

# GRANT'S

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## Paycheck to paycheck

A slight emendation: Amazon isn't the most highly valued company by any and every reckoning of value. By the standard of enterprise value to sales, Conn's Inc. (CONN on Nasdaq) ties the Everything Store, 2.60 times to 2.60 times. Now unfolding is a bearish analysis of a stock that only seems to want to go up.

This may not be news you think you can use. We understand that precious few investors, even *Grant's* readers, will sell anything short. Federal Reserve policy actively discourages the practice. The normal human desire for a good night's sleep likewise militates against selling an asset you don't actually own but must go out and borrow. We are offering up more short ideas because we can't find enough suitable long ideas (reciprocally, in 2009 through 2012, we featured many more longs than shorts). We make no representation that the stock market has peaked. We only judge that, based on our idea of what constitutes value, the evident rewards of being long increasingly pale before the evident risks. Journalistically and analytically, we are tilting to the bear side of the boat.

Back to Conn's. Based in The Woodlands, Texas, the company operates more than 70 clean, well-lit and well-stocked stores in Texas, Louisiana, Arizona, Oklahoma and New Mexico. Conn's sells Samsung washers and dryers, Serta mattresses, Sony televisions and HP laptops, among myriad other products and brands. Many others do, too, of course. But not every retailer "provides financing solutions to a large, underserved population of credit-constrained consumers who typically are unbanked and have credit scores between 550 and 650," to quote from our subject's SEC filings.

Conn's is a subprime retailer, and credit—so we say—is its Achilles heel.

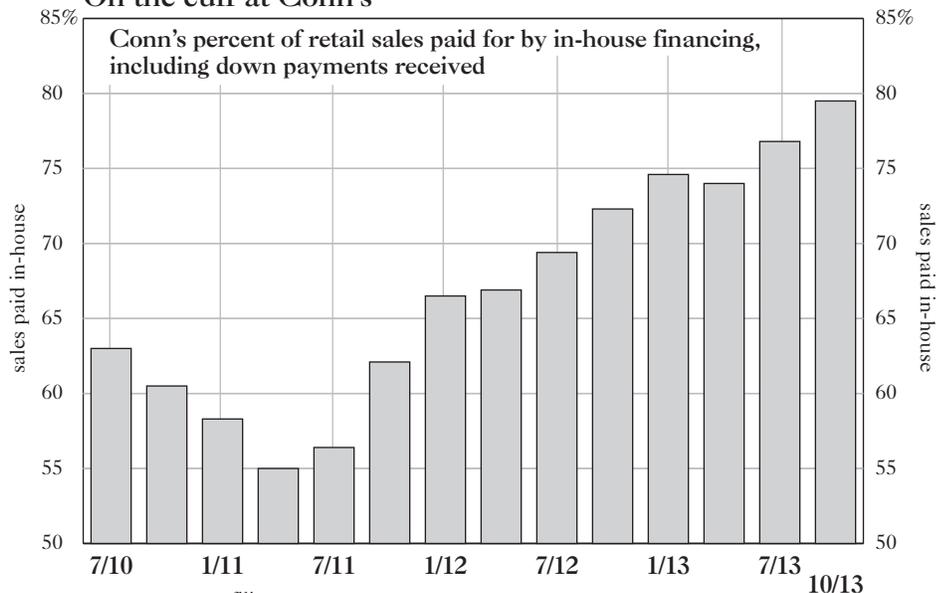
"Conn's," observes colleague David Peligal, "essentially allows these customers to make an aspirational purchase. The lucky aspirants just have to be prepared to pay an 18% interest rate for the privilege. Depending on whether you've been long or short," Peligal adds, "Conn's has either been one of your best investments or one of your worst investments."

Conn's is an outlier in many respects. Its growth is supersonic, its sponsorship is first class (Stephens Inc., the closely held Little Rock investment bank, is among the major investors), its margins are otherworldly—and Amazon has so far failed to lay a glove on it. Best Buy, Sears Holdings Corp., Aaron's, hhgregg

and Select Comfort Corp. are among the predominantly brick-and-mortar retailers that laid holiday eggs. Conn's, whose fiscal year closes on Jan. 31, has disclosed no results beyond November's, which—as usual—have the look of typographical errors: Overall retail sales jumped by 49% and same-store sales by 32%.

"The bull case for Conn's is pretty simple," Peligal observes. "One, it's pretty hard to find retailers competing at 30%. With management guiding same-store sales up 22% to 25% in fiscal 2014 and up 7% to 12% in fiscal 2015, the figures are clearly outpacing the competition. For perspective, Best Buy's shares plunged by almost 30% on Jan. 16, when the electronics retailer disclosed a 0.9% drop in domestic same-store sales comparisons in the nine weeks to Jan.

### On the cuff at Conn's



4. For a second thing, Conn's sees long-term potential for more than 300 stores in the United States; it says its target market comprises 30% of the American population. Many bulls are no doubt saying, 'Gee, there's growth and a big runway for these guys!' More thoughtful optimists may simply reflect, 'Look, we know this is going to end badly, but they're comping 30%. Too many people are short it. Numbers are going up. We're just going to ride this thing and squeeze the shorts.'"

Not the least of Conn's' quirks is that, of the 25.1 million-share float, no fewer than 4.5 million shares are sold short. The stock pays no dividend, and it's easy to borrow. The bear story is to us—though not yet to Mr. Market—more than persuasive.

"Very simplistically," Peligal relates, "two things happen at a Conn's store: Merchandise walks out of the building and dollar bills walk in. The rate of change in merchandise walking out is what counts in the comp stores' data. It's the metric that was up by the amazing, aforementioned 32% in November—and by 23.7% in the first nine months.

"Short-sellers focus more on the rate of growth of dollar bills walking in," Peligal goes on. "The essential bear story is that the rate at which these dollars are walking into Conn's locations this year is largely unchanged, surging comps and new-store openings notwithstanding. So something is wrong with this picture. Essentially, Conn's is giving people merchandise and telling them they don't have to pay for it just yet, or they can pay for it slowly, or the company can restructure their loans, etc. With same-store comps rising by double-digits and with 10% to 15% more locations this year than last, cash revenues are essentially flat. What's financed the scorching growth is customer receivables."

Catering as it does to people who (many of them) live from paycheck to paycheck, Conn's has stepped up the rate of its in-house lending. In fiscal 2012, it financed 60.4% of retail sales, in fiscal 2013, 70.9% of retail sales. In the third quarter ended Oct. 31, it financed 79.5% of retail sales, including down payments, evidently a quarterly record. Like many another retailer, Conn's has engaged an outside financing partner—in this case, GE Capital—to manage part of the lending operation. But unlike much of the retailing world, Conn's has elected to do the bulk of its financing

business itself (GE deals with only the better credits). At a Dec. 11 conference hosted by J.P. Morgan, the chairman and CEO of Conn's, Theodore Wright, addressed his company's financial strategy. "Sometimes people look at our credit operation and they think of us as a credit company," said Wright. "We are not. We are a retailer that has a credit product it uses. We do one thing and one thing only in credit. It's a secured installment amortizing credit product to finance products we sell. That's it. We've done it for 45 years."

The bear story turns on this point. Is it business as usual at Conn's? Or will unscripted credit losses do the damage that (to date) Amazon has failed to inflict? We opt for the latter train of thought, management for the former. The front office has advised analysts to expect a drop in credit problems in the fiscal year ended Jan. 31, 2015. As a percentage of the average portfolio balance, Conn's projects, bad debts will decline to 8% or 9% from the 9.4% or 9.7% expected in the current fiscal year.

"Now here is an odd thing," Peligal observes, "loans past due by 60 days or more, expressed as a percentage of the average portfolio balance, jumped to 8.5% in the latest quarter from 7% in the like year-ago period. The delinquency data commend themselves to the analyst because they are unmassaged, less so the bad-debt data. Suppose that a Conn's customer owes an unpaid credit balance. It is 209 days overdue. By the book, 209 days is the bright shining line, cross it and a good debt becomes bad. Imagine this scenario: A Conn's credit representative calls the reluctant debtor, saying, 'Look, you owe us \$1,000. Just pay us \$100 and I'll restructure your account and make you current.' After having received a string of phone calls from Conn's, the debtor may relent and pay the \$100. If he pays, Conn's may reclassify his balance from 'late-stage delinquent' to 're-aged receivable.'"

On Oct. 31, the Conn's balance sheet showed \$422.2 million of long-term debt and \$3.7 million of cash and equivalents. On Nov. 25, management completed negotiations with a syndicate of banks to expand and extend the company's asset-based, floating-rate loan facility. The amended terms feature a lengthening of the maturity date to November 2017 from September 2016, and a bumping up of the borrowing limit to \$850 million from \$585 million. Here's a sign of the times in

credit: The banks agreed to cut the borrowing cost by 25 basis points per annum. They must be bullish on Conn's, too—or, if not that, confident in Janet Yellen. We surmise that it isn't getting any easier for Conn's to collect what its customers owe. Thus, in the October quarter, operating margin in the credit department fell to 19.6% from 29.9% a year before.

Elsewhere at Conn's—specifically in the beating heart of the retail business—gross margins are up, up and away. In the October period, home-appliance margins registered a year-over-year jump to 32.9% from 28.2%; those in furniture and mattresses, to 50.3% from 45.3%; and those in consumer electronics, to 29.4% from 24.5%. All of this came amid a broad-based rise in average selling prices. Or, in the words of the latest 10-Q report: "continued margin improvement across all major product categories due primarily to the continued focus on higher price-point, higher-margin products and realization of sourcing opportunities."

Too good to be true? One wonders, especially in consumer electronics, where, for retailers not named Conn's, gross margins cluster in the low 20s. Best Buy—no market darling lately—stands out for touching 24%. Then, too, gains in gross margins typically come in dribs and drabs, not by leaps and bounds. "I mean, Best Buy, if they do everything right and everything goes their way, they'll have gross margins up 50 basis points," one bearish portfolio manager—he declines to be identified by name—tells Peligal. "I've never seen a consumer electronics retailer with anywhere near that level of improvement. It's an absurd level of improvement. . . . There's literally nothing you can do as a retailer of these high-ticket, competitive-priced products to do that. So it's a mystery to us."

We're not the only curious ones. On the Dec. 5 earnings call, Michael Poppe, the Conn's chief operating officer, fielded a question about the 490 basis-point spurt in consumer electronics margins. Better sales of pricier items, like 65- and 75-inch television sets, and fewer sales of low-margin products, are the reasons, he replied. Our anonymous source has his own pet theory. He conjectures that Conn's is somehow lumping the present value of future interest payments into the sales price it recognizes at the time the merchandise walks out the door." Asked to comment, Brian Taylor, the CFO, e-mailed a denial: "We recognize interest income as earned over the term

of the retail installment contract—not at the time of sale,” he said.

What do the consumers say? Not what the company says in general, according to Peligal’s survey of a number of consumer-review sites. To investors last month, Conn’s represented that, based on company survey data, “sales customer satisfaction” stood at 94% in each of the first three quarters of this fiscal year. And at the previously mentioned J.P. Morgan conference, Wright remarked, “And because of the value we provide to the consumer, we have a high rate of repeat purchase—71% of our credit balances today are to customers who have bought from us more than once. On average over a five-year period, a customer that buys with us will buy twice more again, so we have strong customer retention because of the value that we provide.”

Maybe the consumers who unburden themselves online are constitutionally cranky, but let’s hear them out. “On the Consumer Affairs Web Site, out of 196 ratings describing overall satisfac-

tion, Conn’s received a 1-star rating 166 times,” Peligal reports. “It received twenty 2-star ratings, five 3-star ratings, two 4-star ratings, and three 5-star ratings. On Jan. 20, a verified reviewer named “Christopher of Austin, TX” describes his experience purchasing multiple items from the north Austin Conn’s store and why he gives the store a 1-star overall satisfaction rating. ‘I feel like by purchasing furniture through Conn’s, I’ve given up my ability to purchase things on credit in the future. I have a credit-monitoring program through my bank that alerts me at least once a week that Conn’s has reported me for delinquency, despite repeated reassurance that my account, provided I honored my end of the arrangement, which I did, would be both current and removed from collections. I’m tired of 8:00 a.m. phone calls asking me for money I’ve already paid.’

“Moving to the Yelp Web site,” Peligal proceeds, “an individual named ‘P.B. of McDade, TX’ also gave a Round Rock [TX]-located Conn’s store a 1-star (out

of five) review on Nov. 29, 2013. Wrote P.B: ‘There is a moral to this rant. Every single person I dealt with at Conn’s—EVERYONE—lacked ANY kind of training on how to deal with ANY kind of customer-service issues. There was not one isolated instance, it was everyone. So bad that I swear I was on Candid Camera. I’m retired from 35 years in the grocery business, the last 20 or so running a store for 2 different large grocery retailers. You will die without good customer service. Conn’s does not even have a clue. Bold prediction. Conn’s will fail. This was my first and last shopping experience with Conn’s.’”

One review, posted on the Glassdoor Web site, especially stands out. Signed “Cut throat,” the critic identifies himself as a Conn’s store manager in Fort Worth, Texas. His advice to Conn’s senior management? “Save what u get, exit to another industry.” Or maybe just sell your stock.



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We resume regular publication with the issue dated Sept. 5 (don't miss it!).

Sincerely yours,

  
James Grant, Editor  
August 22, 2014

# GRANT'S

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### Fiat-fest 2014

(July 25, 2014) The annual summertime monetary hoedown at Jackson Hole, Wyo., won't be the same this year. Fed. host of the August fiat-fest, is cutting Wall Street dead. Economists from the TBTF banks, longtime schmoozers in Jackson Hole, are this year being invited to stay home.

Maybe that's a good thing—the crony financiers were especially thick on the ground at the 2006 proceedings, where they collectively seemed no more alert to than the looming mortgage-cum-credit-crisis. Then, again, the Fed has a job of work on its hands. Its balance sheet is too big and its interest rates are too low. It may need some help in strategizing.

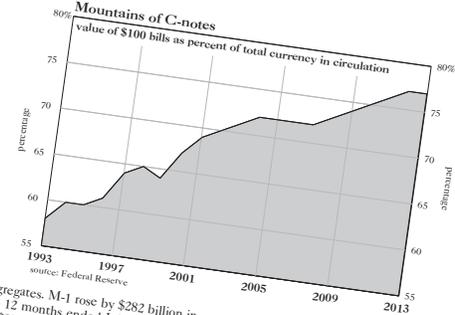
With money-supply growth ticking higher and the rate of producer-price inflation accelerating. "How to exit?" is one this zero-percent world?" is another.

Before QE, the funds rate was the central bank's one and only. "However," excess reserves measured in the trillions today vs. in the billions pre-crisis, the "On to the next rate, then: The new reverse-repurchase rate, perhaps? Maybe or maybe not, the thinking goes, the mere existence of the RRP facility or maybe the interest rate on excess reserves, now fixed at 25 basis points? Or a new funds rate that encompasses more than the funds market?

Accompanying the technical debate is the continued growth of the monetary

#### Mountains of C-notes

value of \$100 bills as percent of total currency in circulation



Year	Percentage
1993	55
1997	60
2001	65
2005	70
2009	72
2013	75

source: Federal Reserve

aggregates. M-1 rose by \$282 billion in the 12 months ended July 7, paced by an \$87 billion increase in currency and a \$196 billion jump in deposits. If \$100 bills represent 77% of the currency growth (as the Fed reports that they did in 2013), and if \$20 bills account for the 3.8 million pounds. More significant growth in deposits, which corroborates the surge in business lending—after all, loans create deposits.

Nearly four million pounds of paper money do create a sense of inflationary anticipation. Where's the thing itself? The Cleveland Fed, which calculates the CPI every which way (median, trimmed and otherwise), essentially comes up with 2%. Two percent is supposedly what the Fed is shooting for. Still, the Fed keeps dancing. And as it fires, asset prices rise. Measured year-over-year, the S&P 500 is up by 17%, the Russell 2000 by 25%, the Case-Shiller Composite Index by 10.8%.



"Well I, for one, am going to miss QE." sb2014

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