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Company Focus:

Pawnshop, payday loan and rent-to-own chains are growing rapidly, thanks to high fees, more relaxed regulation and a clientele with few other places to turn.

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In today's cloudy economic climate -- with the number of unemployed workers at a 20-year high -- more and more people are being forced to resort to extreme financing to pay the bills or keep a TV in the house.

Whether they're hocking the family jewelry, forking over big fees to get an advance on the next paycheck, or paying high prices for appliances in rent-to-own programs, consumers are flocking to so-called "fringe finance" services offered to those whose budgets are already stretched to the limit.

The fringe-finance frenzy isn't particularly good for many consumers. But it's a boon to pawnshop companies such as Cash America International ([PWN](#), [news](#), [msgs](#)) and First Cash Financial Services ([FCFS](#), [news](#), [msgs](#)), as well as companies such as Rent-A-Center ([RCII](#), [news](#), [msgs](#)), an operator of rent-to-own stores. The sector's sales have soared lately, and so have its stock prices.

Should you be an investor? The answer depends in part on your stomach for the controversial businesses they're in. But there may well be a lot of growth ahead for this group, no matter how quickly the overall economy regains its footing.

Revenue growth rates are high

Loans at Cash America of Fort Worth, Texas, with more than 460 shops in the United States and abroad, were up 13.5% from a year earlier in the most recent quarter. That supported healthy revenue growth of 14% a year. Meanwhile, loans advanced 27% at First Cash Financial Services, which has more than 270 pawnshops and check cashing outlets in the United States and Mexico. That contributed to big revenue gains of 24% last quarter for the Arlington, Texas, company.

While several factors are at work here, clearly the downturn in the economy plays a part. "When you've got a choppy economy, obviously it creates some demand," says Douglas Orr, First Cash Financial's chief financial officer. "People get in situations where their overtime is cut back, or they are transitioning between jobs, and they have additional credit demand."

Two other factors are behind the booming business at pawnshops:

Gold prices are up to \$350 or so. That means pawn shops can charge more for their jewelry. It also means more people are putting gold in hock for a loan.

A once-obscure service called a “payday advance” is taking off. In payday advances, workers pay a fee -- as much as 15% to 18% of their paycheck -- for an advance on that paycheck. The size of a typical payday advance is around \$200.

“It is certainly a controversial product, but there is high demand for it,” says Richard Shane, who covers Cash America from San Francisco for the brokerage Jefferies & Co. He points out that payday advances leaped by 65% in the last quarter at Cash America, partly because of consumer demand, and partly because the company is more comfortable with the service. Payday advances are about twice as profitable as standard pawn-based loans. More than 30 states permit them.

Business is booming as well at Rent-A-Center. The company’s revenue grew by 12% last quarter over the year before. The largest U.S. player in its industry, Rent-A-Center caters to consumers with moderate income and poor -- or no -- credit ratings. Through more than 2,500 outlets across the country, the company offers a wide range of items, from furniture and appliances to home electronics and computers.

In a typical deal, a customer makes a weekly rent-to-buy payment over the course of 12 to 24 months, at which point he owns the product. On many items except furniture, the customer ends up paying as much as 50% or more than what he'd pay at a typical retailer. In exchange, he gets a loan of sorts, even though the loans are classified as leases. He also gets conveniences such as no down payment, free delivery or pickup, full warranty and the option to return the product at any point and pick up the rent-to-buy agreement later.

Here again, the economic slump has been good for business. “We appeal to consumers who are generally cash-and credit-constrained. So, in a good economy or a bad economy, there is a large audience,” says Robert Davis, Rent-a-Center’s finance chief. “But one might argue that, in a recessionary environment, we have a little more opportunity to attract customers.”

Because all of these companies benefit from a weak economy, they serve as good hedges if you doubt an economic rebound is around the corner.

What happens if the economy comes back?

But would a rebound hurt these businesses? Not necessarily.

Pawnshops, for example, have a natural, built-in hedge in their business, says Jefferies’ Shane. As the economy improves, pawnshops may lose some loan business. But more people have money, which supports demand for what they sell. As for Rent-A-Center, an improving economy means it loses some customers who move into better jobs. But it gains customers, as well, as some jobless move back into the low end of the workforce.

More important, all of these companies are expanding quickly. And there's plenty of room to grow because the playing field is populated by small, mom-and-pop shops scattered around the country.

First Cash Financial launched 38 stores last year and should open 45 to 50 new stores by the end of this year, Orr says. "We haven't formulated the plans for next year, but we don't see any reason why we will slow down," he says. First Cash Financial is also moving aggressively in Mexico, where jewelry is readily available and pawnshops are scarce.

Cash America, meanwhile, recently bought Cashland, a chain of 120 payday-advance stores based in Dayton, Ohio. Like First Cash Financial, Cash America will be branching out by opening new shops, perhaps 10 to 20 new payday-advance stores by the end of the year.

For its part, Rent-A-Center plans to increase chain-wide floor space by 5% to 10% per year, chiefly by opening 80 to 100 stores a year. The chain is also reaching out more to Hispanics and expanding its product base to check cashing and prepaid phone cards.

Valuations are fairly reasonable

Rent-A-Center shares pulled back to about \$70 from \$82.75 in late July, when it announced earnings but failed to guide higher for the first time in many quarters. That spooked the momentum crowd. But Davis insists the biggest reason the company did not guide higher was that it failed to buy back as much stock and high-interest debt as it had expected in a recent offer. "Our growth has not changed," he says. The company intends to expand sales by 8% to 10% a year and earnings by 10% to 15% for "many years to come," says Davis. At \$70, the company trades at a forward price-to-earnings ratio of 10.4; that's well below the projected medium-term growth rate of 14%.

Cash America and First Cash Financial shares have doubled since early spring. But with a forward P/E of 12.7, First Cash Financial still trades well below its expected growth rate of 21%. Cash America trades only slightly below its medium-term growth rate of 15%, with a forward P/E of 13.7. Both stocks have strong upward earnings-estimate revisions, suggesting more earnings growth ahead.

Jefferies' Shane has a hold rating on Cash America because he thinks the current price is too high. But he admits he's also waiting for confirmation that its recent merger with Cashland goes smoothly. "Right now, the market is giving them a great deal of credit for the acquisition, which is likely to be positive. But we want to hear more details of it before giving them credit for it," he says.

The morality of fringe financing

Some investors considering buying shares of companies like these may wonder whether it's right to invest in businesses that profit from the poverty of others. After all, fees of 18% for an advance on a \$200 paycheck seem a bit much. Likewise, charging low-

income consumers 50% more than what they'd pay for a television at Best Buy (BBY, news, msgs) may not sit well with you.

The companies claim these concerns aren't valid, of course. Yes, a pawn-based loan may be pricey, but it's better than the alternative: having to deal with the loan shark on the street corner or going without electricity. "We think we offer a valued service," says First Cash Financial's Orr, "because if they did not have us, there are not a lot of products they can turn to."

Rent-A-Center's Davis puts it the same way. "We offer a service to a consumer group that is often neglected by credit-card companies and finance companies or other retailers," he says.

Nevertheless, consumer advocacy groups protest many of the business practices of these companies, and their complaints aren't going to dissipate. That's a risk for investors.

But in general, the legal environment is actually swinging in favor of the fringe-finance sector. Lawmakers are relaxing the rules governing these highly regulated areas. Oklahoma, Alabama and Idaho, for example, recently passed laws making it easier for pawn shops to offer loans. And you can be sure that players such as First Cash Financial and Cash America will be taking advantage of the new rules very soon.

At the time of publication, Michael Brush did not own or control shares in any of the companies listed in this column.