Financial Services – Administration

Cash Converters provide pawn broking, cheque cashing (in the UK), 'Western Union' money transfers, short-term loans and cash advances. Cash advances are secured against a person's pay or salary (subject to it being paid into a bank account). The cash advance business (MON-E) has a current loan book of circa $223m.

Financial Services – Personal Loans

CCV's personal loans division (Safrock) includes the provisioning of both secured and unsecured personal loans. Acquired in 2006 the Safrock loan book has grown to circa $66m.

Key drivers of the financing business unit include:

- **Interest rate:** the interest rate charged by the pawn broking industry in general is under review by respective legislative authorities.
- **Critical Mass of Loans:** given the low average loan or advance values ($1,500 & $264 respectively), the profitability of the business relies on a critical mass of loans made.
- **Average loan or cash advance value:** the average personal loan is currently $1,500 whilst average cash advances are currently around $300.
- **Loan turnover rates:** the cash advance and personal loan businesses currently have average loan duration of 4 weeks and 7 months respectively. The turnover rate is critical in determining the amount of total loans written in a given period and upfront establishment fees received.
- **Alternative financing:** As the availability of financing options in Australia increase, CCV is likely to face increasing competition from banks as they increase their lending in smaller loans and higher interest rate products.

Management's strategy going forward is to continue the penetration of financial products into franchise and corporate owned stores, especially in its UK stores where the financing arm is still at a relatively early stage.

Figure 4: **CCV FY11 revenue by division**

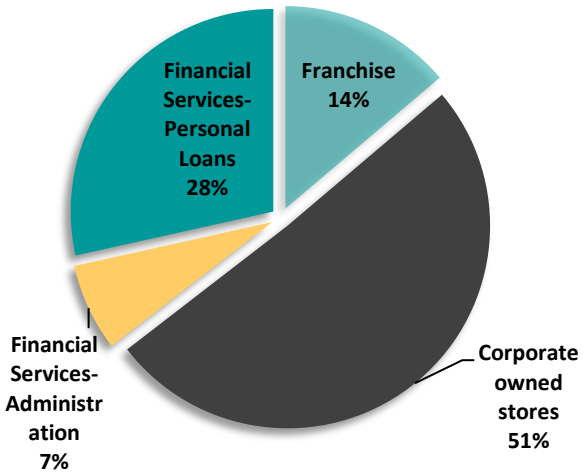
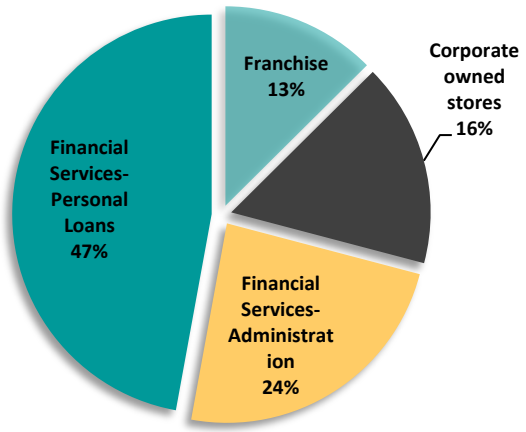


Figure 5: **CCV FY11 Profit before tax by division**



Source: Company data, Microequities estimates

INDUSTRY OVERVIEW

Second hand goods retailing

The Australian antiques and second hand retailing industry recorded circa $2.6bn in revenue for 2011 with annual growth of 3.7% from 2006 to 2011, according to IBIS World and 3.1% per annum growth for the five years to 2016. Second hand retailers have benefited as consumers facing rising costs of living cut back on discretionary household spending and look for cheaper alternatives. Prices of second hand goods have also declined significantly and their availability has increased dramatically as the product lifecycle of goods, especially technology products continue to shorten. The industry is facing competition from online auction and classified websites. The geographical barrier that previously limited the size of the market for buyers and sellers of second hand goods is non-existent these days with the increasing popularity of these online sites. Cash Converters is already countering this by focusing on customer service and the development of its online 'Webshop' to retain its loyal customer base.

The antiques and second hand retailing industry is expected to show 3.1% p.a. revenue growth for the next five years.

Figure 6: **Cash Converter's online retail platform: Webshop**

Source: http://webshop.cashconverters.com.au/

Key drivers for the second hand goods retailing industry include:

1. **Consumer sentiment:** Declines in consumer sentiment is a positive for the second hand goods retailers as consumers favour the cheaper second hand goods over new goods.
2. **Competition from online classified and auction sites:** Competition from online auction and classified sites could reduce the number of people going into physical stores to purchase second hand goods. Online auction sites have driven the increase in second hand retailing as people can now easily transact with a global audience.
3. **Household disposable income:** Slower growth in real income due to rising unemployment and poor economic conditions is likely to result in stronger demand for second hand goods as consumers look to find savings where possible in their household budget.
4. **Interest rate:** Falling interest rates mean consumers are more likely to purchase new goods as the cost of financing their purchase is lower. Disposable income will also increase as

mortgage repayments decline as interest rates fall. We expect further interest rate cuts in 2012 with the major lenders expected to pass on a portion of the cuts.

Barriers to entry in the second hand goods industry are low. Capex requirements are low, supply of second hand goods is growing and the industry is highly fragmented. The main barriers include:

1. **Access to capital in a post GFC environment:** Bank lending has been cut back since the GFC with debt funding difficult to establish a business.
2. **Licenses:** State laws administered by the Department of Fair Trading in each state require used good retailers to be licensed as second hand dealers

Alternative credit

Cash Converters also operate within the alternative credit industry. Main competitors in the cash advance business include traditional credit cards, specialist pawnbrokers and financial institutions. Key competitors to the personal loans business unit include traditional high street banks, pawnbrokers and financial institutions.

Cash Converters provide both short term and small amount loans. Negative perceptions of the industry within the general community means the company is more susceptible to regulatory scrutiny. The Australian Federal government is currently in the second phase of the COAG National Credit Reforms, part of their goal of introducing a nationwide consumer credit framework to increase the effectiveness of consumer protection. Regulations currently vary in different states as noted in the table below.

The Australian federal government's credit reform is a potential headwind for the payday lending industry.

Figure 7: **Consumer credit legislations in the various states**

Jurisdiction	Regulation
ACT	• A maximum cap of 48 per cent per annum, inclusive of fees and charges. • Credit providers are required to be registered. • Responsible lending obligations apply to credit card providers. • The ACT Government has not made an announcement about the future of its interest rate cap.
New South Wales	• A maximum cap of 48 per cent per annum, inclusive of interest, fees and charges commenced in March 2006. • In March 2010 NSW enacted legislation which continues, until 1 July 2011, its interest rate cap with amendments to expand the definition of credit fees and charges included in the calculation.
Northern Territory	• No interest rate cap or licensing/registration requirements.
Queensland	• A maximum cap of per cent per annum, inclusive of interest, fees and charges. Current arrangements commenced on 31 July 2008. • Queensland has retained its interest rate cap.
South Australia	• No interest rate cap. However, following the release of a discussion paper in October 2006, South Australia developed legislation to introduce an interest rate cap which was put on hold in light of the impending transfer to the Commonwealth.
Tasmania	• No interest rate cap or licensing/registration requirements. • Introduced, but did not enact, legislation to restrict advertising of credit products where the total cost of credit exceeded 40 per cent per annum.
Victoria	• A maximum cap of 48 per cent per annum for unsecured credit and 30 per cent per annum for secured credit, exclusive of fees and charges. • Victoria has enacted legislation which continues its cap until 1 July 2011. • Credit providers are required to be registered. • Unfair contract terms have applied to credit contracts since mid-2009. • Mandatory EDR membership since March 2009.
Western Australia	• No interest rate cap. • Credit providers (except authorised deposit-taking institutions (ADIs)) must be licensed.

Source: Australian Treasury department

The Green Paper released in 2010 provided five alternative proposals that could be implemented:

1. Maintain the status quo with no further Federal government reforms
2. National interest rate cap
3. Introduce warnings on high cost products (improving disclosure requirements)
4. Prohibit rollover of loans
5. Restrictions on interest rates and fees

In our view, the government proposals that have the most significant impact on CCV's earnings are the following:

1. Credit providers must not enter into contracts (other than 'small amount' credit contracts) if the annual rate of the contract exceeds 48%.
2. Small amount credit contracts (loans of less than $2000 and for a period of less than 2 years) can charge a maximum establishment fee of 10%, 2% monthly interest rate cap and 200% cap on default fees.

Key government proposals include an interest rate cap and establishment fee cap on short term and small amount loans.

Further dialogue with industry is expected before the Bill is put before a vote in parliament. We believe the government will take into account the findings of the parliamentary committee and short-term finance product is a necessary form of credit for certain parts of the community. We believe the current proposals will be watered-down and introduced from calendar year 2013. Our model shows earnings will be partially impacted in FY13 before hitting a trough in FY14. On the upside, there is potential for a reduction in competition following the reforms and thus driving significant growth in the loan book. The UK business may also grow faster than we expect and offset most of the impacts of the regulations on the Australian operations. The UK Office of Fair Trading have looked at the same issue recently and concluded that price controls would not be appropriate for the payday lending industry.

We believe government's reforms will be implemented in CY13 with earnings hitting a low point in FY14.

COMPETITOR & PEER ANALYSIS

Albemarle & Bond [LSE: ABM]

Albemarle and Bond is a UK listed provider of pawn broking, financial services and jewellery products. The group has over 200 stores and operates under the Albemarle Bond and Herbert Brown brands. 27 new stores were opened in 2011, compared to 17 in 2010. Services provided include pawn broking loans, gold purchasing, unsecured loans and jewellery retailing. The company recently announced its 20th year of consecutive profit growth. Revenue in FY11 was up 24% to $101.9m with EPS growing 6% over the previous period. The company in its outlook statement forecast strong demand for short term loans as mainstream banks cut back on lending.

Money3 Corporation [ASX: MNY]

Money3 is a provider of short term credit of between $100 and $20,000 for terms up to 36 months. Other services include cheque cashing, insurance and international money transfers. Money3 has expanded to 25 store locations around Australia and Singapore with the majority of stores located in Victoria. It currently has around 30,000 line of credit customers and 12,500 loan customers. FY11 saw the company deliver a NPAT of $2.4m on $13.5m of revenue. Revenue has grown at an annual compound rate of 20.5% since FY07 with EPS growing 10.8% p.a. during this period.

FlexiGroup [ASX: FXL]

FlexiGroup is a provider of vendor and retail point of sale finance and telecommunication products. The business operates under four distinct business lines, FlexiCommercial (leasing to medium and large business customers), Flexirent (leasing and loan provisions to both consumer and business customers through retail chains such as Harvey Norman, Good Guys, Bing Lee, Apple Resellers, Flight Centre and Noel Leeming), Blink (mobile broadband product offered through major retail chains) and Certegy (interest free and cheque guarantee services through key partners including Modern Group, Midas, Michael Hill Jewellers and Freedom Furniture). FlexiGroup operates across numerous industries, including IT and electrical equipment, home furnishing and improvement, medical and travel.

Silver Chef [ASX: SIV]

Silver Chef provides B2B equipment rental for the hospitality industry and general commercial equipment markets. Rentals are initiated through a network of third party equipment dealers and operate under the Silver Chef (hospitality) and GoGetta (broader commercial asset market) brands. The dealers are incentivised to promote Silver Chef products allowing sales to be conducted at the full retail-price. Since the business began 25 years ago, it has evolved with the launch of the GoGetta brand in 2008, entering the non-hospitality assets market.

Thorn Group [ASX: TGA]

Thorn Group, (formerly Radio Rentals Australia Ltd) provides electrical and household appliance rental and purchase plans. Products offered for rent include audiovisual equipment, whitegoods, IT equipment, and furniture and gym equipment. The company operate a number of different brands. Radio Rentals and Rentlo (South Australia) offer rental plans for home and office IT equipment on 18 month and 36 month contracts with an option to purchase the product at the end of the lease term. The group also offers unsecured personal loans to consumers under its Cashfirst brand. Thorn Business Services provides equipment rental solutions to businesses and government clients. A fourth arm of the group, National Credit Management Ltd provides credit receivables management services throughout Australia.

ThinkSmart [ASX: TSM]

ThinkSmart Limited provides point of sale finance for IT equipment leasing to the small and medium businesses and general consumer markets. TSM provides SmartPlan, a rental finance offering through the PC City and PC World stores in Europe and RentSmart, through computer and electronics retailers in Australia and New Zealand. The company also has also developed a proprietary credit approval system, SmartCheck allowing both in-store and online automatic credit checks and approvals. TSM's main geographical markets include Australia, New Zealand, United Kingdom and continental Europe.

SWOT ANALYSIS

STRENGTHS

- CCV's extensive store footprint, client base, ability to grow its loan book and strong management experience.
- Established systems, processes, software and first or second mover into new markets.
- The conversion to corporate stores allows CCV to better control its product range, store opening hours and brand image. It also allows greater promotion of its financing products driving increased awareness and profitability.
- Strong brand recognition in Australia with advertising on mainstream media platforms.
- Acquisition of franchise stores at low EBIT multiples is testament to the financial discipline of management. After converting to a corporate model, a wider product range can be implemented to improve profitability.
- Strong balance sheet after the placement with EZCORP, conservative gearing levels and strong free cash flow. Store acquisitions continue to be funded from cash flows.
- Bad debt as a percentage of the total loan book is relatively low. This is testament to CCV's internal credit application approval system.

WEAKNESSES

- CCV over the last few years have revamped the business with consumer credit now making up the majority of annual EBIT. The business is now largely a finance and dependent on loan growth to drive future growth.
- Future growth and shareholder value creation also depends on management's ability to acquire franchise operations at low EBIT multiples.
- There could be a disparity between what management expects of franchise operators and what is actually happening. Unscrupulous lending practices and poor customer service could severely damage the Cash Converter brand. CCV have put in place franchise covenants to protect the group from these potential risks.

OPPORTUNITIES

- The current credit reporting standards in Australia only flags people who have made a late payment. Proposed changes to credit reform will also show the positives such as people with a good track record of on time payments. This will help CCV to assess the credit worthiness of potential borrowers.
- Conversion of franchise stores to corporate owned stores in the UK could improve the product range and profitability. The current economic climate cold flush out desperate sellers at low EBIT multiples.
- There will be increasing growth in the amount of second hand goods that CCV receives with a shortening in the product lifecycle of technology and household goods. This will put downward pressure on the prices CCV pays for second hand goods. This could also lead to increasing demand for consumer credit to purchase new products.
- Further store expansions domestically and internationally will supplement organic growth. CCV could also benefit by rolling out its consumer credit products into all of its existing stores.
- Outside of the UK and Australian markets, we see potential expansion into North America and Asia through a master franchise model or JV similar to the one originally proposed with EZCORP, reducing the risk of high upfront capex. The size of these untapped markets presents a lucrative opportunity to derive significant growth.
- Potential changes in regulation of the pay-day lending industry and unfavourable credit conditions could result in a lessening of competition in the provisioning of consumer credit. After the global financial crisis in 2009, many banks cut back on the provisioning of sub-prime loans and short term unsecured loans.

THREATS

- The payday lending industry is often perceived as vultures. Government and welfare organisations will use this perception to call for tighter regulation. The Australian federal government proposals for interest rate caps on payday lenders could have severe impact on CCV's profitability. Any major regulatory reforms will not come into effect before from FY13 at the earliest. CCV's response to date has been to ramp up overseas expansion.
- Competition from other lenders offering alternative credit solutions such as credit cards, redraws on mortgages and interest-free loans. This will reduce the attractiveness of CCV's products and put downward pressure on loan volumes and interest margins.
- Weak economic outlook is likely to impact on discretionary spending and could lead to a decline in same store sales in CCV's store operations. On the other hand, consumers may increasingly choose to buy from second hand goods retailers in tough economic times.
- Continued decline in IT equipment prices has accelerated with increased obsolescence and rapid development in new technologies. This will reduce the re-sale value of second hand goods and may place pressure on retail margins.
- The online retail environment poses a potential threat to CCV with auction sites such as eBay eliminating the geographical barriers when individuals sell their second hand goods.
- Volatility in the gold price affects the value of jewellery used as collateral for pawn broking loans. If clients default on their loans, the full amount may not be recoverable.

FY11 RESULT

Strong result all round

FY11 NPAT was up 27.5% from pcp to $27.6m on the back of a 47.6% jump in sales to $186.1m. EBITDA of $41.7m showed a 25.4% improvement from pcp. A final dividend of 1.75c was declared taking the full year payout to 3.5c, representing a payout ratio of 48%.

FY11 NPAT was up 27.5% from store acquisitions and rollout of financial services products into UK stores.

Driving the growth in revenue was a rise in personal loan interest revenue, establishment fees, corporate store revenue and financial services commission. The acquisition of existing franchise stores continued with a further 21 store acquisitions (6 in the UK and 15 in Australia). Fourteen greenfield corporate owned stores were opened in the UK and one in Australia. Corporate store revenue was up 61.3% to $100.9m with partial contribution from stores acquired during the period.

The Australian personal loan book expanded by 36.1% to $52.7m and the UK personal loan book was up 746% to £5m. The cash advance administration platform delivered $12.3m in EBIT up 35.6%.

The share price has been depressed for the best part of 2011 due to the uncertainties over the outcomes of the Federal government review of consumer credit legislations. A parliamentary committee consisting of five Labour members, four Liberals and one Green recently reviewed the proposed Bill.

Key recommendation included:

1. The government should 'revisit' the proposed caps on interest rates and establishment fees
2. Any changes should not to be put in place before calendar year 2013.

We believe the government will come to a compromise with industry and put in place a watered-down version of the original proposals. The introduction of any changes is likely to be delayed until the beginning of calendar year 2013. However, going by the government's past track record, there is always the possibility of erratic and unpredictable proposals. Despite the negative perceptions of payday lender in the wider community, the facts remain that this is a key source of funding for low to medium income borrowers. The low default rate and repeat customers (i.e. each CCV payday lending customer borrows four times a year) backs up this view. Actual borrowers using Cash Converters' services have already voiced their concerns to the proposed caps on "nocap.com.au", a website launched by CCV as part of its campaign against the credit reform bill.

FY12 FORECASTS

National Consumer Credit Reform

The Australian federal government has undertaken a review of the price control methods put in place by various states and the potential implementation of a common national approach to price control. The proposals include a cap of 10% for the initial establishment fee and a 2% monthly cap on interest rate charged on the loan. The government has already flagged any proposals will not be implemented before the middle of 2012. The parliamentary committee has recommended a CY13 start to any proposals, and we feel this is most likely with the government taking more time to consider arguments from key stakeholders. Any attempts by government to force legislations through the parliament will

face strong opposition from CCV's large customer base.

In our modelling, we have taken into account a scaled back version of the government's original proposals from CY13 onwards. Our model indicates NPAT would reach its trough in FY14 at $24.5m. Over the longer term, we believe the continual growth of the UK store and loan book will counteract the negative impacts of the Australian business. Domestic legislation changes could also drive down competition and see stronger than anticipated loan volume growth.

We believe the credit reforms will be scaled back and implemented at the start of CY13.

Figure 8: **CCV – Financial forecasts summary**

Figures in A$'million unless stated	FY11A	FY12F	FY13F
Revenue	**187.6**	**243.1**	**250.4**
Operating Expenses	**-145.8**	**-191.9**	**-208.2**
EBITDA	**41.7**	**51.2**	**42.1**
% Chg YoY	*25%*	*23%*	*-18%*
EBITDA Margin	*22%*	*21%*	*17%*
Depr & Amortisation	-3.0	-5.3	-6.6
EBIT	**38.7**	**45.9**	**35.5**
EBIT Margin	*21%*	*19%*	*14%*
Net Interest Expense	.5	.0	.1
Profit Before Tax	**39.2**	**46.0**	**35.6**
Tax Benefit (Expense)	-11.6	-13.8	-10.7
NPAT	**27.6**	**32.2**	**24.9**
Extraordinary items	.0	.0	.0
Normalised NPAT	**27.6**	**32.2**	**24.9**

Source: Company data, Microequities estimates

Key Growth Drivers

1. Franchise store acquisition

Currently, there are over 600 Cash Converters franchised stores, and while franchised stores contribute to CCV revenue stream through passive franchise fees, the advantages of owning the stores include:

- Opportunity to improve store performance and profitability (through better training of staff (pricing/sales techniques, and implementation of other "know-how" methodologies)
- Better control over the implementation of advised corporate changes
- Introduction of financial services products to improve profitability

We believe acquisitions going forward will be funded through various combinations of debt, equity and cash. Based on recent transactions of around 3.5 to 4 times EBIT multiples, we believe future

acquisitions will be priced at around 4 to 4.5 times EBIT multiples. We expect CCV to pay around A$1.2m to A$1.4m for each store.

2. Developing existing corporate owned stores:

Financial services products such as cash advances could be rolled out into existing corporate owned stores to further increase profitability. Store refurbishments have historically driven an increase in the amount of transactions and coupled with brand image renewal and the increased marketing campaigns, have contributed to a revenue growth. Profitability and increased profit margins remain a key issue for the management in the upcoming years, which is tackled through increased pricing training and valuation techniques. Cash Converters management sees the UK as a key market, and therefore we expect to see high corporate store and financial services growth coming from the UK.

3. Further international expansion

Further store expansions into the UK and the rest of the world present an excellent platform for growth. The previously proposed strategic alliance with EZCorp identified North and South America and other regions of the world as potential markets to expand CCV's presence.

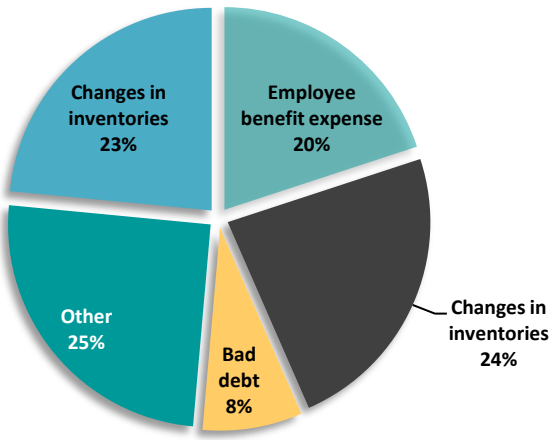
EZCorp Takeover

EZCorp decided not to proceed with the acquisition of further shares in CCV and the two joint ventures following doubts over the outcome of the Australian credit reform review. Although we are certainly disappointed with this outcome, greater certainty around the proposed credit reforms could see renewed corporate interest from EZCorp.

Opex

Total expenses were up 55% in FY11 to $148.3m from pcp. We forecast a 33% increase in total expenses for FY12 with significant cost increases in employee expenses, depreciation and changes in inventories due to the acquisition of corporate owned stores.

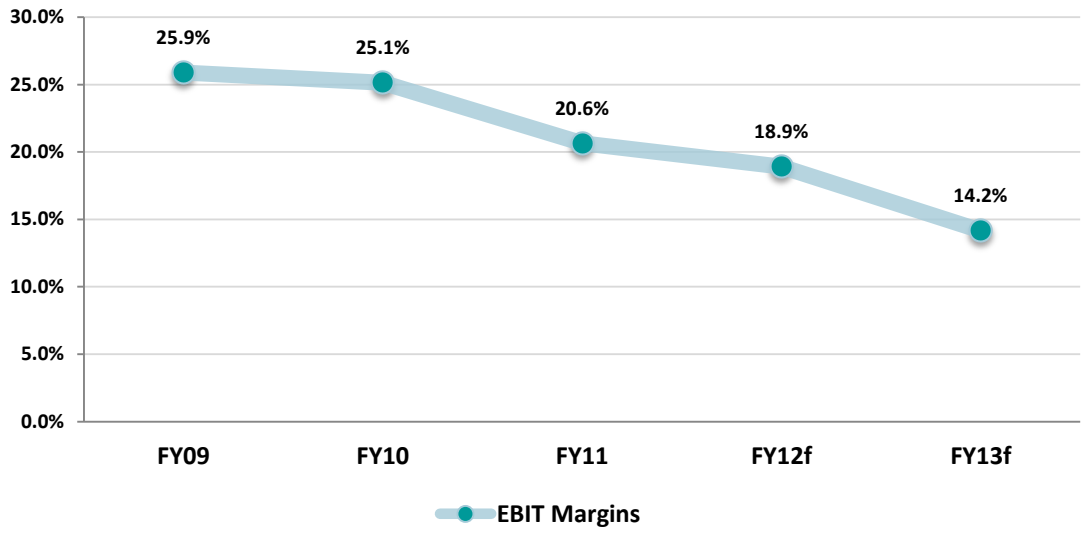
Figure 9: **CCV – Operating expense composition FY11**



Source: Company data, Microequities estimates

We expect continued EBIT margin decline with the introduction of the credit reforms halfway through FY13 having the most pronounced impacts on margins.

Figure 10: **CCV – EBIT margin forecast**



Source: Company data, Microequities estimates

Balance Sheet

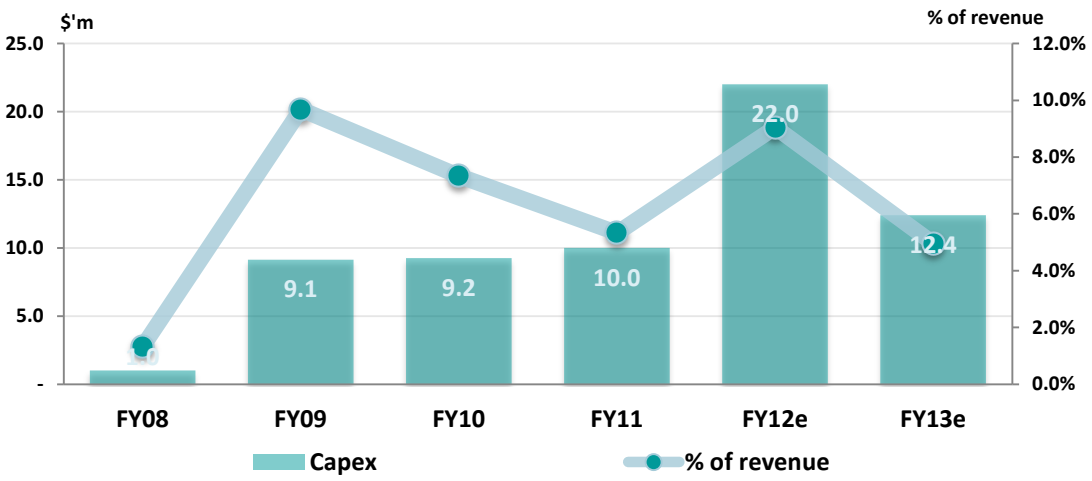
The business is well funded with a strong cash balance of $23.5m. Most of the cash holdings will be used to acquire franchise stores and expand the loan book. We forecast the dividend policy to remain at around 50% of full year NPAT. Accordingly, we forecast total dividend for FY12 of 4.0c.

Capex

Capex requirements are relatively modest with regard to store refurbishments. We forecast another five Australian stores to be refurbished in FY12. Most of the capex going forward relates to the acquisition of franchise stores and opening of greenfield stores. We expect the acquisition of each store to cost on average $1.24m (including acquisition costs) with a corresponding increase in inventory. We forecast capex of $22.0m in FY12 and $12.4m in FY13.

We expect the majority of capex to be related to store acquisitions and greenfield store openings.

Figure 11: **CCV – Historical and forecast annual capex**



Source: Company data, Microequities estimates

INVESTMENT CASE

Promising geographic expansion plan	Cash Converters has identified the United Kingdom as a target growth market, and plans a considerable increase in both franchisee and corporate stores to capture a larger share of the UK second-hand retailing market. The stores however, are not only sought for the potential retail revenue, but will be used as a platform for the financial services business, as CCV has indicated, that financial services will be a key driver of their growth, and therefore we expect a significant increase in the UK loan book over the next three years.
Brand image upgrade	Since 2005, Cash Converters has been working on changing its corporate image, completely revamping the interior of the stores, changing logos and changing sales techniques to attract long-term customer loyalty. Cash Converters pricing strategy revolves around long-term loyalty, which means that every time a customer returns with a new product to sell, Cash Converters sales team will aim to increase their profit margins.
Diversified revenue streams	Changing the brand image was only a part of the Cash Converters company restructuring process. In 2006, CCV purchased Safrock and MON-E, in order to incorporate financial services within their store structure. The business model of receiving weekly franchise fees in 2005 changed to having corporate stores alongside franchisees, and incorporating loan and cash advance business within this structure.
EZCorp Possible Acquisition	In May 2010, EZCorp increased its stake in CCV to 33% from 30%, through an equity raising of 16,200,000 shares at $0.60. Although EZCorp has pulled out from taking a further stake in the business, they remain a major shareholder and thus a full takeover offer of Cash Converters cannot be ruled out sometime in the future. In any case, we expect EZCorp to remain committed long-term investors in Cash Converters. They have already shown this with their long-term shareholding in UK listed pawnbroker Albemarle & Bond.
Online Web-shop and lending business	As eBay is considered a significant competitor in the second-hand retailing industry, Cash Converters has created a web-shop, where the goods sold in the stores can be found and bid online. Web-shop is still in an early stage, potentially increasing brand awareness. CCV sees this as a potential to increase store sales in future years.

Strong corporate stores revenue growth	Through corporate training, the staff at Cash Converters (including franchisees) go through pricing techniques, which both aim at increasing customer loyalty, and increasing profit margins with every next sale/purchase. Cash Converters usually applies a 55%-60% mark-up on the goods sold in the stores.
Fast loan book growth	The loan book has increased by 75% from FY09 to FY10, and based on CCV management's plans to increase financial services in the UK and Australia, we expect the loan volumes to show double-digit growth in FY12 and FY13 for both Safrock and MON-E.
Low bad debt ratios	Cash Converters Limited has managed to weather the financial storm relatively well, with bad debt staying at relatively low levels in FY08 and FY09 at 7.61% and 6.46%. FY10 shows a similar trend, with bad debt expense decreasing to 5.3%. In the years ahead, we expect the bad debt ratio to slightly increase to 5.5% as the UK economy continues to weaken as cash advance loan book ramps up.
Attractive valuation	Cash Converters is trading at a significant discount to our DCF and PE blended valuation of $0.78. It is also trading below the peer average forward PE multiple of 7.6x. We believe concerns over the domestic payday lending reforms have already been factored into the share price and thus there is minimal downside risk.

RISK ANALYSIS

Cash Converters is exposed to the fluctuations in the retail industry through its franchise and corporate owned retail stores of second hand goods. More recently, there have been increasing pressure on governments to place a cap on interest rates charged by payday lenders. Enactment of such legislation domestically and in Cash Converters' international markets could affect its profitability and its share price. We have identified the following general risk factors pertaining to Cash Converters: *(list is not exhaustive)*

- **Corporate stores sales risk.** We expect an uptick in consumer confidence and spending as economies recover from the GFC. However, second hand stores, which profited from fire sale of inventory during the GFC, might not be able to achieve the same margins and levels of sales, due to:
  - Decreased bargaining power by the store staff, we assume that significant amount of clients who sold their inventory during the GFC were willing to sell at heavily discounted prices, which we believe might change as the GFC subsides, and which might decrease the profit margins of the stores.
  - Decreased amount of inventory might be brought into the store compared to GFC period, which is counterbalanced by increased advertisement of Cash Converters stores, and a more attractive branding

  Other corporate stores sales risk might include slow inventory churn, mispricing of inventory (underpricing valuable goods, or overpricing goods which are not highly demanded) and low demand for second hand goods.

- **Poor consumer sentiment.** Trends in consumer confidence levels affect the demand for antiques and used goods. Consumer confidence levels are at the troughs in the cycle with global uncertainty putting further strains on confidence levels. Whilst confidence levels can dampen retail spending levels, Cash Converters may outperform during tough economic conditions with consumers likely to choose cheaper second hand items.

- **Credit risk.** The company is exposed to a range of credit risks in different parts of the business units. In the pawn broking division, goods provided as collateral may decline in value and thus the full amount owing may not be entirely recoverable in the event of a default. A decline in the gold price could reduce the value of jewellery provided as security. The lending division is exposed to the risk of personal loans remaining unpaid due to worsening economic conditions and unemployment. These loans may need to be written off and will ultimately affect the profitability of Cash Converters. The retail division also faces the risk that goods will have to be sold at prices below the cost for which they were bought. This is a particularly relevant during the current economic conditions where a combination of slow retail sales and the high Australian Dollar driving down the price of new technology imports, are putting significant downward pressure on second hand goods.

- **Funding.** CCV currently has a revolving credit facility with Westpac to provide capital for expansion through store purchases and for rolling out the Group's financial products in the UK faster than it could achieve through cash flows. CCV is required to maintain certain financial ratios and bound by covenants in the Westpac Facility Agreement. The credit facility expires in March 2015. Volatile credit markets may make it difficult to rollover the facility. This could result in forfeiting rights on properties, closing down stores and or restrict future expansion plans.

- **Retention of key staff.** The company's ability to operate and expand may be constrained by the availability of key store personnel, e.g. second hand goods valuers. Without these key staff, items may be incorrectly valued which could limit their ability to recover the full amount on an unpaid loan. Business relationships, specialist skill and knowledge may also be lost if key personnel are not retained, restricting the ability of the company to grow.

- **Reputational risk.** The overall group is not responsible for the day-to-day managerial control over the franchise stores. A major risk of the franchise model is the potential damage to the Cash Converter brand if a franchisor fails to uphold the high standards of the company. With the company also selling its master franchise license in other

geographical locations, the risk to the brand becomes elevated. The company has put in place covenants to protect the company's reputation, including the use of franchisor's brand, trade name, goodwill and reputation. The franchisees must report to the franchisor including weekly reports on the operations and financial information. The company is also at risk from poor public perception. There is a public perception that companies in the pay day lending industry are predatory in terms of the effective interest rates charged. Community groups, the media and legislators encourage consumers to hold this perception. This could result in a decrease in demand for loans and impact on the company's profitability.

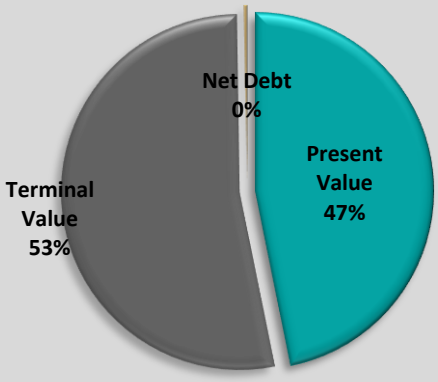
- **Competition from online retailers and auction sites.** The shift to online retailing along with the growth in online auction sites has meant consumers are no longer bound by a certain geographic location. Increasing range of merchandise are being sold online with consumers choosing to dispose of their second hand goods through online auction websites such as eBay.
- **Competition in the payday lending industry.** The microfinance and payday lending industry in Australia is highly competitive. The main competitors and their products include specialty finance brokers, banks offering personal loans and credit cards. These products often offer bundle products and lower interest rates but we believe with more stringent credit checks. Cash Converters' however, targets a specific demographic for their retail financing division, who are highly loyal customers. In addition, Cash Converters uses the corporate stores as a platform for their retail financing division, thus bundling their products (selling corporate store items through a loan, and increasing usage of corporate store space by having retail financing offered through their corporate stores).
- **Increase in bad debt**. In the last three years, the average bad debt on Safrock loans has been around 6.85%, while the highest it has reached was 7.61% in 2008. Potential increases in bad debt in times of tough economic conditions or due to poor internal credit checks could dent profitability. Whilst the Australian economy is fundamentally sound with unemployment rates under the long-term average, the UK economy remains fragile.
- **Regulation risk – New South Wales**. The 48% interest rate cap in New South Wales limits Cash Converters to charge an annual rate of over 48% in New South Wales. This regulation significantly decreases the amount of annual interest rate charged to the customer. The Federal government has proposed a cap on interest rate charges starting in July 2012 at the earliest. The proposed changes would stipulate a 10% establishment fee and an interest rate on the loan up to a maximum of 2% per month.
- **Geographic risk**. Cash Converters has been increasing its presence in the UK market with further store rollouts and increasing the size the loan book. The UK and European economies remain weak with poor consumer confidence and high rates of unemployment. Further deteriorations in operating conditions could have a detrimental effect on the quality of the loan book and retail sales in Cash Converter stores.

VALUATION | RECOMMENDATION

DCF Valuation

Our DCF model provides us with a $0.92 valuation for CCV. We have used a fundamental BETA of 1.01, and a WACC of 10.59%. We have used a long-term growth rate of 1% in our DCF model.

DCF Valuation Breakup

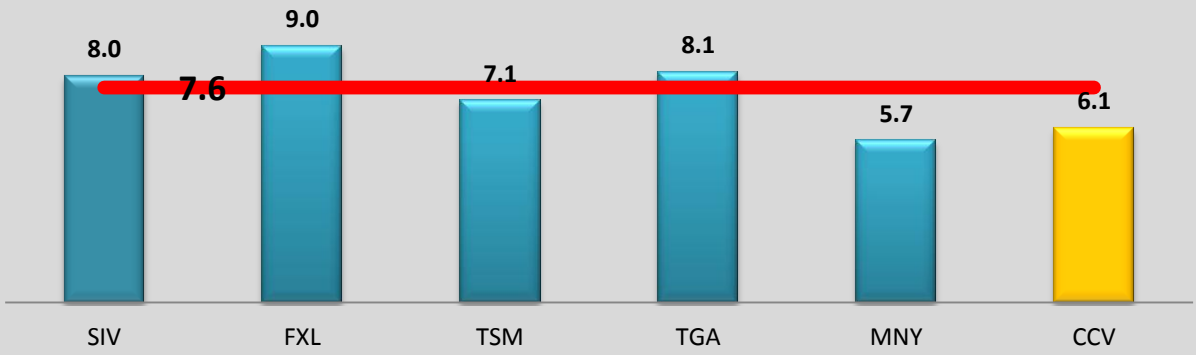


Key assumptions *(as at 16/01/2012)*			
Equity Beta:	**1.01**	**Debt:**	**$22.6m**
Risk free rate:	**3.67%**	**K_d:**	**5.02%**
Return on Equity:	**11.22%**	**WACC:**	**10.59%**
LT Growth Rate:	**1.00%**		

Relative Price/Earnings Valuation

We have undertaken a relative valuation using the most appropriate peer comparisons available. Using a forecast FY12 PE multiple of 7.6x, we have derived a relative valuation of $0.64 per share, representing a 23% premium to the last traded price.

Peer group financial summary (*as at 16/01/2012*)



Investment Opinion

We initiate coverage on Cash Converters International with a STRONG BUY recommendation and a price objective of $0.78. The price objective is based on a combination of our DCF valuation of $0.92 and our relative peer valuation of $0.64 which we have applied a peer group average forward PE of 7.6x.

CCV has a long and established track record for earnings growth. The market has punished the company in light of the proposed Federal government legislation on payday lenders and the withdrawal of the tie up with EZCorp. However, the steps taken by management to shield the company from potential regulatory threats such as expanding the UK lending business means the medium to longer-term investment case remains. Considering the share price decline from its highs, there is considerable upside once short-term concerns are alleviated.

TOP 20 SHAREHOLDERS LIST

CCV – Top 20 Shareholders as at 13 September 2011

		SHARES HELD	ISSUED CAPITAL
1.	EZCORP Inc	124,418,000	32.76%
2.	JP Morgan Nominees Australia Limited	21,227,307	5.59%
3.	HSBC Custody Nominees (Australia) Ltd	19,558,996	5.15%
4.	National Nominees Limited	13,091,752	3.45%
5.	Alli Nominees Pty Ltd <Madden Account>	11,726,597	3.09%
6.	Benos Nominees Pty Ltd	10,915,870	2.87%
7.	Hosking Financial Investments Pty Ltd <Hosking Investments A/C>	9,128,057	2.40%
8.	Fawngrove Pty Ltd <Global Graziers Family A/C>	8,273,792	2.18%
9.	Mrs Diana Kathryn Cumins <Diana Cumins Family No 1 A/C>	5,752,511	1.51%
10.	Mrs Heather Janette Hubbard + Russell Leonard Tyrrell <Hubbard Retirement Fund A/C>	4,493,926	1.18%
11.	Australian Executor Trustees Limited <No. 1 Account>	4,481,632	1.18%
12.	Merrill Lynch (Australia) Nominees Pty Limited	4,178,478	1.10%
13.	Mrs Merle Cooke <Cooke Super Fund A/C>	3,573,000	0.94%
14.	Citicorp Nominees Pty Ltd	2,734,255	0.72%
15.	Riolane Holdings Pty Ltd <Cumins Super Fund A/C>	2,273,519	0.60%
16.	RBC Dexia Investor Services Australia Nominees Pty Limited	2,246,100	0.59%
17.	Michael Edward Constable	2,233,801	0.59%
18.	CS Fourth Nominees Pty Ltd <Credit Suisse Equities Aust LTD>	1,844,049	0.49%
19.	Mrs Andreana Debra Groom	1,666,971	0.44%
20.	Toscana Holdings Pty Ltd <W Hubbard Family A/C>	1,664,282	0.44%
TOTAL FOR TOP 20 SHAREHOLDERS:		255,482,895	67.27%

FINANCIAL SUMMARY

PROFIT & LOSS SUMMARY ($m)			
Year Ending June	**2011A**	**2012F**	**2013F**
Revenue	**187.6**	**243.1**	**250.4**
Op. Expense	**-145.8**	**-191.9**	**-208.2**
EBITDA	**41.7**	**51.2**	**42.1**
% Chg YoY	*25%*	*23%*	*-18%*
% Margin	*22%*	*21%*	*17%*
Depreciation & Amortisation	-3.0	-5.3	-6.6
EBIT	**38.7**	**45.9**	**35.5**
% Margin	*21%*	*19%*	*14%*
Net Interest Expense	.5	.0	.1
PBT	**39.2**	**46.0**	**35.6**
Tax	-11.6	-13.8	-10.7
NPAT	**27.6**	**32.2**	**24.9**
Extraordinary items	.0	.0	.0
Normalised NPAT	**27.6**	**32.2**	**24.9**

PROFITABILITY RATIOS			
Year Ending June	**2011A**	**2012F**	**2013F**
Sales	**186.1**	**241.5**	**248.7**
% Chg YoY	*48%*	*30%*	*3%*
Price/Sales	1.1x	0.8x	0.8x
EPS (cents)	**7.2**	**8.5**	**6.6**
% Chg YoY	*9%*	*18%*	*-23%*
P/E	**7.1x**	**6.1x**	**7.0x**
Enterprise Value	196.6	196.6	196.6
EV/EBIT	**5.1x**	**4.3x**	**5.5x**
EV/EBITDA	**4.7x**	**3.8x**	**4.7x**
DPS	3.50¢	4.00¢	3.50¢
Dividend Yield	6.7%	7.7%	7.6%
ROE	*16%*	*16%*	*11%*
Debt to Assets	*10%*	*8%*	*8%*
Debt to Equity	*13%*	*11%*	*10%*

BALANCE SHEET SUMMARY ($m)			
Year Ending June	**2011A**	**2012F**	**2013F**
Cash & cash equivalents	23.5	17.9	22.0
Trade and other receivables	9.0	10.4	11.9
Inventories	14.1	16.9	19.4
Other Current Assets	66.4	85.2	101.6
Total Current Assets	**112.9**	**130.4**	**154.9**
Other financial assets	.0	.0	.0
Trade and other receivables	2.5	2.1	2.4
Property, Plant & Equipment	13.1	21.3	23.1
Intangible assets	20.0	24.7	26.3
Deferred tax assets	4.6	4.6	4.6
Other Non-Current Assets	76.9	76.9	76.9
Total Non-Current Assets	**117.1**	**129.5**	**133.3**
TOTAL ASSETS	**230.0**	**259.8**	**288.2**
Trade and other payables	19.7	20.9	22.1
Borrowings	4.6	5.0	5.4
Current tax liabilities	6.7	6.9	5.3
Other Current Liabilities	5.0	4.1	4.3
Total Current Liabilities	**36.1**	**36.8**	**37.2**
Trade and other payables	.0	.0	.0
Borrowings	18.0	16.4	17.9
Provisions	.0	.0	.0
Deferred tax liabilities	3.3	6.9	5.3
Other Non-Current Liabilities	.0	.0	.0
Total Non-Current Liabilities	**21.3**	**23.3**	**23.2**
TOTAL LIABILITIES	**57.4**	**60.2**	**60.4**
NET ASSETS	**172.6**	**199.7**	**227.8**

CASH FLOW SUMMARY ($m)			
Year Ending June	**2011A**	**2012F**	**2013F**
EBITDA	$41.7	$51.2	$42.1
Decre./(Incr.) in work. Cap	$5.0	-$3.0	-$2.8
Net Int. (Paid)/Rec	$0.5	$0.0	$0.1
TaxesPaid	-$11.6	-$13.8	-$10.7
Incr/(decr) in provisions	-$0.7	-$0.2	-$0.2
Other Op. Cash items	-$3.3	-$3.8	$3.1
Cash from Operations	**$31.6**	**$30.4**	**$31.6**
CAPEX	-$10.0	-$22.0	-$12.4
Disposals/(Acquisitions)	$0.0	$0.0	$0.0
Other Inv. Cash Flows	$0.0	$0.0	$0.0
Loans to/from other ent.	$0.0	$0.0	$0.0
Cash Flow From Invst.	**-$10.0**	**-$22.0**	**-$12.4**
Incr/(Decr) in Equity	$0.0	$0.0	$0.0
Incr/(Decr) in Debt	-$8.7	$1.2	-$1.8
Ord, Dividend paid	-$12.4	-$15.2	-$13.3
Preferred dividends	$0.0	$0.0	$0.0
Other Fin. Cash Flow	$0.0	$0.0	$0.0
Cash Flow From Fin	**-$21.2**	**-$14.0**	**-$15.1**
Net Incr/(Dcr) in cash	**$0.5**	**-$5.5**	**$4.1**
Forx & Disc. Op.	$0.0	$0.0	$0.0
Net Inc/(Decr) Cash	**$0.5**	**-$5.5**	**$4.1**
Equity FCF	$21.6	$8.4	$19.2

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RECOMMENDATION GUIDE

Recommendation	Market Price undervalued/overvalued to Microequities price objective
Strong Buy	**Above 40%**
Buy	**20 to 40%**
Hold	**0 to 20%**
Sell	**0 to -20%**
Strong Sell	**Greater than 20%**

ADDITIONAL VOLUNTARY DISCLOSURE BY MICROEQUITIES*

Investment Banking	Staff Interest	Analyst personal Interest	Equity Stake By Microequities	Disclosure to Company	Business Relationship
NO	NO	NO	NO	✓	✓

* To promote transparency, Microequities voluntarily discloses potential conflict of interests covered by this research document.

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- Microequities Pty Ltd has a research distribution agreement with Cash Converters International Limited.