Lowering Price Target: PROG Holdings (PRG)

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Domestic Financials

Price (12/6/22) ($):	18.43	Beta:	1.16	FY: Dec	2022E	2023E	2024E	2025E
1-Yr Price Target ($):	16.50	WACC (%):	14.23	Revenue	2,602	2,411	2,471	2,455
LT Price Target ($):	12.00	M-Term Rev Int Gr Rate Est:	-1.93%	*Growth (%)*	*(2.8%)*	*(7.4%)*	*2.5%*	*(0.7%)*
52WK H-L ($):	12.11 - 47.25	M-Term EPS Gr Rate Est:	4.11%	Operating Profit	183	191	200	194
Market Cap (Mil):	$997	Debt/Equity:	60.0%	*Growth (%)*	*(2.8%)*	*4.3%*	*4.7%*	*(3.0%)*
Insider Holding (%):	1.60	Net Debt/EBITDA:	37.4%	Op. Profit Margin	7.0%	7.9%	8.1%	7.9%
Avg. Daily Vol (3M):	756,150	ROA:	6.8%	EPS:	$2.05	$2.16	$2.40	$2.32
Short Interest (%):	5.36%	ROE:	12.2%	P/E	9.0x	8.5x	7.7x	8.0x
ESG Rating:	C	ROIC:	8.6%	EV/EBITDA	5.8x	5.6x	5.4x	5.5x

($USD Millions)

Conclusion: We are recommending a SELL for PRG because our work suggests that consumers are less willing to pursue leasing solutions for furniture, home appliances, and electronics than consensus expects. We also believe that the outcome of the Pennsylvania Attorney General's lawsuit poses a greater threat to PRG's ability to operate as a going concern than what consensus is anticipating. In the near term, our view on consumer behavior compels us to lower earnings forecasts 11% below consensus for next year. Long term, our view on the ongoing litigation prompts us to expedite PRG's final year of operations by four years (to FY 2024) compared to what the market expects (FY 2028), as we believe PRG is not a going concern.

Price Target: Our forward P/E ratio assumes PRG's 55% current discount to the market multiple. Applying this to our NTM +1-year EPS estimate of $2.34 results in a January 1, 2024 price target of $16.50. Our long-term price target is derived from a probability-weighted DCF using three models (base, bull, bear), the market-implied forecasting period of six years (FY2028), and a WACC of 14.2%, resulting in a price target of $12.

Research: PROG Holdings has the lowest coefficient of variance among sell-side analysts covering small-cap financial stocks (0.04), and EPS estimates have frequently followed movements in the stock's price. To find information not already disseminated in the market, we conducted a survey of 452 US citizens, of which 126 identified as having a credit score at, or below near-prime (<620). Of this credit-score category, ~70% state they are not likely to consider leasing as a payment option for items such as furniture, home appliance, or electronics, even if they had no options to get a loan. Only about one in five Americans in this survey with below a 620 credit score say that they are more willing to purchase these items today versus one year ago. Sell-side analysts continue to comment on the challenging environment in the Lease-to-Own (LTO) industry due to inflation, but fail to mention consumers' lack of willingness as a near-term headwind.

We have also determined that PRG cannot exist as a going concern under its current operating model. Progressive Leasing (~98% annual revenue) must offer leasing solutions at extremely high APRs to earn a spread on uncollectible renewal payments. Most leases are offered on 12-month terms, and because of defaults and early buyouts, PRG can depreciate its leasing inventory in its entirety on a roughly 8-month useful-life basis (~150% of leased inventory annually). As states continue to enact legislation that caps APRs at 36%, PRG will no longer be compensated for the rate of uncollectible renewal payments, loan losses, and defaults of its customer base. PRG will inevitably be forced to tighten its lending and offer lease terms of longer durations (likely 3-5 years) to match its competitors and offer lower payments to customers. Thus, depreciation will drop to somewhere between 20-35% of leased inventory annually, significantly reducing an illusory source of free cash flow in the form of depreciation add-backs. Using our WACC of 14.2% and consensus estimates, we find PRG's market-implied final year of operations to reach FY 2028.

Knowing PRG's operating model is entirely dependent on usury rates, we researched regulations on the state and federal levels for predatory lending laws. We found that states have become more proactive in the last year alone in setting stricter APR caps on non-bank loans, and we expect this trend to continue (Appendix A and B). Federally, we found Bill S.2349, “Protecting Consumers from Unreasonable Credit Rates Act of 2021” from the US Congress website, which is aimed to establish a national maximum interest rate of 36% to eliminate predatory lending. Using a site that tracks the activities of the US Congress, we found that the average rate of bills enacted into legislation over the last 16 Congresses (2005-present) is ~5%. We use this average to assign a 500 basis-point premium to our WACC.

On August 25, 2022, Pennsylvania’s Attorney General filed a lawsuit against PRG’s Progressive Leasing unit for allegedly violating the Rental Purchase Agreement Act. This law requires that companies must clearly disclose fees for lease-to-own financing, and an investigation by the AG’s office found “widespread non-compliance” after visiting multiple stores across Pennsylvania. Based on customer testimonies (Appendix C) and claims from Best Buy employees (Appendix E), we have reason to believe that PRG may be violating the Rental Purchase Agreement Act and the Truth in Lending Act in other states. The three most recent complaints on PRG’s Better Business Bureau page highlight the company’s use of harassment tactics to collect missed payments, and other complaints detail PRG’s failure to disclose hidden fees and interest rates. Our bear case assumes several states follow suit after the Pennsylvania Attorney General settles with PRG over unfair lending practices.

Change in Estimates: We estimate revenues to be 3.4% and 6.8% lower than consensus estimates by 2023 and 2024, respectively, which translates to decreases in net income of 44% and 60%, holding all else constant. Using the DCF, we assign a 500 basis point premium to our WACC of 9.2% to account for the probability that PRG no longer continues operating as a going concern, threatened by the passing of Bill S.2349 (approximately 5% of bills become law). Our bear case DCF model (50% of probability-weighted DCF) accounts for the probability of the Attorney General’s lawsuit (97% chance of settlement) and the likelihood of other states following suit or thousands of victims pursuing arbitration to regain damages. We estimate this litigation process will take between 14-24 months, which is why FY 2024 is PRG’s final year in our bear case DCF.

How I Differ: BofA, Truist, Jefferies, and Stephens all mention headwinds from higher-tier credit tightening and inflation as the main catalysts for a difficult NTM, but none of them mention consumers’ lack of willingness this year versus last to pursue LTO. Consensus often cites regulation as a material risk, but we have yet to see it quantified in a way that threatens PRG’s status as a going concern. The market will likely adopt our lower short-term view by 2Q2023 after the holiday season has ended and gross merchandise volumes normalize. Our long-term view will likely be adopted by 4Q2023, as the progress of Bill S.2349 reveals which direction it is moving toward, along with the outcome of the Attorney General’s lawsuit.

Where I Could Be Wrong: There is a reasonable possibility that the federal bill never passes (~95%) and that PRG decides not to settle with the PA Attorney General’s lawsuit, goes to court, and wins the case. To reflect this possibility, our bull case uses the same final year of operations as the market-implied forecasting period (FY 2028) and eliminates the 500 basis point WACC regulation premium, resulting in a price target of $20.90, representing an upside of 13.4%. Our bear case maintains the 500 basis-point WACC regulation premium and expedites PRG’s final year of operations by four years to account for the company’s settlement and probability of further lawsuits and arbitrations—concluding that the cost of litigation and the decision to continue operating in an APR-capped environment will be greater than the value of PRG’s ability to generate free cash flows. The bear case results in a $5.70 price target, representing a downside of 69.1%.

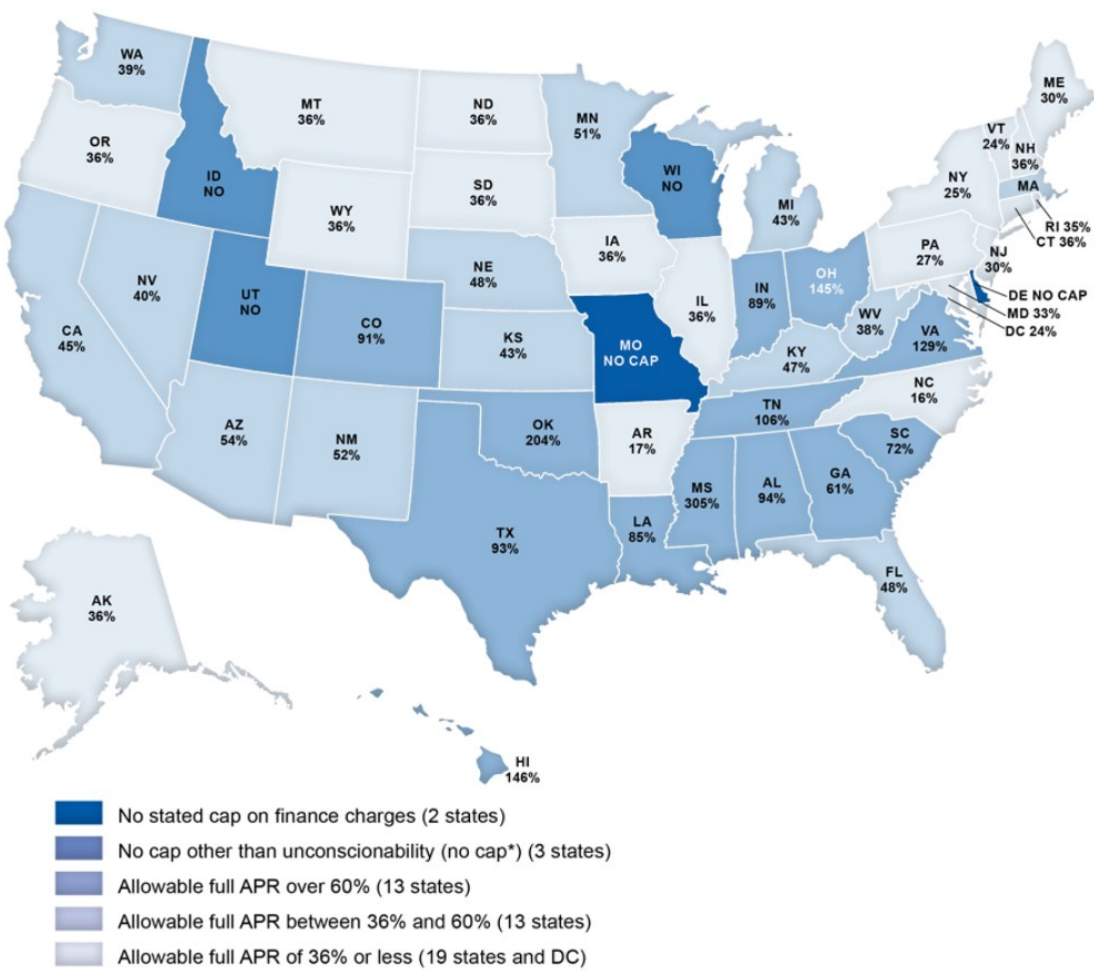
Appendix:

Appendix A: State Regulation Changes

Regulation Changes (June 2021 - June 2022)	
North Dakota	Enacted bill that places 36% APR cap on all non-bank loans, which previously had no cap
New Mexico	Enacted bill that places 36% APR cap on all non-bank loans (plus 5% fee on loans $500 or less), which previously had an APR cap of 175%
Hawaii	Repealed payday loan law, but enacted a new law allowing longer and larger high-rate loans (allowable interest rate on a 6-month $500 loan increases from 25% to 146%)
Maine	Added strong anti-evasion provision to its non-banking lending law, which places a 30% APR cap on all installment loans <$2,000, w/ lower cap on larger loans
Mississippi	Extended "Credit Availability Act" from July 2022 to July 2026, allowing installment lending w/ 300% interest on 4-12 month loans of up to $2,500
Oklahoma	Enacted law which raises allowable interest rates for certain installment loans and allows non-bank lenders to add a junk fee of $38.85 to every loan
Wyoming	Bill passed to repeal special protections that had applied to formerly categorized "supervised loans" and allows non-supervised loan rates to be charged on all loans

Regulation Changes (June 2017 - June 2021)	
California	Capped APRs for loans between $2,500 and $10,000 (previously there was no cap); APR for loan of $2,600 is capped at 41%
Colorado	Reduced the APR for payday installment loans under the state's Deferred Installment Loan Act from 180% or more to 36%
Illinois	Capped APR for all non-bank loans at 36%, calculated using the Military Lending Act methodology
New Mexico	Capped APRs for consumer loans of $5,000 or less at 175%; formerly there was no cap
Ohio	Closed loopholes for fees that made rate caps ineffective; now caps the rate on a $2,000, 2-year loan at 37% APR (still allows very high rates for loans of $1,000 or less)
Indiana	Increased the already excessive fees that lenders can charge
Iowa	Increased allowable APR for $2,000 two-year loan from 31% to 36%
Oklahoma	Increased allowable APR for $500 six-month loan from 108% to 204%
Tennessee	Increased junk fees that non-bank lenders can charge
Virginia	Closed a loophole that payday lenders were using to evade the state's rate caps, but increased the caps for non-bank installment loans

Appendix B: Maximum APRs for Closed-End Installment Loans by Non-Bank Lenders



Appendix C: Complaints Filed with the BBB

Initial Complaint
11/10/2022

Complaint Type: Problems with Product/Service
Status: Answered ?

They send people to youre home at 8 am to ask about a lease thats already in a payment plan no where in their lease does it state that their come to youre house if you miss a payment I was in a car accident not working obviously aware that I missed a payment I literally just return back to work yesterday and for the past two days both a man and a woman has came to my home not is only that harrasment but it shows poor customer service

Initial Complaint
11/08/2022

Complaint Type: Problems with Product/Service
Status: Answered ?

This is totally new and Im not able to explain, on two separate occasions men from this company have sat outside my home watching my house. Finally, a guy knocked on my door asking for my son they will not say what the business is although this is my home. Today another heavy set man shows up beating on my door as if the hinges were going to come off my front door, my pictures shook off my wall and I get up to see what business he had here he ask if my son was here I told him no and he states he couldnt tell me what he needed. I recorded him because I have a no trespass sign and its my home and if you have business here I should know or send him a letter. I told him that Im in a meeting and working so if he didnt want to speak to me the homeowner then they need to stop harassing me. I recorded this man as well as me telling him to stop coming to my house.

Initial Complaint
10/19/2022

Complaint Type: Billing/Collection Issues
Status: Resolved ?

I have used progressive leasing in the past and never had any issues. However on 9/17/2022 I received an email about a new lease which I did not open. It was done in ** and I live in *******. Called them and the agent said it didnt get delivered and the account was cancelled. Fast forward a week to find out he DIDNT cancel the account and the person who opened the account got the merchandise. I was hit by a category 5 hurricane and they closed the investigation into the fraud because I didnt turn in the paperwork when I had no internet and no phone due to this hurricane! I FINALLY was able to go to the library to leave this review. They are allowing fraudulent accounts to open without proper ID which is not ok!! CANCEL THIS FRAUD ACCOUNT!

Appendix D: Probability-Weighted DCF & WACC Premium Calculation

Probability-Weighted DCF			
DCF	Value	Weight	Weighted
Base Case	$ 17.60	40.0%	$ 7.04
Bear Case	$ 5.70	50.0%	$ 2.85
Bull Case	$ 20.90	10.0%	$ 2.09
Total		100.0%	**$ 12.00**
Current Price			$ 18.43
Upside (Downside)			(34.9%)

WACC Premium Calculation			
Congress	Bills Proposed	Enacted Legislation	Rate of Approval
117th	17,297	643	3.7%
116th	16,601	1,229	7.4%
115th	13,556	1,085	8.0%
114th	12,063	776	6.4%
113th	10,637	448	4.2%
112th	12,299	500	4.1%
111th	13,675	639	4.7%
110th	14,042	745	5.3%
109th	13,072	589	4.5%
Average of Last 16 Congresses			**5.0%**

Appendix E: Best Buy Employee Testimony

lacroixdood · 7 mo. ago

GS: ARA

If someone is really set on financing I usually tell them to come back in 6 months to apply for the BP again.

If they insist on using Progressive even after I mention that they could end up paying double the price, I let them do it because I've already given my disclaimer.

Worst part isn't that they're making a bad financial decision, but that they can't read to save their own life. When it comes to signing the lease at checkout about 9/10 times I get asked either what boxes to check off or how to choose early buyout.

I'm okay with explaining that you need to call for early buyout because the page makes it look like 12 months and 90 days are your only options. That's on Progressive for being sleazy.

When they ask about what boxes to check off, that's on them for not reading what they are agreeing to.

Appendix F: PRG's Actual Pre-Approval Estimates (>100%)

Estimate lease-to-own costs before you apply

This easy budgeting tool helps you to explore costs. This is not an offer to lease. Your actual pricing details may vary based on approval.

12-month lease-to-own estimate

This is an estimate of what you will pay if you complete all standard payments.

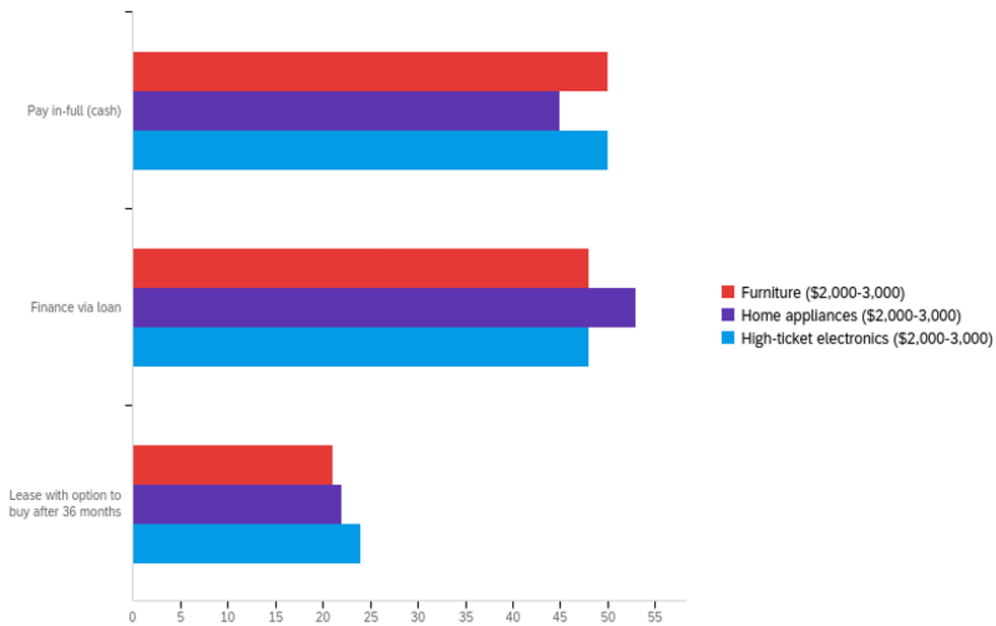
Cash price	$2,200.00
Lease-to-own cost	+ $2,589.00
12-month lease-to-own total	**$4,789.00**

Tax calculated at signing

$90.97 + tax due **every week** near your paydays for **12 months**.

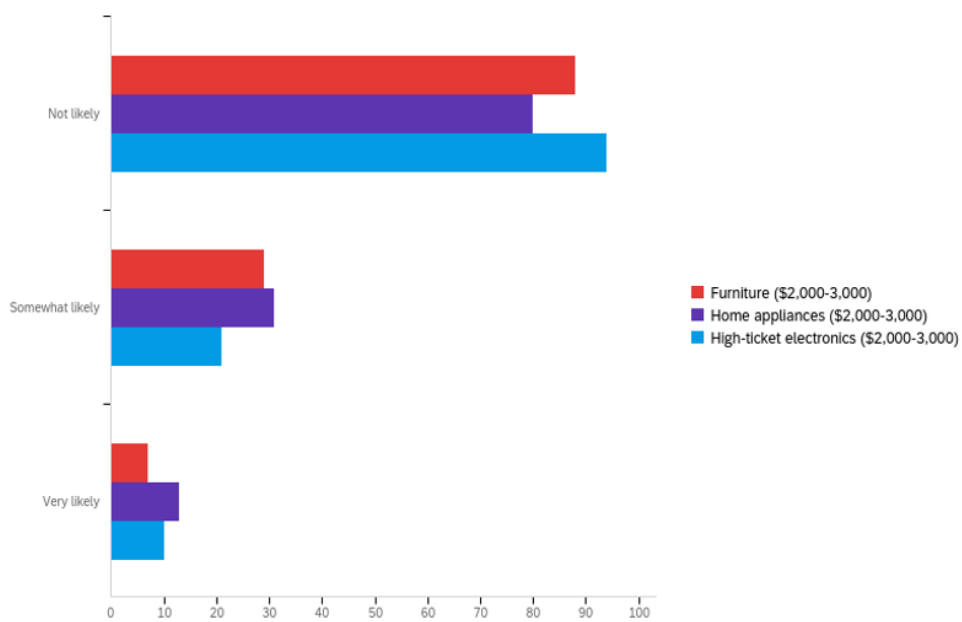
Appendix G: Consumer Preference Sample Question Based on 126 Consumers with <620 Credit Score

Q4 - If you had to purchase these items today, which option would you choose?



Appendix H: Sample Question 2 from 126 of 452 Surveyed

Q5 - How likely are you to consider leasing the items below today if there were no options to get a loan?



Porter's Five Forces (Industry-level)

Barriers to Entry: Given that there are three main companies in the electronics and appliance rental industry, there are significant barriers to entering this industry. With the economy doing as poorly as it is, it will be harder for smaller companies to enter. The main barrier to entering this industry is the geographic location where these companies choose to operate. Some states have stricter regulations on leases that may take advantage of their customers.

Buyer Power: As there are millions of consumers seeking financing solutions for electronics and home appliances, buying power is quite low within Prog Holding's industry. Further, as PRG primarily markets to underserved sections of the consumer lending spectrum, its customers often have limited options to obtain financing at the point of sale. This allows Prog and it's few competitors to charge healthy fees for their products.

Supplier Power: In the case of Prog Holdings, supplier power is strong. PRG relies on its retail partners to provide a variety of key business functions including marketing and selling its leasing products. Further, the firm derives nearly half of its total revenues from only three key retailers. Losing one of these key retailers would result in a significant negative impact on the firm's performance.

Threat of Substitution: There are threats to companies that charge high-interest rates on small appliances and electronics. The main threat is another company charging lower interest rates on their leases. One company charging a lower interest rate or creating a better lease-to-own solution will attract more customers looking to lease an electronic or an appliance.

Degree of Rivalry: As the lease-to-own industry has a small number of companies that take up much of the market share, there is a lot of competition. The three biggest players take up roughly 66% of the market share, so there is a lot of competition to gain the last 34% of the share. The already established companies are using strategies like charging slightly lower interest rates than their competitors to attract a larger number of customers.

Economic Moats

Prog Holdings Inc. ($PRG): As a market share leader of lease-to-own solutions in the United States, Prog Holdings benefits from a vast array of consumer purchase data that can be used to further optimize its propriety underwriting model. This creates a strong data network effect that provides increased accuracy and efficiency when offering leasing products to the firm's underserved consumers. Beyond consumer data network effects, Prog benefits from its large network of retail partners which include some of the nation's largest consumer product retailers. Being marketed by these major retailers provides excellent brand awareness for the firm which, in turn, makes it more valuable to merchants.

Rent-A-Center Inc. ($RCII): As a close competitor to PRG, Rent-A-Center Inc enjoys many of the same benefits of a large consumer network as PRG, including extensive consumer purchase data, and a strong network of retailers. In addition to great network effects, RCII's economic moats also benefit from exceptional leadership. RCII's leadership's ability is a valuable intangible asset, and it has shielded them from much of the regulatory scrutiny that has troubled Prog Holdings.

Revenue Drivers

The main revenue driver for Prog Holdings is the massive interest charges they rely on through their loans. The largest product segment in this industry is appliances. If there is an increasing demand for appliances, then Prog Holdings will be able to give out more loans to their suppliers. With an increasing demand for household appliances and electronics, Prog will be able to charge a higher interest expense and hand out more leases. Prog Holdings makes about half of their total revenue from 3 companies and about 75% of their revenues from their 10 largest partners. Another main driver for Prog Holdings would be an overall increase to unemployment. With an increase to unemployment, consumers will not have the income to properly buy consumers appliances and electronics and turn to a short-term option of leasing them.

Stage of the Business Life Cycle

Prog Holdings is operating in stage 5 of the business life cycle. Though they were spun off a couple years ago, they have already established themselves as a large player in the industry. As they take up a large portion of the industry market share, this eliminates them from being a young-growth company. The reason for them being a stage 5 company is due to the industry being on the decline. With the looming threat of regulation on both the state and federal levels, the rent-to-own industry will see a major decline in demand in the coming years. However, as the industry may be on the decline, Prog Holdings still takes up a massive amount of market share as their 3 top partners take up about 50% of their total revenues, and 10 of their top partners take up 75%.