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EZCORP, Inc. (EZPW)

Q2 2019 Earnings Call

CORPORATE PARTICIPANTS

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

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

OTHER PARTICIPANTS

John Hecht
Analyst, Jefferies LLC

Gregory R. Pendy
Analyst, Sidoti & Co. LLC

Scott Buck
Analyst, B. Riley FBR, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, ladies and gentlemen, and welcome to the EZCORP Second 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 call over to [ph] Michael Kim (00:00:30), Investor Relations. Please go ahead, Michael.

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 contains 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 risk 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 fluctuation 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, Michael. Good morning, everyone, and welcome to the second quarter results. If I turn to page 4 of the presentation, I'd like to highlight the key themes from the quarter. Firstly, the pawn metrics for the quarter have been extremely positive with strong underlying fundamentals. We recorded total PLO growth of 10% and same-store loan growth of 6%.

Same-store loan growth in the U.S. was a strong 5% and Latin America 9%. This resulted in PSC growth of 10%. Merchandise sales were up 6% with merchandise margin slipping a little to 36% from 37%. While net revenue growth remained strong at 6%, EBITDA slipped 3% year-on-year as a result of a number of factors. Firstly an increase in operations expense of $3.2 million in Latin America, of which around $1.9 million was due to new acquisitions, de novos, store expansions and enlargements.

And then the U.S. operations expense increased by $2.3 million primarily as a result for the annual wage increase coupled with the cost of a new compensation plan enacted this year. Increased corporate expenses of $1.2 million was a result of increased benefits expense, hiring fees for new talent particularly in the IT department and continued improvements in IT infrastructure.

We continue to look for opportunities to reduce this level of expense. Coupled with this was a lower equity accounted profit contribution from Cash Converters International as well as an increased loss in our Canadian business as we switched our product portfolio in Canada from single pay to multiple pay with a digital capability being developed.

This variance was a circa of $1.3 million negative impact on EBITDA. We're strategically reviewing the Canadian business having already closed three stores this quarter. While the revenue growth is very sound, the variant expenses has led to EPS of $0.22 a share which is flat to last year. In terms of our more strategic investments, which I'll cover a bit later, Evergreen continues to be on track for the end of this calendar year and we've now rolled out what we call our POS2 terminals to 505 (sic) [515] stores.

We continue to accumulate cash with the quarter end balance of $348 million which is sufficient for the board to consider the repayment of the June 2019 convertibles of $195 million. Since September 30, 2018, our cash balance has grown by $62 million. As you have seen, we've also strengthened the composition of the board with a number of new independent directors appointed over the last month. We remained disciplined on the acquisition front and while we continue to see attractive opportunities, the vendor asking prices do not reflect the desired returns and ROIC targets that we have set for ourselves.

Turning now to slide 5, the results of the last quarter clearly highlight in my mind how we're serving our customers' need for cash better than the market. This is reflected in the strong PLO, PSC and sales growth numbers. We continue to expand organically in Latin America with eight de novo stores, four expanded stores and five relocations. We also acquired five stores in Mexico during this quarter. As discussed previously, we have rolled out POS2 terminals into 404 stores in the U.S. out of 508 and 146 (sic) [111] stores in Mexico out of the total 351. Full rollout of POS2 should be completed by the end of this current quarter or early into the next quarter.

Turning to slide 6, and just to recap on the strategic digital initiatives we have underway and firstly with Evergreen, we remain very excited about the possibilities of this customer-centric digital platform. And just to recap some of the foundation thinking behind it, the estimated market size for financial services for the unbanked and under bank customers in the U.S. is around $175 billion in revenues, which we – EZCORP has an offering which is our pawn offering, which kept us only $1 billion of this revenue stream.

We remain uniquely positioned to disrupt this market with a circa 4 million customer base, unique technology being developed in conjunction with Boston Consulting Group Digital Ventures, full transactional data on from all of these customers that provide a rich credit profile and a significant retail footprint. What we generally see with many fintechs is a product mono-line and channel approach to the customer, typically with high customer acquisitions costs, whereas Evergreen will be capable of offering multiple solutions for either build, direct build or partnering, leveraging off the existing customer base that EZCORP has. We will integrate broader product offerings such as transactional accounts with this offering.

This past quarter has been spent continuing to develop the platform and work with partners to continue to build out the offering. We've also continued our customer research and discussions to ensure that production is consistent with the end needs of the user. We believe Evergreen will enhance the retention and acquisition of pawn customers, as well as attract completely new customers to a more fulsome offering.

Our other initiative is POS2 which is a platform that enables us to leverage product and customer insights. We currently have a number of stores using the dynamic customer grading system, and we are watching this group closely to ascertain any learnings that we can get from this. The first product in the dynamic pricing systems will be TVs, and this is aiming to be integrated by July of this year, and post that, we'll gradually roll in pricing around laptops and tools.

Over to you Danny for the financials.

Daniel M. Chism

Chief Financial Officer, EZCORP, Inc.

Thanks, Stuart, and good morning, everyone. As noted in our earnings press release, prior-period results have been corrected primarily for the overstatement of historical balances of pawn service charges receivable discovered in our account reviews. None of the corrections were material to any prior period, compared to amounts previously reported the corrections reduced net income from continuing operations in the prior-year quarter by $200,000 with no change in diluted EPS. In the first quarter of fiscal 2019, included in the current year-to-date results, the correction increased previously-reported net income by $900,000 or $0.01 per share. Greater detail in these adjustments are included in note one to the financial statements in the 10-Q we filed yesterday.

Separately, you may have noticed we reported in this 10-Q a material weakness in our IT General Controls. Compensating controls previously prevented deficiencies in our IT General Controls from rising to the level of material weakness.

We discontinued those compensating controls during Q2 to optimize store level system performance which caused us to re-evaluate the underlying IT General Control deficiencies and characterize them as a material weakness. We're focused on remediating this quickly to regain an effective control environment.

Turning to our financial results. On an adjusted basis, diluted earnings per share were flat to the prior year quarter at $0.22, as Stuart mentioned. Excluding the decrease in earnings from noncore operations in Canada and Cash Converters, adjusted diluted EPS would be $0.25.

Included in GAAP results for the quarter was a $6.5 million noncash impairment to the carrying value of cash converters consistent with the stock's closing price on March 31. Results also included a $3.9 million increase in net interest expense, $1.5 million of corporate expense related to investment in Evergreen and $800,000 recovery in Latin America of a previously reserved receivable from a bankrupt refiner and $1.1 million of revenue from the settlement of certain PSC-related indemnification claims with the prior owners of GPMX.

As a reminder, we used adjusted net interest expense to analyze the business. This removes the effect of noncash interest expense related to our convertible debt as well as noncash interest income on our note receivable from AlphaCredit.

Adjusted net interest expense was $900,000 in the quarter compared to $300,000 in the prior year quarter. In the current quarter, adjusted net interest expense excludes $5.6 million of noncash interest expense and $1.1 million of noncash interest income, the latter of which will continue to decline as the note principle continues to be repaid monthly. The $195 million of cash convertible senior notes expected to be repaid in June of this year represent $3.6 million of total interest expense in the current quarter.

Turning to the adjusted highlights on Slide 7. On a consolidated basis, the average and ending balance of pawn loans outstanding or PLO was up 10% year-over-year with a commensurate 10% increase in pawn service charges or PSC and monthly yield consistent with the prior year quarter at 15%.

Ongoing PLO growth reflects acquisitions and new stores as well as organic growth with same store loan growth of 6%. Through acquisition and de novo expansion, we added 79 pawn stores in Latin America over the last 12 months, closed two pawn stores in the U.S. and closed three consumer lending stores in Canada.

Merchandise sales were up 6% in total and 4% on a same-store basis. Overall merchandise margins edged slightly lower to 36% as a greater portion of our overall sales were generated in Latin America where margins are lower with a higher concentration in general merchandise.

Including new product development costs, our Canadian CASHMAX related customer lending operations experienced roughly a $900,000 decrease in EBITDA year-over-year following regulatory changes previously discussed in the transition to a longer-term product.

With store operating EBITDA from Pawn segments up $1.9 million or 4%. The $700,000 decrease in consolidated EBITDA was due to the lower contribution from the Canadian operations, $400,000 lower equity in cash converters income and a $1.2 million increase in corporate expense. The corporate expense increase arose primarily from investment in human capital and professional fees. I'd expect corporate expenses to moderate a bit as we move through the second half of the year.

For the quarter, diluted EPS was flat to the prior year at $0.22 including the roughly $0.03 attributable to the lower earnings in Canada and Cash Converters. Year-to-date, adjusted EBITDA is up 5% to $55.4 million with adjusted EPS up 10% to $0.54.

On slide 8, you can see the long-term growth in EBITDA and EBITDA margins we've delivered over the last three fiscal years and the progress so far this year. Year-to-date, consolidated EBITDA has increased $2.8 million or 5% with growth across both the U.S. and Latin America.

Year-to-date, EBITDA margins in the U.S. are relatively unchanged from the same period this year compared to last year and are slightly higher than the full year 2018. Latin America posted a 33% EBITDA margin in the quarter and 34% year-to-date.

While we're excited about the growth prospects for the new and acquired stores added over the past 12 months, they do temporarily suppress EBITDA margins. Looking ahead, we see opportunity to gain efficiencies as these stores mature and are fully integrated and as we realize synergies.

Turning to the U.S. Pawn highlights on page 9. Last quarter, I mentioned the effect of the government shutdown and tax refund delay was not yet known. While we did see a delay in customers receiving refunds this year, we believe the effects were largely contained within the period.

Loan demand remained robust throughout the quarter with the ending same-store loan growth up 5% reflecting our continued focus on meeting customers need for cash. Furthermore, ending PLO per store of $257,000 was strong on a seasonal basis up 6% year-over-year. Pawn service charges increased 5% consistent with the PLO increase while merchandise sales were up 2% both in total and on a same-store basis. U.S. merchandise margins were roughly 130 basis points lower at 37% as aged general merchandise improved from 9% at beginning of the quarter to 7% at the end of the quarter.

Our ongoing efforts to reduce aged general merchandise inventory suppresses margins in the short term. That said, optimizing inventory reduces our exposure to obsolescence, improves return on earning assets, drives higher margins over time, and frees up additional capacity for lending. At 37%, U.S. merchandise margins remain well within the 35% to 38% target range.

Net revenues in U.S. pawn were up 2% from the prior year quarter. Operating expenses remained at 68% of net revenues, but we're up 3% in total primarily from increased labor and benefit costs including vacancy reduction. As a result, U.S. pawn EBITDA was flat to the prior year at $31.4 million with the segments profit before tax up 2% to $28.4 million largely reflecting lower depreciation expense.

Turning to Latin America, slide 10 highlights total PLO growth of 27% for Latin America pawn, including the impact of the new and acquired stores, while total pawn service charges increased 30% from the prior year quarter. The segment continues to gain scale with strong same-store loan growth of 9% and ending per store loan balances seasonally strong at $91,000. Merchandise sales growth remained robust this quarter, up 25% in total and 12% on the same-store basis. Merchandise margins were approximately 75 basis points lower than the prior year quarter at 31%. Margins are typically a bit lower in Latin America than the U.S. due to the higher concentration in general merchandise.

In contrast to last quarter, operating expenses were down 100 basis points as a percent of net revenue to 67% driving positive operating leverage with the 26% increase in net revenues translating into a 30% increase in EBITDA. The dollar increase in operating expenses was primarily related to new and acquired stores, though there remain opportunities to gain further efficiencies as related stores continue to scale and season. After depreciation and interest, the Latin America segments adjusted pre-tax income increased 20% to $7.8 million.

Turning to slide 11, we continue to maintain a strong balance sheet and disciplined capital management. We ended the quarter with $348 million of cash providing us sufficient capital to retire our $195 million of cash convertible debt, when it matures in June and fund our ongoing operations with $80 million to $100 million of capital available to invest in acquisitions, new store development, building loan balances and other growth opportunities. At the end of the period, we had a net debt leverage ratio of 1.6 times.

In addition to cash flow from operations, we continue to receive timely principal and interest payments from AlphaCredit in accordance with the terms of those notes receivable. Year-to-date operating cash flow increased 11% to $50.6 million and the company collected another $14.6 million of principal under the AlphaCredit notes. We anticipate receiving another $13.5 million principal in the remainder of fiscal 2019 plus interest. We also expect to collect another $6 million from AlphaCredit in September 2019. This is the first installment of the related deferred compensation fee with the remainder due in fiscal 2020.

Now that you have a little 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. On page 12, we provide a high level of the investment highlights for the company. Firstly, it's the strong growth history that we've established in an industry that has proven resilient over long period of time. Secondly, we continue to invest and enhance our ability to meet our customers' needs for cash through investment in digital solutions. Thirdly there continue to be opportunities 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. Fourthly, we have seen the benefits of geographic expansion with the marginal net revenue increase from Latin America of $6 million being some three times more than the marginal net revenue increase from the U.S. And finally, we're building a financial and operational performance history that reflects our focus on meeting our customers' needs for cash better than others in the market.

So with that, [ph] Michael (00:18:52) we'll pass it over for questions.

Unverified Participant

Operator, we're ready to take questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] And your first question comes from the line of John Hecht from Jefferies. Please go ahead.

John Hecht
Analyst, Jefferies LLC

Q

Hi, good morning. Thanks very much. First question is, how long do you guys expect Canada to be a drag? How long will the product transition take there?

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

A

Hi, John.

John Hecht
Analyst, Jefferies LLC

Q

Hi.

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

A

We're going through a strategic review at the moment. We're trying to figure out rightsize. We're looking at the market because there has been a substantial change. It's not as simple as just shutting down or growing up. We've got to actually figure out what is the right thing to do. The change of regulation has obviously brought a few challenges into lower-margin products. It's certainly, as you'd point out, not a core business for us at this point of time, and as such we have to deal with that in the right way and make sure that we come to the right solution that makes sense for everyone.

John Hecht
Analyst, Jefferies LLC

Q

Okay. And then can you give us an update on how cash converters is doing and the level of commitment there and what you expect?

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

A

Yes. So, well, our level of commitment is 34.75%, which is on a value sense is a lot less than where it should be. At the moment, they're going through the final stages of the class action. That is obviously putting a bit of a depressed influence on the share price. At this stage, the court case has been held as awaiting judgment. But with the uncertainty around that, that has caused some, as I said, depressed value. The other thing is there's a general election in Australia in the next two weeks. There's a fair sense that labor might get in with that. It is uncertainty about what that means for the regulation or the regulatory environment. So, the industry has a bit of a questioning around most stocks that are sitting there as well. So, I think, clarity, hopefully, on both of those will be through very quickly.

John Hecht
Analyst, Jefferies LLC

Q

Okay. And then final question is how – in terms of geographic demand in the U.S., is there any region that you see positive kind of variance relative to expectation, negative, or is it fairly consistent domestically?

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

A

We're pretty well covered in Florida and Texas which we believe are still the two best markets. We have seen some very good growth out of both of those. There's a little bit of variability through the Midwest, but Texas and Florida continue to drive a lot of those results.

John Hecht
Analyst, Jefferies LLC

Q

Okay. Great. Thanks very much guys.

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

A

Thanks, John.

Operator: And your next question comes from the line of Greg Pendy with Sidoti. Please go ahead.

Gregory R. Pendy
Analyst, Sidoti & Co. LLC

Q

Hey, guys. Thanks for taking my questions.

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

A

Good morning, Greg.

Gregory R. Pendy
Analyst, Sidoti & Co. LLC

Q

Firstly, I just wanted to – good morning, just wanted to go into scrap. I thought there might be a little bit of a catch up. Is that something given what took place in the first quarter? Is that something that we should expect some time within year-end?

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

A

Yeah. I'd say I'd expect a little bit of a catch up there in Q3, Greg, although some of that also is strategically trying to get more margin out of selling jewelry in stores rather than scrap which obviously takes a little bit longer to do that versus just being able to send it to a refinery immediately. But long-term, we think that probably provides a better overall return.

Gregory R. Pendy
Analyst, Sidoti & Co. LLC

Q

Okay. And then I guess just continue with that a little bit. The inventory is up around 4% just on the U.S. side alone and you also kind of improved the aged inventory. Is there a higher mix of jewelry within that inventory?

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

A

There's not that big a difference in the mix. What I would say is it's the growth in inventory was up 4%, the loan balance was up 6% same-store. So I'd say those are actually relatively well in tracking a healthy relationship. The growth there is more in the younger categories...

Gregory R. Pendy
Analyst, Sidoti & Co. LLC

Q

Got it.

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

A

...but trying to keep turning it at a fresher pace.

Gregory R. Pendy
Analyst, Sidoti & Co. LLC

Q

That makes sense. And then just one final question. I guess I know you're coming off a very strong 1Q on the PLO balance on the U.S. side, but can you just kind of give us some color on I guess what the monthly cadence of the PLO balance looked like throughout the quarter?

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

A

Yeah. We don't typically dive into monthly figures on that. I would say the one bit of anomaly that we saw within the quarter was with the tax refund delay. It shifted the repayment of loans a little bit later in the quarter, which also then fed the beginning of rebuilding the loan portfolio as we move back into the loan season over the next several months. That started a little bit slower. Although the tax refund season from start to finish really was fairly well encapsulated within the quarter. I think it largely resolved itself within the quarter but just a little bit of shifting of when that cash was actually received.

Gregory R. Pendy
Analyst, Sidoti & Co. LLC

Q

Got it. That's helpful. Thanks a lot.

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

A

Thanks, Greg.

Operator: [Operator Instructions] Your next question comes from the line of Scott Buck with R. Riley FBR (sic) [B. Riley FBR] (00:25:04). Please go ahead.

Scott Buck
Analyst, B. Riley FBR, Inc.

Q

Hey. Good morning, guys. I want to drill down a little bit on the Latin America build out. It sounds like there are some pricing headwinds. Is that universal across Mexico, Central America and into South America or is that primarily Mexico?

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

A

Hi, Scott. It's primarily in what we're seeing in Mexico.

Scott Buck
Analyst, B. Riley FBR, Inc.

Q

Okay.

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

A

There are opportunities with the – as I said the vendor expectations at this stage are reasonably healthy, for them not so much for us. We haven't really looked at much in the way in Central or South America at all. Our focus is primarily being really into the Mexican region as we have some gaps in our geography. So, we've started trying to target geographies where we believe the fill-in works well. There's very few – there's some large chains around and there are some interested vendors, but we continue to try and see whether their price expectations would meet ours. At this stage, there was a gap and which has stopped us from acquiring.

Scott Buck
Analyst, B. Riley FBR, Inc.

Q

Okay. That's helpful. And given the headwinds there, I mean what's the pipeline for new store or organic store growth in Mexico?

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

A

Danny, could you handle that one?

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

A

Yeah. So, we've not only opened a number of stores this year, but also looking at relocations and remodels. On some of those where we've seen a pretty healthy payback when we do those, more of those have been centered around acquired stores with GuatePrenda, and again have pretty nice return. We have opened, I believe, nine new stores year-to-date, and continue to work on opening additional new stores in the remainder of the year.

Scott Buck
Analyst, B. Riley FBR, Inc.

Q

Great. And last one for me. Some of the recent store openings and acquired stores over the past 12 months, have you seen a slower path to accretion there giving the prices you paid, or have the acquisition pricing issues become more recent of a problem?

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

A

The acquisition prices we're seeing at the moment, they've been around for a while. We've done a few small chains which have worked out reasonably well. The larger GuatePrenda chain which we bought, that performance has been very, very strong and the returns on capital coming out of that are probably above where we thought we would be at this point of time into the integration.

Scott Buck
Analyst, B. Riley FBR, Inc.

Q

All right. Thank you, guys.

Operator: And now I would like to turn the call back over to Mr. Stuart Grimshaw.

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

Thanks very much everyone, for listening in this morning. We appreciate your support and we've been around most of the day for calls with the investment community. So have a great day. Thank you.

Operator: Ladies and gentlemen, thank you for your participation. This does conclude today's conference call. You may now disconnect.