EZCORP, Inc.
First Quarter Fiscal 2018 Results Conference Call
February 1, 2018

Transcript

Corporate Participants

Stuart I. Grimshaw – Chief Executive Officer & Director, EZCORP, Inc.
Daniel M. Chism – Chief Financial Officer, EZCORP, Inc.
Jeff Christensen – Vice President-Investor Relations, EZCORP, Inc.

Other Participants

John Hecht – Analyst, Jefferies LLC
Michael Cohen – Director-Research, Opportunistic Research LLC
Henry J. Coffey – Analyst, Wedbush Securities, Inc.

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, ladies and gentlemen, and welcome to EZCORP First Quarter Fiscal Year 2018 Results 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. [Operator Instructions] As a reminder, this conference call is being recorded.

I would now like to turn the conference call over to Jeff Christensen, Vice President, Investor Relations for EZCORP. Please go ahead, Jeff.

Jeff Christensen, Vice President-Investor Relations, EZCORP, Inc.

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.

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

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

Thanks, Jeff. Good morning, everyone. I'd like to welcome you to the first quarter results presentation. As some of you have probably flicked through the slides, it's been an exceptionally pleasing first quarter and really continues the momentum that we've been building on over the past few years. As we go through the slides, you'll also see that we had very strong operating metrics across all lines of the business.

As we turn to slide 3, we can actually see how this has played out. Firstly, most important, we've got adjusted EPS, which is up 73% year-on-year. Now, obviously, there is some tax noise that sits around that, but if you go to the profit before tax line, you'll see adjusted profit before tax is up 59% and 52% on a GAAP basis. That's very strong performance over that period of time.

It was also highlighted by strong growth in our PLO, which was up 9%, and from the PLO raising that much, the PSC was up 11%. There was strong margin improvement particularly in the U.S. where we saw a very good return on the sales that had occurred. And as we look through into the Latin American Pawn business, we can see that the PLO growth story continues with a more than doubling of the effect of having some terrific management plus increased store count where profit before tax has doubled. On a same-store basis in Latin America, you'll see that there was a strong double-digit growth, which we'll come to, which has continued the strong compounding effect that we have seen.

The U.S. Pawn story is a very good one as well with profit before tax up 4% despite the continuing impacts of Hurricanes Harvey and Irma on the PLO, PSC and sales lines. Same-store PLO in unaffected U.S. stores is up 3%. And we'll see the PLO per store relatively stable at $285,000, which is a very good size portfolio.

A lot of the momentum that's been created has been through the store acquisitions that have driven some strong earnings. And as we have mentioned over many times throughout the acquisitions in Latin America, there were two of them for 112 stores with GuatePrenda and 21 stores in the northwest part of Mexico. We also opened four stores in Latin America and we expect to open eight more in Q2. We now see a mix of 43% of pawn stores based in Latin America, which is a high growth segment for us.

As we turn to slide 4, we see the continued momentum that has occurred and this chart highlights the sustained and accelerating growth in earnings and the result in operating leverage as we can see as evidenced by the EBITDA to net revenue line and you can see the improving ratios, we were at 12% in FY 2015. And by the time we've hit the first quarter FY 2018, we're at 22%. And underneath that, you see that's been driven on a reasonably constant store count until the first quarter of fiscal 2018 with the acquisitions coming in. So, even with the acquisitions, we've been able to increase the operating leverage of the business.

And this is further evidenced on slide 5, where we can see how that leverage has played through the various segments and particularly in Latin America as you see for the 2015, 2016 and 2017 years, without acquisitions, the leverage in Latin America has improved from 23% to 35% and in this first quarter, we've increased that to 38%. The CAGR growth is very impressive at 49% through those three years also.

When we look at the U.S. Pawn, which is a much more mature market, we've been able to maintain that operating leverage. Indeed in the first quarter of this year, we've increased it by 100 basis points to 32% in what was, in some respect, a challenging quarter with the headwinds of the hurricanes and the floods. So, the leverage performance has been very strong through that.

When I turn to slide 6, Danny will run through how the pawn cycle works, we always say that the PLO is the cornerstone of our business. And we have had some very strong consistent PLO growth over that time on an absolute basis as well as on a comparative basis. And as you look at the first quarter of 2018, we have actually continued to improve that as we go through. The slide on the right shows that despite the hurricane impact of net revenues being flat, we're able to increase our profit before tax by 4% and that's been done through obviously the margin improvement as well as some good expense control. And we've got a little box in there that shows, with the stores unaffected by hurricanes, net revenues was up 3% and the PBT was up 8%, which just gives you an indication of the impact that has been felt through the portfolio.

Turning now to slide 7, I think this is a great slide and one that we're very proud of with the performance that has occurred. The compounding growth that we've seen through this business continues and that's very pleasing. And if you look over the last three quarters, we did 34% in December 2015, 14% in December 2016, and 11% in December 2017, that's double digit compounding growth over three consecutive years, which is an outstanding result for the team there, and it is same-store, so that gives you an indication of just how good the management has been on a same-store basis.

And then we look at the leverage factor on the right hand side. It is a very, very strong continued growth story that we are achieving and we see this market as very important to us going forward.

With that very high level summary, I'll pass it over to Danny.

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

Thanks, Stuart, and good morning, everyone. Let's move to slide 8. As Stuart mentioned, this is a very good quarter for EZCORP despite the lingering effects of the Q4 hurricanes on our U.S. Pawn loan balance. A 53% increase in diluted earnings per share came from several sources. We delivered growth in all areas of the operations and successfully executed the acquisition of 133 pawn stores in Latin America. This represents the eighth consecutive quarter of year-on-year earnings growth.

The 9% rise in pawn loans outstanding was a significant accomplishment, delivering a similar increase in net revenue. We further leveraged this into a 52% improvement in profit before tax to just under $20 million. Included in those results is a healthy improvement in interest income following the September restructuring and the notes receivable related to the sale of Grupo Finmart. We continue to receive timely principal and interest payments in accordance with the terms of the notes.

The widely publicized U.S. tax reform act was signed into law on December 22 and became effective January 1. At the risk of putting everyone to sleep this early in the morning, I do want to provide some color around this, as it will have a material positive impact on our earnings moving forward, but does have a one-time impact this quarter and some anomalies later in the year.

Among other things, it changes the maximum federal tax rate from 35% to 21%. As a company with a September 30 fiscal year-end that straddles the effective date, we're required to apply a blended 24.5% federal rate to our earnings this entire fiscal year. The 21% federal rate will apply beginning October 1, the first day of our fiscal 2019. Partially offsetting that, the benefit of the lower rate, there is a significant reduction in the deductibility of performance based compensation, a smaller federal benefit on state taxes and a limitation on the ability to utilize foreign tax carry forwards.

As foreign tax rates are now higher than U.S. rates, that portion of our total expense will increase limiting the improvement in our overall effective tax rate. Excluding discrete items, I expect our effective tax rate will be in the 32% to 33% range the remainder of this fiscal year and to improve about 200 basis points in future years.

Included in the current quarter are two discrete tax items. Upon signing the new act, we revalued our net deferred tax assets to the lower federal tax rate now in effect resulting in a $2.8 million charge. Partially offsetting this, we recognized a $1.6 million tax benefit from the expiration of the statute of limitations on some uncertain tax positions from prior years. In the fourth quarter this year, I expect an additional discrete charge of $2 million to $2.5 million to further revalue certain short-term deferred tax assets that will arise at the 24.5% rate and then reverse at the 21% federal rate applicable in the future years.

Now onto slide 9, this presents our results on a normalized basis after adjusting for discrete items in constant currency. The largest discrete items excluded are the tax items I just discussed. The trends are similar to the U.S. GAAP results. Acquisitions and strong organic growth drove the 9% net revenue increase. Improvements were seen in pawn service charges and sales gross profit including a margin expansion on sales. Disciplined expense management and higher interest income magnified the net revenue improvement into a 73% jump in earnings per share to $0.26. This is the highest first quarter net income we've produced in five years.

Slide 10 presents U.S. Pawn results adjusted for discrete items. As you know, pawn loans outstanding is the most influential driver of revenue and profitability. In U.S. stores unaffected by hurricanes, PLO was up a healthy 3% on a same-store basis, as Stuart had mentioned, driving a similar increase in pawn service charges. Actively managing the expense structure enabled us to leverage relatively flat net revenue into higher profit before tax, this reached $28 million for the quarter.

This was the first full quarter of operations reflecting the impacts of Hurricanes Harvey and Irma on PLO, pawn service charges, and sales. Following the storms, PLO recovery continues, though we still expect it will be after the tax refund season before the affected areas return to a normal PLO balance. We significantly increased our sales margins in the quarter to 39% primarily with greater discipline around discounting.

However, the offset was a slowdown in inventory turns and an increase in inventory on-hand particularly in jewelry and firearms, which tend to retain their value fairly well. I expect sales margins will return to our typical 35% to 38% range for the full fiscal year as we continue to refine the balance of the margins and sales volume.

Looking at the graph on page 11, you'll see U.S. Pawn's net revenue was flat to the prior year, reflecting continued effect of last year's hurricanes. Despite that headwind, we still delivered a 4% increase in profit before tax through effective expense control.

Slide 12 shows the accelerating growth in Latin America same-store PLO. Strong execution and a higher yield drove a 17% growth in pawn service charges. Reflecting both organic growth and the significant contribution from acquired stores, the segment delivered 73% higher net revenue on a constant currency basis and slightly higher than that on a U.S. dollar basis.

Leveraging the expense structure allowed us to more than double profit before tax to $9 million in the quarter. Latin American operations now represent 24% of total pawn profit. The acquired stores added significant net revenue and profit growth and have exceeded our expectations in the short period we've owned them. We acquired 133 pawn stores and opened 4 stores in Latin America this quarter. This represents a 56% increase in pawn store count in this region. We also plan to open eight more stores in the second quarter.

This market provides many attractive opportunities to grow and diversify our revenue base. The plan is to tap those through continued organic growth, new store development, and acquisitions.

PLO yield, inventory turns, and return on earning assets all increased and merchandized margins were healthy, up 100 basis points from this quarter last year.

Slide 13 shows the story well. PLO more than doubled driven by strong organic growth, store acquisitions and new stores that put us in a great position for continued significant growth in net revenue and profit. The Latin America Pawn segment delivered truly outstanding results. All in all, it was a solid performance for the company this quarter with earnings improvement in U.S. Pawn and Latin America driving the 53% improvement in earnings per share.

With that, I'll hand the call back over to Stuart.

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

Thanks, Danny. Turning to slide 14, as we discussed at the Investor Day, we continue to work on improving the customer and employee experience, and the three boxes on this slide give some insight as to how we look at the operations. Firstly, with the advantage in customer experience leadership and PLO growth, the upgrading of the point-of-sale system continues, and we're now in 206 stores with 25 of those being in Mexico. We have an analytic and customer behavior team that actually looks at all the transactions and assists the store in better managing the customer experience with relevant and live data.

We continuously look at customer experience and we provide feedback to our team that serves as a great learning experience. And we have a lot of training, coaching and mentoring, which we can see through the way that we've organized the Pawn business with our district and regional managers and the spans of control, which typically average per district manager around seven stores.

The second one is just transforming the customer and team member experience, particularly with best-in-class systems. We are currently migrating our legacy environment into the cloud-based infrastructure and that involves moving off servers which are over 12 years old, so that will give us a more efficient platform to work on which enables us to integrate acquisitions much more smoothly than we would have in the past. Training is actually enhanced, speed to market is enhanced, and we can plug and play with the various applications that we do want to bring in.

And finally, the acceleration of growth via the disciplined acquisitions and new stores; and as Danny has mentioned, we've seen the shift in the balance of our stores towards Latin America, and the geographic diversification as you've seen is enhancing the earnings profile of the company. And we've been fortunate with the acquisitions to have acquired a quality management team and that is going to benefit us very much in the long-term.

Turning finally to slide 15, we've just changed the format of this slide just to make sure everyone was awake, because after 15 slides at this time in the morning, it's very important that you are because this is actually quite an important slide about what have we done and why. And I think I'd start with the proven management execution because, over the past three years, we've been on a journey. And as we've seen in slide 4, we've moved the company through many iterations to be in the growth phase of its operation and that has resulted in accelerated earnings growth in a market that is very attractive on a regulatory basis as well as a pure business model basis, and where the capacity for internet disintermediation is very low. Coupled with the increased desire for the cash from the credit-constrained customer, this industry is a very attractive one for us. We are now in seven countries and expansion has been into the high-growth Latin American markets. And we're using new technologies to enable and enhance the customer experience and all of this has resulted in market leadership in the key drivers of growth. And particularly in the PLO as we've spent over the last three years, emphasizing PLO is the cornerstone and we've consistently been the market leader in achieving those growth targets.

So, with those comments I'd just like to close out. I think it has been a great quarter for us. So, we're very pleased. And now we'll open up for questions.

QUESTION AND ANSWER SECTION

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

<Q – John Hecht – Jefferies LLC>: Morning, guys. Thanks so much for taking my questions. First one, Danny, you talked about sort of consolidated retail margin trends or gross margin trends. I'm wondering, can you give us the trends by channel as you think we should think about them in the next three or four quarters. What I mean by that is, U.S. retail versus Mexico retail and then the wholesale margins as well?

<A – Danny Chism – EZCORP, Inc.>: I wouldn't put a whole lot on the wholesale margins or the scrap margins that's more just kind of run of the mill activity and we don't typically hedge that position. So, that's just moving through as that comes in. But the larger driver are the retail margins. In the U.S., I do expect those margins to probably revert back into the 35% to 38% range that we typically target. And I think we probably got a little overly disciplined in our discounting in this quarter and that slowed the inventory turns a little bit. I do expect margin to moderate back into that 35% to 38% range in the remainder of the year in the U.S., we were at 39% this quarter.

In Latin America, I'd expect similar margins to what we saw this quarter, obviously, that will change a little bit over time as we introduce more general merchandise in the acquired stores in GuatePrenda, but I wouldn't expect substantial movements in those margins beyond that.

<Q – John Hecht – Jefferies LLC>: Okay. And then, maybe for Stuart, Mexico is obviously very strong, any domestic customer trends worth pointing out? We've had a little change in gold prices and some wage inflation potentially in the domestic segment. You guys seeing anything different in terms of new customers or recurring customer trends?

<A – Stuart Grimshaw – EZCORP, Inc.>: I think John, the biggest trend we're probably seeing is still in those hurricane-affected areas where the government payouts have continued longer. I think we'll see a return to normality once the tax credits start coming through and it's still a bit early to see, but the indications are that it's going to be delayed beyond last year. Any delay will change those trends for instance, our customers used to have cash (federal tax refund) on Valentine's Day, they don't have that cash anymore on Valentine's Day, so that's changed fundamentally some of the sales profiles we've had over the last 12 months. So, typically our customers react to cash in hand pretty quickly, they spend it and re-adjust their pattern, so there's nothing new macro coming through that we've seen that's impacting the business.

<Q – John Hecht – Jefferies LLC>: Okay. Thanks. And then, final question is, Danny, you did give some specific details around the tax rate, but clearly a big savings for you guys this year overall. How do you guys see that rolling through? Do you see that is mostly going to flow to the bottom line? Do you anticipate using some of those savings to further invest in the business more rapidly? Anything worth noting there?

<A – Danny Chism – EZCORP, Inc.>: I'm not sure I'd say that would change our strategy in investing. Obviously, we'll always look at our capital structure and make sure we're putting in place what we need to continue to fuel growth and I don't think that's dependent upon the taxes. The tax reform act will have a net positive impact on us moving forward. If you looked historically that effective tax rate has been in the 36% to 38% range. I expect this year to be, again, excluding the discrete items that introduce a little bit of noise, I'd expect our effective tax rate will probably be in the 32% to 33% range in FY18 and then, 30% to 31% moving forward. So, pretty substantial improvement in the overall effective tax rate. And the reason that doesn't go all the way down to the federal rate, obviously, you've got the impact of state taxes, foreign taxes, non-deductible items, those types of things.

<Q – John Hecht – Jefferies LLC>: Thank you.

<A – Danny Chism – EZCORP, Inc.>: I'm impressed you stayed awake in the tax section this early in the morning.

<Q – John Hecht – Jefferies LLC>: We're up and at them here.

<A – Stuart Grimshaw – EZCORP, Inc.>: Thanks, John.

<Q – John Hecht – Jefferies LLC>: Thank you, guys.

Operator: [Operator Instructions] Your next question comes from the line of Michael Cohen with Opportunistic. Please go ahead.

<Q – Michael Cohen – Opportunistic Research LLC>: Hi, guys. Thanks for taking my question. Quickly, just an update, you guys noted there are around 206 stores on the new point-of-sale system. Just maybe if you could provide a little more color commentary on how some of the stores that have had the POS the longest are performing, the lift that it's providing you, and the learning that you've had so far?

<A – Stuart Grimshaw – EZCORP, Inc.>: We probably introduced a majority of the point-of-sale system in about October. We had a big download on it then. Still pretty early, but what we're finding is that transaction times are improving, the ability to process loans is improving. So, on a productivity basis, it's working. It's still too early given the noise around the hurricanes to draw any conclusions as to how that works as most of the rollout occurred in the Texas and Florida stores that are impacted by the natural disasters that did occur.

So, I think by the end of this quarter, we'll be in a better position to get some learnings. The one thing I would say is that we probably overestimated the amount of time it takes to train people on the system, it's quite intuitive. So, we've been able to pretty much half the time to train these people. So, we'll probably able to report a bit more by the end of this quarter.

<Q – Michael Cohen – Opportunistic Research LLC>: Great. Thank you. And then, just back to the tax, not to sort of beat a dead horse. Are there any strategies that you can employ to minimize the leakage in terms of things that are non-deductible. I mean, I think you had sort of implied certain types of employee compensation, is there a way to structure that differently such that you capture the tax benefit?

<A – Stuart Grimshaw – EZCORP, Inc.>: We're looking at everything. It's still pretty early. I think, in this space, it's probably good to be a fast follower rather than a market leader. So we'll probably watch what's happening across the board and see how it looks to us because everyone's doing the same thing trying to understand how you can actually get the best advantage from that tax act that has passed. So, we're watching it very closely.

<Q – Michael Cohen – Opportunistic Research LLC>: Great. Thanks for taking my questions, guys.

<A – Stuart Grimshaw – EZCORP, Inc.>: Thank you.

Operator: [Operator Instructions] Your next question comes from the line of Henry Coffey with Wedbush. Please go ahead.

<Q – Henry Coffey – Wedbush Securities, Inc.>: Good morning, everyone. I've sort of been watching this from the sidelines and the developments have been extremely impressive. One of your competitors reported this morning, their legacy stores had same-store sales of 3% in the U.S., you're taking about 3% same-store sales. I know World had a much higher revenue quarter after the whole progression of difficult quarters. Is there something going on in the alternative loan market that's putting a little more life into it? Is it easy comps from prior periods or just really hard work at the store level?

<A – Stuart Grimshaw – EZCORP, Inc.>: Thanks, Henry. Long time, no hear. Welcome back. We actually, we're a bit different, we don't look at our competitor in the legacy, we look at its overall basis and our numbers are much stronger. What we're seeing is that I think the consumers had choice with cash in their hands. And I think both ourselves, and I'm sure FirstCash, will start seeing some more positive numbers coming through as the customer starts to want the cash leading up to the tax credit system. So I think it's a mature market and, as such, you're not going to experience the same growth rates we're seeing in the Latin American areas. If you look at our performance over the last three years, we've outperformed substantially on a comparative basis to what we're doing. I don't think you're going to get super strong growth numbers out of the U.S. in the short term. But the budgets we set, we try to stretch management to achieve it. The U.S. is a mature market and as such we've got to be close to our customer and watch our expenses.

<Q – Henry Coffey – Wedbush Securities, Inc.>: I guess I'm looking at it differently in saying 2% or 3% same-store sales growth or even 1% or 2% same-store sales growth in the U.S. in the alternative loan market would be a huge improvement over what we've seen.

<A – Stuart Grimshaw – EZCORP, Inc.>: What we're trying to do is use the leverage because we've got a high fixed cost base. Some of the alternative loan markets' are running on a much lower fixed cost high variable cost basis particularly on line lenders for example. Their dispositions are probably a little bit different, so when you look at the alternative loan market and particularly in the unsecured market, the charge off ratios are what you want to look at and what fall through to the bottom line. Our bad debts are what we sell in the store and we're getting some pretty good margin on that. So I think our business model is actually very sustainable compared to some of the others.

<Q – Henry Coffey – Wedbush Securities, Inc.>: Great. Thank you very much.

<A – Stuart Grimshaw – EZCORP, Inc.>: Thanks, Henry.

Operator: And I'm showing no further questions at this time. I would now like to turn the conference back to Mr. Grimshaw for his closing comments.

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

Thanks very much. And thank you for everyone who is on the line. We appreciate the interest in our company. We thank you for your support

We've had a very strong quarter. We've started to drive the earnings really well. Both Danny and Jeff are available for questions later this morning. But once again, thank you and have a great day.

Operator: Ladies and gentlemen, this concludes today's conference. Thank you for your participation and have a wonderful day. You may all disconnect.