GRANT'S

INTEREST RATE OBSERVER®

Vol. 35, No. 13d | Two Wall Street, New York, New York 10005 • www.grantspub.com | JUNE 30, 2017

Reaching for customers

"We didn't believe in conducting credit checks then and we don't conduct credit checks now," said R. Charles Loudermilk Sr., founder of Aaron's, Inc., in the dark days of 2009. "But, we do ask for the phone numbers of our customers' mothers."

Aaron's (AAN on the Big Board), subprime lender and a retailer besides, is front and center in this exploration of the mores of late-cycle American credit. The supporting cast of characters includes Rent-A-Center, Inc. (RCII on the Nasdaq), an Aaron's comp, as well as Amazon.com, Inc., an Aaron's nemesis, and Signet Jewelers Ltd. and Conn's, Inc., a pair of newly acquired Aaron's credit partners. Easy money in a time of technological disruption furnishes the main narrative thread. Skipping down to the bottom line, we are bearish on Aaron's and bearish on credit.

News of the coming arrival of Amazon Prime Wardrobe (order up to 15 items of clothing, try them on, buy what you like, return the rest for no charge) followed hard on the bombshell announcement of Amazon's bid for Whole Foods Markets, Inc. Boom! went the share prices of grocery retailers and department stores alike.

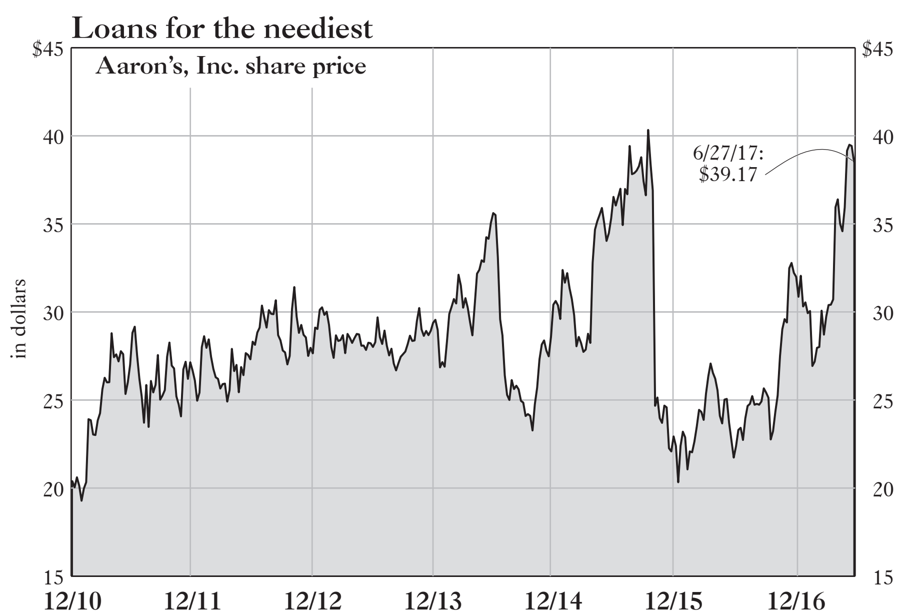
Why the Aaron's stock price hovers near its all-time high in the teeth of the Bezosian gale is the question that sparked this analysis. Not only would the physical retail business of Aaron's appear to be at risk, but so, too, would its subprime lending operations. Delinquencies and defaults on consumer loans, especially on subprime credit cards and subprime auto loans, are accelerating, as these pages have been reporting (see, for instance *Grant's*, June 2). How many checks can a mother write?

On form, Aaron's would know. The $2.77 billion market-cap enterprise has been in business since 1955. In his founding transaction, Loudermilk bought 300 Army surplus folding chairs with the proceeds of a $500 bank loan; you could rent his furniture for a dime a day. Now "rent-to-own," along with the associated RTO financing opportunity, is the Aaron's revenue model.

In RTO, you pay for the use of, say, a couch, TV or laptop. Stay current on your monthly or fortnightly payments, and the product is yours at the end of the lease term (typically 12 to 24 months). Lessees may terminate the transaction either by returning the item to the lessor or by buying it, within 90 days of signing, at full list price.

"So, for example," colleague Evan Lorenz explains, "a customer in San Antonio could buy a LG 65" Smart 4K UHD TV with webOS 3.0 for $1,408.99 outright or rent-to-own the set for 24 monthly lease payments of $99.99 (or $2,399.76 in total). If restructured as a fully amortizing loan, those 24 payments would equate to a 57.4% interest rate. Due to the high implied rate, RTO is not exactly the first option for borrowers with access to credit cards or other forms of finance."

With $3.2 billion in trailing 12-month revenue, Aaron's is the largest RTO retailer in the United States, $300 million ahead of No. 2, Rent-A-Center. You can rent-to-own at 1,155 Aaron's-owned stores and 688 at Aaron's-franchised stores. The out-



source: The Bloomberg

lets sell furniture (42% of 2016 sales), consumer electronics (26%) and appliances (24%). RTO kiosks, manned or unmanned, at 18,627 other retailers, constitute another fast-growing line of business; Progressive Leasing is the name of this Aaron's subsidiary. Turned down for a loan by a bank? DAMI, the Aaron's dinged and dented credit business, is prepared to fill the void. It levies interest charges and fees which, in the first quarter, worked out to a 39% annual borrowing rate.

In the first quarter, DAMI delivered a $1.8 million pre-tax loss. Aaron's brick-and-mortar operations produced a $48.6 million pre-tax profit, Progressive a $35.8 million pre-tax profit.

Unrated Aaron's could teach its speculative-grade clientele a thing or two about financial management. The company shows $114.8 million in debt net of cash against $356.8 million in trailing 12-month adjusted earnings before interest, taxes, depreciation and amortization (EBITDA). In the first three months of the year, operating income of $86.5 million covered interest expense of $4.8 million by 17.9 times. Progressive's net write-offs in the first quarter, expressed as a share of revenue, dropped to 4.8% versus 6.2% in the like period of 2016.

Progressive Leasing—the fruit of the 2014 acquisition of Progressive Finance Holdings—is the Aaron's growth propellant. In the first quarter, the division created $262.9 million in invoices (i.e., new sales financed by RTO), a 20% year-over-year increase. Also in this period, Aaron's same-store sales declined by 9.3% while the Aaron's store count (both owned and franchised) fell by 189, to 1,843. Pre-tax profit supplied by the Aaron's retail department slipped by 20% compared to a 63% jump furnished by Progressive.

"The bull case around Progressive stems from the fact that a significant portion of the U.S. population is credit-challenged, either because they can't manage their credit responsibly or because they don't have a recurring income stream that most creditors like to see," Northcoast Research analyst Nicholas Mitchell, who rates Aaron's a buy, tells Lorenz. "As a result, there is a huge portion of the market that, for lack of a better phrase, falls far enough down the subprime bucket that most guys won't take on the risk." Thus, the opportunity for lenders such as Progressive. Mitchell estimates that the addressable market for virtual RTO is between $25 billion and $50 billion. In the 12 months ended March 31, Progressive and Acceptance Now, Rent-A-Center's virtual RTO division, booked revenues of $1.3 billion and $822 million, respectively.

The largest virtual RTO company, Progressive has the edge over its rivals in scale and technology. What the big retail chains need is what Progressive has to offer, says Mitchell. "[Retailers] are looking for great data analytics. They are looking for back-office support especially for duplicative systems. As a retailer, you want to make sure that your partner is going to be online as close to 100% as possible, so backup systems are key."

Our old friends Conn's, Inc., the furniture, electronics and appliance retailer with $1.6 billion in trailing sales, and Signet Jewelers Ltd., the mall- and off-mall-based jewelry retailer with $6.2 billion in trailing sales, would seem to see things just as Mitchell does. This spring, each inked a partnership with Progressive. (For Conn's, see the issue of *Grant's* dated Jan. 24, 2014; for Signet, see *Grant's*, June 3, 2016.)

. . .

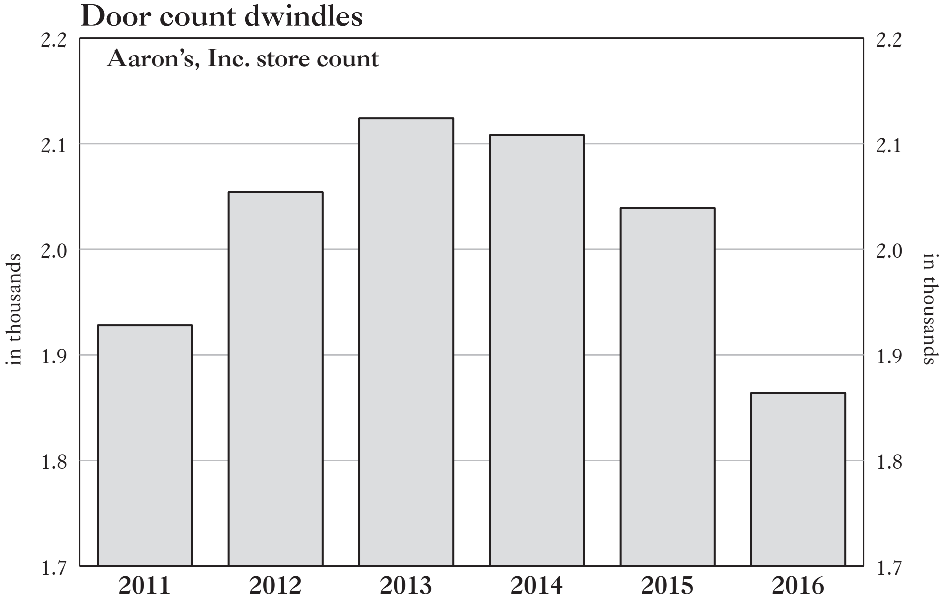
"Whatever the future may hold for Progressive," Lorenz relates, "Aaron's is mano-a-mano with Jeff Bezos, the same as other retailers. It doesn't look like a fair fight. Aaron's stores are small and carry a limited selection of inventory. According to the 2016 10-K report, the average Aaron's store is 8,000 square feet while the average Best Buy, Inc. store is 39,000.

"Unlike most other retailers, Aaron's does not disclose its inventory levels on its balance sheet," Lorenz goes on. "Rather, it records a line item called 'lease merchandise,' which consists of inventory that has been leased to customers and inventory that is sitting in stores and warehouses. After a 2016 reprimand from the Securities and Exchange Commission, Aaron's finally broke out the merchandise that is on lease and the merchandise not on lease in its footnotes. Based on the new disclosures, the average company-owned store held $174,352 in inventory as of March 31. For comparison, Best Buy stocks $3.3 million in inventory per store as of April 29. The 65" LG TV noted earlier is the 2016 model—Aaron's does not stock the 2017 version.

"What you pay depends on where you live. The aforementioned LG TV costs $1,408.99 for a customer in San Antonio. It runs to $1,549.99 for a resident of the south side of Chicago and $1,707.99 for a Manhattanite. (Lease payments and implied interest rates fluctuate wildly by zip code, too.) The same TV—the 2016 model—can be purchased from Amazon.com or Walmart.com for $1,197."

For a cash-strapped customer, price may not be the deciding consideration. Credit—its terms and availability—might count for more. It would be better for Aaron's if there were more such

Door count dwindles



source: company reports

straitened individuals to whom to cater. According to Fair Isaac Corp., consumers who are rated deep subprime (with scores below 550) fell to 11.7% of the population in April 2016 from 16% of the population in October 2009.

And as there are fewer needy borrowers eight years into an economic expansion, so there are more willing lenders. Credit-card balances jumped by 7.3%, to $764 billion, in the first quarter, according to the New York Fed, and available but undrawn credit grew by 5.5%, to $2.6 trillion.

"We've seen a consumer who's certainly gotten more indebted," Capital One Financial Group Corp. CFO R. Scott Blackley said at the May 30 Deutsche Bank Global Financial Services Conference. "We've seen growth in the amount of outstanding indebtedness in student loans, in auto [loans], and we've seen revolving credit that's really been expanding," including, Blackley added, growth in subprime credit availability.

These trends aren't punishing Aaron's alone; Conn's and Signet, which also finance a meaningful portion of their customer sales, suffered 15.2% and 11.5% year-over-year declines, respectively, in same-store sales. Best Buy, which abstains from the customer-finance business, reported a 1.4% rise in first-quarter domestic same-store sales.

That Aaron's has been closing stores isn't surprising. That the shuttering juices the financial results of the shutterer is a little less intuitive. Recall that RTO contracts run for 12 to 24 months. By turning out the lights in a retail location, Aaron's enjoys an immediate savings in operating expense (analysts ignore restructuring charges relating to store closures) and a long tail of revenues from in-place RTO deals.

Aaron's franchisees, too, have been closing locations. Fifty went dark between 2012 and 2016. And there would have been 131 had Aaron's not purchased 81 stores from the former franchise holders. Here, too, a cheerful accounting patina brightens up an unfavorable business event.

"The cost of acquiring franchisee stores shows up in cash flows from investing activities under 'acquisition of businesses and contracts, net of cash acquired,'" Lorenz points out. "The purchase price of a franchisee's store includes that seller's floor inventory. Normally the cost of acquiring retail stock is a charge to cash flow. Not so when you buy a store lock, stock and barrel. So when Aaron's leases a couch or a TV which it hauls out from the storeroom of a former franchisee, the cash-flow metrics look better than they really are. Still and all, the store network is declining."

Aaron's is turning out the lights on more than its stores. In the first quarter, the front office unhelpfully commingled the stores both owned and franchised into a single reportable segment rather than, as had long been the case, disclosing them separately. Comparing the two separate categories had been informative (franchise-derived revenues are, by their nature, higher margin). Collapsing the data into an undifferentiated mass makes you wonder what management would prefer you didn't know.

The bulls would have a better case if invoice growth per location at Progressive were not decelerating. In the first quarter, invoice volume expanded at the more than respectable year-over-year rate of 20%, to $262.9 million. It's growth that would seem more eye-popping if the number of retail sites with a Progressive kiosk had not burgeoned by 38%, to 18,627.

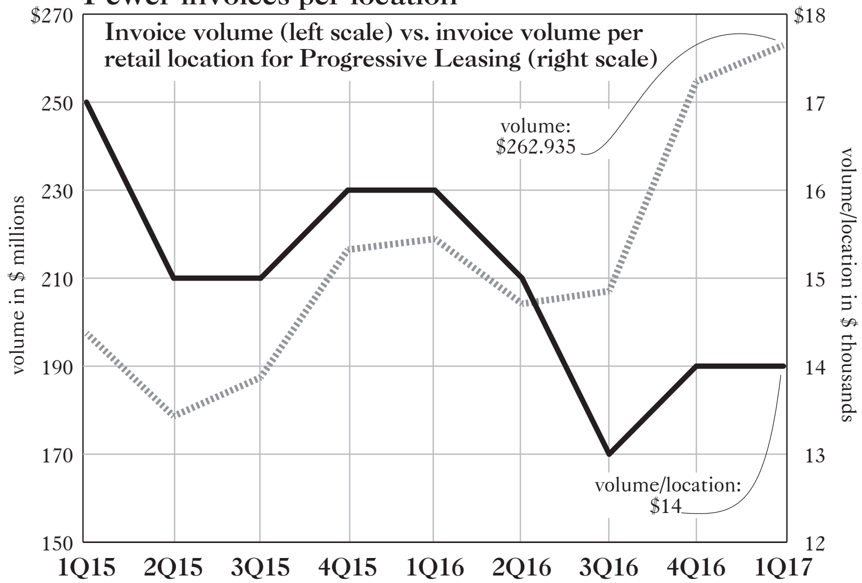
Yes, it does take time for a new Progressive retail affiliate to get up to speed on the mechanics of RTO, but the gap between store growth and invoice growth is widening. To continue to deliver what Wall Street demands, Progressive must sign an ever greater number of new retail partners—for instance, with the aforementioned Conn's, Inc. and vendors of appliances, mattresses and furniture.

Prior to the tie-up with Progressive, Conn's had done its rent-to-own business through Acceptance Now, the subsidiary of Rent-A-Center. The Rent-A-Center CEO, Mark E. Speese, pulled no punches in telling dialers-in on a May earnings call why his company had given Conn's the heave-ho: "[W]e determined not to renew the agreement due to the quality and performance of customer accounts originating from Conn's stores, which consistently underperformed compared to the rest of our Acceptance Now segments in terms of delinquencies, losses and product returns."

Naturally, there's a Conn's side of the story, though it reflects no glory on the customer base. Acceptance Now, goes the rebuttal, rejected too many credit applications. This leaves the impression that Progressive will be expected to say yes more frequently than the evidently careful underwriter has customarily done.

Signet, too, makes a problematical partner. Customer finance is an integral part of the Signet business model. In the case of the Sterling Jewelers division, in-house lending funded 62% of sales in 2016, up from 52.6% in 2008. The contention in these pages (*Grant's*, June 3, 2016) was that Signet's credit book was performing worse than its atypical accounting methods revealed.

Fewer invoices per location



source: company reports

Posh, said the bulls. Signet was poised to sell its credit portfolio, they observed. They predicted that the loans would fetch a price sufficiently fancy to validate both the jeweler's credit judgment and accounting approach. No such vindication ensued. The sale that did take place (it was announced on May 25) netted Signet $1 billion for its prime loans at par, but no bids surfaced for $700 million in subprime loans.

Which is where Aaron's comes in. Here's what Signet CEO Mark S. Light had to say on the jeweler's May 25 earnings call: "Progressive will provide a lease-purchase payment option to our customers [who] are at the low end of our current in-house credit structure, as well as those who are currently not covered, and at no risk to Signet." By the sound of it, Progressive will lend to the most marginal borrowers to whom Signet has historically extended credit as well as to the kind of deeper subprime customer to whom Signet has chosen not to extend credit. You wonder if the customers' mothers have heard about it.

"It's the nature of rapidly growing loan books to glow with good health," Lorenz notes. "Borrowers typically don't default on their first payments, so portfolios packed with freshly issued loans show fewer problems than do seasoned loans.

"As to what happens when loan growth slows, we can look to Rent-A-Center's Acceptance Now business unit. Acceptance Now expanded its revenues by 26.9% in 2015, but growth came to a screeching halt in 2016 and operating profits plunged by 14.6% year over year as charge-offs piled up."

Aaron's is valued at 19.9 times trailing earnings per share, or 16.4 times the more flattering adjusted earnings per share. Analysts have penciled in adjusted earnings growth of 5% and 13% for 2017 and 2018.

Sentiment on the stock is split, and 5.2% of the float is sold short. Even insiders seem divided. The last insider buy was on Aug. 19, when a director purchased 40,000 shares for $25.29 each. Since then, insiders have been sellers, to the tune of 47,750 shares, at an average price of $32.30.

No indecision, though, at corporate headquarters over how to respond to calls and emails from this publication. We got the silent treatment.

•