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EZCORP, Inc. (EZPW)

Q3 2019 Earnings Call

CORPORATE PARTICIPANTS

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Scott Buck
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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, ladies and gentlemen, and welcome to the EZCORP Third Quarter Fiscal Year 2019 Earnings Conference Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session and instructions will follow at that time. As a reminder, this call may be recorded.

I would now like to turn the conference over to [ph] Michael Keim (00:00:31) Investor Relations. Please go ahead, [ph] Michael (00:00:34).

Unverified Participant

Thank you, and good morning, everyone. During our prepared remarks, we will be referring to slides which are available for viewing or download from our website at investors.ezcorp.com. Before we begin, I'd like to remind everyone that this conference call, as well as the presentation slides, contain certain forward-looking statements regarding the company's expected operating and financial performance for future periods.

These statements are based on the company's current expectations. Actual results for future periods may differ materially from those expressed or implied by these forward-looking statements due to a number of risks and other factors that are discussed in our annual, quarterly and other reports filed with the Securities and Exchange Commission. And as noted in the presentation materials and unless otherwise identified, results are presented on an adjusted basis to remove the effect of foreign currency fluctuations and other discrete items.

Now, I'd like to turn the call over to Mr. Stuart Grimshaw. Stuart?

Stuart I. Grimshaw
Chief Executive Officer & Director, EZCORP, Inc.

Thanks, [ph] Michael (00:01:42) and good morning and welcome to the third quarter results. If we turn to page 4 of the presentation, I would like to highlight the key themes from the quarter. The pawn metrics for the quarter remain positive with the continued strong underlying fundamentals. Firstly, we recorded total PLO growth of 4% and same-store loan growth of 3%. The same-store loan growth in the U.S. was a positive 2% and Latin America 3%. This resulted in PSC growth of 9% driven by the above PLO growth and also by slightly improved yield of 14% indicating an improving quality of loan portfolio.

Thirdly, merchandise sales were up 4% with merchandise margins slipping a little to 35% as we continue to focus on reducing our aged inventory position.

And fourthly, while net revenue growth remains strong at 5% despite lower scrap sales, EBITDA increased 19% year-on-year as a result of a continued focus on the cost reduction initiatives. The strong EBITDA performance resulted in EPS growth of 13% year-on-year to $0.18 per share. The slight decrement to the 19% EBITDA growth was primarily due to an increased depreciation charge and a higher relative tax rate to that of last year.

As previously outlined to the market, we retired $195 million of the June 2019 convertible notes from cash on hand. We also acquired seven stores in Nevada using cash which saw our cash balances reduced to $139 million overall. The cash generation from the quarter from operations was a pleasing $14.3 million.

We continue to remain disciplined on the acquisition front. And while we see attractive opportunities, the vendor asking prices should not reflect the desired returns and ROIC targets we've set for ourselves.

Turning now to page 5. The results of the last quarter highlight how we are serving our customers need for cash better than the market. This is reflected in the strong PLOs, PSC and merchandise sales growth numbers. We continue to expand with the seven recently acquired stores in Nevada and in Latin America with four de novo stores opened in the last quarter and 12 in total year-to-date. You'll recall we also acquired five stores in Mexico last quarter.

In terms of our more strategic investments, Evergreen continues to be on track for roll out at the end of this calendar year. As discussed previously, we have rolled out our Point-of-Sale 2, into 486 stores in the U.S. out of 514 with the remaining stores to be completed by the end of this current quarter. We advised last quarter that we had 55 stores in Mexico out of 351 on the Point-of-Sale 2 system. However, we had to roll back these stores due to some specific unique transaction issues that weren't fully accounted for configuration of the point of sale system 2. These issues have been resolved although it did cause a few hiccups at the store level initially. And we expect that Mexico will be fully completed by the end of the calendar year.

While this results in the three months delay what we originally envisage. We've always stated that having a fully operational system is more important than being dictated to by timeline. While on the issue of technology, on Tuesday, July the 9, we experienced a major system wide outage with our cloud provider. This outage impacted all of our stores throughout the U.S. and Mexico and lasted for 24 hours. The impact was that our stores could not access any of the retail systems needed to perform our normal day to day activities and resulted in stores closing in the U.S. and limited manual transactions in Mexico.

Although their services have been stable since the incident, we continued to work with the cloud provider to ensure no repeat occurrences and to address any potential weaknesses in their service. The dynamic pricing module that we spoke about in the last call will be piloted in 15 stores in the next few weeks. The focus is on electronic devices and starting one [ph] category (00:05:38) initially to test its accuracy and how it's accepted at the store levels.

Turning to Canada, CASHMAX has started to turn its performance around with the closure of a number of unprofitable stores, operational efficiencies initiated and a focus on the shorter duration loan product mix. The benefit of these management initiatives are just starting to be seen and we expect further improvements in the final quarter of this financial year.

Many of you would have seen the write-down of certain assets announced by cash converters in Australia. These are results of changes in management estimates of the useful life of software assets, as well as an independent assessment of the loan portfolio resulting in an increased write-off. While disappointing as adjusted earnings was in the expected range of $18 million to $20 million it does mean that the company is expected to book a statutory loss for the 2019 financial year. In terms of the balance sheet, as a result of the pay down of the June 2019 convertible, our net debt leverage ratio has reduced from 2.5 times 12 months ago to currently be at 1.7 times.

Over to you Danny for more detailed financials.

Daniel M. Chism

Chief Financial Officer, EZCORP, Inc.

Thanks, Stuart, and good morning, everyone. Turning to our financial results. On an adjusted basis diluted earnings per share increased 13% from the prior quarter to $0.18. Included in the GAAP results of $0.06 for the quarter was a $6.1 million adjustment in Latin America to correct the calculation of certain transaction tax liabilities in prior periods. $4.6 million of this reduced merchandise sales and $1.5 million increased interest expense.

On a go forward basis, I would expect the application of this tax to reduce merchandise sales in Latin America by 1.5% to 2% from what would otherwise have been expected. With no offsetting reduction in cost of goods sold, that's the same amount by which net revenues will be impacted. Also included in GAAP results for the quarter was a $1.8 million income tax benefit in the U.S. related to the expiration of statute of limitations on prior uncertain tax positions for which we had made a full accrual, compared to a similar $3.3 million benefit in the same quarter last year.

The current quarter's GAAP results include $1.4 million of corporate expense related to the investment in Evergreen and a $3.7 million increase in net interest expense. We use adjusted net interest expense to analyze the business. This removes the effect of non-cash interest expense related to our convertible debt, as well as non-cash interest income on our notes receivable.

Adjusted net interest expense was $1.1 million in the current quarter compared to $500,000 in the prior year quarter. In the current quarter, adjusted net interest excludes $5.4 million of non-cash interest expense and $1.3 million of non-cash interest income, the latter of which will decline as note principal is repaid monthly.

The $195 million of cash convertible senior notes that we repaid in mid-June represents $3.2 million of total interest expense in the current quarter. Separately, the adjusted results also remove a $5.2 million of favorable litigation settlement from the prior year period to keep the comparison as apples-to-apples as possible.

Turning to the adjusted highlights on slide 6, on a consolidated basis, the average balance of pawn loans outstanding or PLO was up 8% year-over-year with a slightly improved yield driving a 9% increase in pawn service charges or PSC. Ending consolidated PLO was up 4% reflecting acquisitions in new stores, as well as organic growth with same-store loans up 3%. The stores we acquired in Mexico last June are not yet included in the same-store. We've added 17 stores in Latin America year-to-date and acquired seven stores in Nevada last month for $7 million as Stuart mentioned including our first entry into the Reno market.

We closed two more consumer lending stores in Canada this quarter consolidating their loan balances in the nearby stores. Including new product development costs, our Canadian stores had a $300,000 negative EBITDA in the quarter. That's roughly $100,000 decrease in EBITDA year-over-year, a substantial improvement from the $900,000 year-over-year decline we saw in Q2.

Refocusing on pawn results, merchandise sales grew 4% in total and 1% on a same-store basis. Overall merchandise margins edged 90 basis points lower to 35%. Same-store sales growth in both the U.S. and Latin America has slowed a bit. The slower same-store sales growth in relation to average loan growth, de novo stores and continued expansion of the general merchandise business in acquired Latin America stores contributed to the overall increase in inventory balances.

With improved overall leverage in both operating and corporate expenses reflecting targeted expense management, the 5% net revenue growth translated to a 19% increase in EBITDA. The adjusted effective tax rate for the quarter increased a bit, reflecting refinement of the year-to-date estimate. I expect a fourth quarter effective tax rate of about 30% on our adjusted results.

For the quarter, adjusted EPS improved 13% to $0.18. Year-to-date adjusted EBITDA is up 9% to $72.2 million with adjusted EPS up 11% to $0.72. It's difficult to segregate and estimate the impact of the system issues Stuart mentioned, but it did impact the ability to make loans, collect PSC or sell merchandise during the impacted times. This will impact our PSC and merchandise sales in the fourth quarter in the U.S. and Mexico. We estimated impact to the EPS about $0.01 to $0.02 in the current quarter and expect it will impact the EPS next quarter by $0.03 to $0.04.

Slide 7 demonstrates the growth in EBITDA and EBITDA margins we've delivered longer term and the progress year-to-date. Year-to-date consolidated EBITDA increased $6.5 million or 9% with growth in both the U.S. and Latin America. Year-to-date EBITDA margins in the U.S. expanded 175 basis points in the quarter and 65 basis points year-to-date. Latin America pawn posted a 34% EBITDA margin in the current quarter and year-to-date, reflecting new and acquired stores and other factors I'll discuss in a minute.

Turning to the U.S. Pawn on highlights on page 8. U.S. pawn produced a 2% same-store loan growth at the end of the quarter, reflecting our continued focus on meeting our customers need for cash. Ending PLO per store showed similar percentage growth year-over-year, seasonally strong at $289,000. With slightly improved yields indicating the loan growth at high quality, U.S. pawn reported a 6% increase in pawn service charges. Merchandise sales were flat to the prior-year quarter. At 37%, merchandise margins remained in our target range but were roughly 60 basis points below the prior-year period, reflecting the effective liquidation of aged general merchandise now standing at 6%, improved from 7% at the beginning of the quarter.

Through effective expense leverage, holding expense is almost flat to the prior year. The U.S. pawn segment's 3% net revenue increase translated to a 9% EBITDA growth to $26.6 million. After lower depreciation, the segment's profit before tax increased 11%.

Turning to Latin America, slide 9 highlights total PSC growth of 21% on a 20% higher average loan balance outstanding during the period with yields relatively unchanged, including the impact of new and acquired stores.

Adjusted merchandise sales were up 17% in total and 7% on a same-store basis. Merchandise margins were approximately 100 basis points below the prior-year quarter at 29%. Margins are typically a bit lower in Latin America due to the higher concentration in general merchandise.

Operations expense increased 22% to $18.3 million including stores acquired or opened since the prior-year quarter and stores expanded or relocated. New, acquired and expanded stores are part of the overall Latin America growth opportunity, where they do temporarily suppress EBITDA margins.

Same-store operations expense increased 12%, primarily due to store licensing requirements recently enacted in Mexico, an increase in robbery losses and related security costs, and labor costs that increased at a rate slightly lower than the total revenue growth. The Latin America segment's adjusted EBITDA for the quarter was up 5% to $9.4 million. After depreciation and interest, the segment's adjusted pre-tax income decreased 4% to $8 million.

Turning to slide 10, we continue to maintain a strong balance sheet and disciplined capital management. As we mentioned, we repaid the $195 million of cash convertible notes in the quarter with cash on hand ending in the quarter with a net debt leverage ratio of 1.7 times and cash of $139 million. After taking into account daily cash needs and a buffer, that results in $70 million to $90 million of investable capital

On page 11, you can see the sustained operating cash flows over the past few years and $65 million produced year-to-date supplemented by payments from Alpha Credit notes receivable which remain on schedule. We anticipate receiving another $6.1 million of principal, plus interest from Alpha Credit in the remainder of fiscal 2019. In September, we expect to receive another $6 million, representing the first installment of the $14 million deferred compensation fee.

Now that you have a better understanding of the financial results, I'll turn the call back over to Stuart.

Stuart I. Grimshaw

Chief Executive Officer & Director, EZCORP, Inc.

Thanks, Danny. Let's turn to page 12. We provide a high level of the investment highlights. And I'll briefly cover the five items. Firstly, there's a strong growth history that we've established in an industry that has proven resilient over a long period of time and through many economic cycles.

Secondly, we continue to invest and enhance our ability to meet our customers' needs, to invest in a digital solutions such as that we're building in Evergreen. We remain uniquely positioned to disrupt for the circa 4 million customer base, unique technology being developed with assistance from Boston Consulting Group Digital Ventures, full transactional data on all of these customers that provides that rich credit profile coupled with a significant retail footprint. We also believe Evergreen will enhance the retention and acquisition of pawn customers, as well as attract completely new customers to a more fulsome financial services offering for this cash constrained customer segment.

Thirdly, there continue to be operations for inorganic growth but only at the right price. We are not acquirers of stores to solely increase store numbers, it has to make sense on many criteria. The recent acquisition in Nevada was one such instance of all things aligning.

We've seen the benefits of geographic expansion with the marginal net revenue increase from Latin America of $3.8 million being some 60% more than the marginal net revenue increase from the U.S. And finally, we continue to build on our financial and operational performance history that reflects our focus on meeting our customers' needs for cash better than others in the market.

With that I'll open up to questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from John Hecht with Jefferies. Your line is open.

John Hecht
Analyst, Jefferies LLC

Q

Thanks, guys, for taking my questions and good morning. First one is related to – you're Evergreen in the digital venture and the divestments in there. What milestone should we be looking for over the course of the year? How do we see the implementation? And then will there be more onetime expenses tied to this?

Stuart I. Grimshaw
Chief Executive Officer & Director, EZCORP, Inc.

A

Thanks, John. At the moment, we are still getting through the build of Evergreen which we anticipate will probably finish around that September, October timeframe. At that stage, we'll be operational so it will go out of the build into the launch. We're obviously going to do a soft launch first just to make sure it meets all the requirements that we're setting. It will have functional capability for the pawn stores as well by the time of release at the end of the calendar year.

So internally, we have a stage getting mechanism really under funding of it. You'll probably be able to see – later in the year, we'll be able to show you what the screens are like and how they're going to operate and what the product capability is, but from there, we'll turn into an operational expense which we'll clearly outline hopefully at the next call to give you the transparency that you require.

John Hecht
Analyst, Jefferies LLC

Q

Okay. And then you talked about declining margins in Mexico some expenses. Are these sort of transitional issues or are these sort of new run rate or how do we think about the development of Mexico metrics?

Daniel M. Chism
Chief Financial Officer, EZCORP, Inc.

A

Yeah. Good morning, John. I'd say there are a few things there. One of them was some new licensing requirements that went in in Mexico within the last year specifically. And that increased roughly $1 million in the quarter, de novo store costs as well are in there. I would expect some of that to be new run rate although the expenses obviously come on with that immediately where the revenues take a bit of time to ramp up with the portfolio. And then there were also some severance costs in the quarter. As you saw, there were some control issues and we've made a few changes in staffing in that operation to address some of those issues.

If I pull out all those, the expense increase in Latin America was probably closer to 8% on a kind of normal run rate with the licensing being on top of that, with inflation at about 5% to 8% in relation to revenue growth, I thought was pretty good. The other that I would say is included in that 8% also as we talked about last quarter was a bit of an increase in robbery expense and the spend on security costs related to that. Hopefully that will come back in line over time. But that remains a bit elevated currently

John Hecht
Analyst, Jefferies LLC

Q

Okay. And then last question is, you guys have done quite a few acquisitions in the past several quarters. I'm wondering if you could talk about the performance of the acquired stores. And then on top of that kind of opportunities that you did just referred to, Danny, you just referred to improving the performance, kind of what the ramp rate is on that opportunity?

Stuart I. Grimshaw
Chief Executive Officer & Director, EZCORP, Inc.

A

On the acquisitions, I think we've done three in Mexico in the last 12 months. Not too big, but they're operating well. I think we can still get improvements out of that. We're trying to get the new POS system into their – to actually increase the ability to lend more – I suppose more aggressively on the general merchandise than what we've seen. A number of the acquisitions have been capital constrained, so it takes a while to train the employees up on the general merchandise and the way we lend. So we're starting to see some of that benefit coming through now. Probably it has been a little bit slower because we did three recently quickly, but they're starting to hit their run rates now. What is the last?

Daniel M. Chism
Chief Financial Officer, EZCORP, Inc.

A

Yeah. I would just add on the acquisitions. The other on the last two that we did in June or the two that we did last June took a little bit longer than we had anticipated to get those on the – our point-of-sale system. Let's say that delayed some of the improvements that we expected to drive in it. But thus migrated over in December-January timeframe, so they're starting to respond as we'd expect.

Stuart I. Grimshaw
Chief Executive Officer & Director, EZCORP, Inc.

A

I'm sorry, John, what was the last one? Last part of the question?

John Hecht
Analyst, Jefferies LLC

Q

I think you guys – sort of as you buy a store typically, what is the ramp rate for improving other metrics?

Stuart I. Grimshaw
Chief Executive Officer & Director, EZCORP, Inc.

A

It's one of those ones that depends, depends on the quality of their acquisition. When we have ones without experience in general merchandise, we'll see some early move but typically by the end of the first year you'll start to see the improvements come through. Those stores that we purchased which are actually operating very well. You'll see a slower improvement over time. So it really is quite varied depending on the quality of the – the quality of the teams that we're buying under the acquisition.

Daniel M. Chism
Chief Financial Officer, EZCORP, Inc.

A

And I'd add. You'll see the – you should see the income statement improvement more quickly than you will cash just because there will be some additional investment as we grow the portfolio and some inventory, as well as a lot of those when we acquire them, need some capital investment. But that cash generally washes with the cash generation of those stores in their first year.

John Hecht
Analyst, Jefferies LLC

Q

That makes sense. Thank you, guys, very much.

Stuart I. Grimshaw
Chief Executive Officer & Director, EZCORP, Inc.

A

Thanks, John.

Daniel M. Chism
Chief Financial Officer, EZCORP, Inc.

A

Thanks, John.

Operator: [Operator Instructions] Your next question comes from Scott Buck with B. Riley FBR. Your line is open.

Scott Buck
Analyst, B. Riley FBR, Inc.

Q

Good morning, guys. I'm curious given the pricing headwinds on the acquisition front in Latin America whether we're going to see more transactions here in the states similar to what you did in June with the seven stores in Nevada.

Stuart I. Grimshaw
Chief Executive Officer & Director, EZCORP, Inc.

A

Hi, Scott. Yeah, it'd be good to see a number of those in the U.S. come through because they are larger PLO per store businesses and we like to increase the cash flow out of the U.S. There's still opportunity in Latin America and particularly in Mexico. And so we're hopeful we'll still see the acquisitions. They're not coming through as quickly as we can as we indicated some of the vendor issues on price have been somewhat challenging.

But with the recent sort of economic activity or lack of activity in Mexico we're starting to see a few more of the vendors come down their price expectations. So we can manage those as well. We're hopeful we can – we'll be able to transact. But there's nothing at this point of time that I can say would give me a 100% confidence that will happen but we still look pretty hard.

Scott Buck
Analyst, B. Riley FBR, Inc.

Q

That's helpful. Within the U.S. is the preference to acquire within the current footprint or expand into some new geographies?

Stuart I. Grimshaw
Chief Executive Officer & Director, EZCORP, Inc.

A

Depends on the quality of the operations. I mean as I said before we're not just chasing stores for stores sake, we think that there's good opportunity and probably our two key markets which is Florida and Texas. We like those areas. But we'd also – there are areas that we would like to expand into that we look at. But there aren't a lot of assets of size up for sale. Most of the stores, the chains that we've got are around that five to seven stores. So there's not – any acquisitions out of the U.S. are not likely to be big ones.

Scott Buck
Analyst, B. Riley FBR, Inc.

Q

Okay. Great.

Daniel M. Chism
Chief Financial Officer, EZCORP, Inc.

A

There's probably about 20, 25 states or so in the U.S. maybe a little bit more that have attractive pawn laws. So there are certainly geographies we just wouldn't have an interest in going into as well.

Scott Buck
Analyst, B. Riley FBR, Inc.

Q

Got it. That's helpful. Last one, I think, can you speak to kind of the pipeline for de novo store openings in Latin America. I mean, I think you did, what, four this quarter?

Stuart I. Grimshaw
Chief Executive Officer & Director, EZCORP, Inc.

A

Yeah.

Scott Buck
Analyst, B. Riley FBR, Inc.

Q

Is that an appropriate quarterly run rate to think about going forward?

Stuart I. Grimshaw
Chief Executive Officer & Director, EZCORP, Inc.

A

We'd like to increase that. The offset to that is making sure we get the right location which we know is the driver of the successful de novo strategy. We're going through those exact numbers at the moment, Scott. So probably later on, we'll be able to give you an idea of how we're thinking about de novo is for the next financial year.

Scott Buck
Analyst, B. Riley FBR, Inc.

Q

Perfect. Thank you, guys.

Stuart I. Grimshaw
Chief Executive Officer & Director, EZCORP, Inc.

A

Thanks.

Operator: There are no more further questions queued up at this time. I'll turn the call back over to Stuart Grimshaw for closing remarks.

Stuart I. Grimshaw
Chief Executive Officer & Director, EZCORP, Inc.

Thanks very much, everyone, for your interest in the results. It's been a great quarter. We look forward to talking to you with any questions you may have. Have a great day.

Operator: This concludes today's conference call. You may now disconnect.