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The Global Value strategy returned -4.33% net for Q1 2016. This quarter started off with a difficult January for US equities before recovering in February and March.

In this letter, I will be delving into our position in EZCORP Inc. (EZPW) which fell 40% in the first quarter and became the largest detractor to our performance in Q1 (though it has since gained 36% in the first two weeks of April). We have used this drop as a buying opportunity, and EZCORP is now our second largest holding. It can be expensive to buy into a business that enjoys a happy consensus, and often the best opportunities are in companies where investor fear has driven prices down to deep bargains. However, I believe that beneath all of the cosmetic problems of EZCORP is a fundamentally strong business which is trading at an excellent valuation. I will detail the various issues which have punished the stock, upcoming catalysts for a re-rating by the market and recovery in stock price, and valuation estimates with a comparison to peers.

Overview of EZCORP's business

EZCORP is an Austin-based company and is the second largest pawnshop chain in the United States. Pawnbroking is an old business with an over 3000 year history. In a pawnshop, a short-term loan is made to a borrower with a physical item being offered up as collateral. If the borrower fails to pay back the loan by the agreed time, the item is forfeited to the pawnbroker and sold to customers as merchandise. Currently, over 80% of the majority of pawn stores are mom & pops which provide an attractive target for large chains like EZCORP to execute a rollup strategy. EZCORP operates 516 stores in the United States and 237 stores in Mexico. EZCORP has three categories of business, US Pawn, Mexican pawn (Empeño Fácil), and Grupo Finmart. Grupo Finmart provides payroll withholding lending to Mexican government employees. EZCORP also owns 32% of Cash Converters, a publicly traded pawnbroker and short-term lender in Australia.

The profitability of a pawn business when well-operated is tremendous. Guidance given by the management during their recent annual meeting is that they earn annualized returns of 140% from repaid pawn loans. If the loan goes into default, resulting in liquidation of the collateral merchandise, then the returns will be around 110% annualized. This high yield is largely due to the short-term nature of the loans.

Recent Weakness

Pawn shop profitability is closely related to the price of gold for two reasons. A significant portion of forfeited merchandise is jewelry which is sent in to foundries for gold scrapping.

Additionally, the allowable value of the loans will be lower if the jewelry is less valuable thereby reducing the interest income paid from the loan. In the last three years, there has been a great pullback on gold prices. Currently the price of gold is down by a third from its peak.

Another factor which hurt the company in previous years was a foray into payday loans which did not yield favorable financial results for the company (especially in light of recent regulatory changes in that space). Fortunately, EZCORP has since exited all of their payday loan operations in the United States.

There were also accounting issues related to the Grupo Finmart subsidiary in Mexico which forced the company to restate their financial statements and temporarily cease reporting financial statements. These issues have since been resolved, but many investors felt compelled to exit their investment in the company thereby depressing share prices. Accounting issues and declining market capitalization sometimes lead larger mutual funds to be forced to liquidate a position due to their mandate or other business concerns. For example, one large mutual fund company sold over 2.8 million EZPW shares in Q4 2015 and Q1 2016 which was nearly their entire position in the company. The accounting issues were due to differences between Mexican and American accounting in recognizing income from structured asset sales and loan portfolios[1]. I consider these issues to be immaterial. This is especially true when you consider that Grupo Finmart will probably be divested in the next few months.

The restatement and restructuring have also caused large nonrecurring expenses and one-time write-downs which have depressed earnings.

EZPW Stock Performance - Past 5 Years

[1] "Ezcorp to restate certain financial results" - investors.ezcorp.com/home?item=273

Shareholder Structure

Another reason for the lower valuation compared to peers is the shareholder class structure. Since the IPO of the company, there has been a dual class structure with the nonvoting shares held by the public and all of the voting shares held by a single controlling shareholder, an Australian private equity manager named Philip E. Cohen. Cohen also owns a financial and business transaction advisory named Madison Park with which he previously had an advisory relationship with EZCORP. EZCORP was paying millions of dollars, approximately $7 million/year for ambiguously-described advisory services. Some investors pointed out that this appeared to be a preferred dividend for the benefit of Cohen and filed a class-action lawsuit to recover damages for minority shareholders. I will not go into all of the details of the ongoing lawsuit, but the relationship with Madison Park has since been terminated.

In a recent memorandum opinion[2] on January 25th 2016, a Delaware district judge declared that, as the controlling shareholder Philip E. Cohen has a personal fiduciary responsibility to other investors. This is a high level of legal responsibility placed on Cohen and will make him unlikely to allow the Board of Directors to create a separate form of compensation for his share class in the company. This has the effect of aligning his interests with other shareholders, but I still think most investors would be more comfortable with a single share class.

One positive of having a single controlling shareholder is the nimbleness it lends to the company for the purposes of restructuring. In the past year, there have been several members of the board of directors replaced, a large number of replacements of C-suite executives, and major restructuring of the business. I think it would have been difficult to have such a great amount of change accomplished in a company with a more traditionally distributed shareholder base.

Upcoming Catalysts

There are several upcoming catalysts in the next few months which could lead to a revaluation of the company's stock by the market. The first catalyst is the sale of Grupo Finmart either to a local competitor or a Mexican private equity fund. While officially the company is merely doing a strategic review of the business, it appears almost certain that the review will end with the sale of the business. Management has given guidance that they expect this to occur in the next 3-6 months (their window for the end of their "strategic review period" for the division). Many investors, for good reason, will avoid investing in businesses that they do not understand. While the pawnbroker business is very understandable, the accounting of Grupo Finmart makes it an opaque black box for most people. Additionally, the returns on capital that EZCORP is getting from making loans through Grupo Finmart are not as high as those they can receive from reinvesting in the pawn business. The result of this sale and subsequent reinvestment of the capital will not only provide financial benefit for the company but also make it more attractive to investors.

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[2] In Re Ezcorp Inc. Consulting Agreement Derivative Litigation: Memorandum Opinion - 1.usa.gov/1TjS3mS

Joe Rotunda has recently rejoined EZCORP. Rotunda ran the company from 2000 to 2010, which was a period of outstanding performance for the company. Since Rotunda left in 2010, the operational costs for the company have increased, resulting in a significant cut into earnings. EZ Pawn used to have lower operational costs per store compared to Cash America but now it is significantly higher. Immediately after returning to the company, he liquidated much of their merchandise inventory at fire sale prices which hurt the gross margins in the short-term. Rotunda has already made several operational changes to improve customer experiences, increase efficiency, and increase the amount of loans the company is capable of making. The results are already apparent as US Pawn's most recent quarter was their best in over 5 years. It should not take a herculean effort to turn around this business. Simply returning to either the average store performance for the pawn industry or EZ Pawn's historical performance would be great wins.

A recovery in the price of gold would also significantly benefit the profitability of the pawn business. I cannot make any predictions about the likelihood of this occurring in the near future.

Currently, there is a self-imposed trading freeze for executives in the company during their restructuring period. Once the sale of Grupo Finmart is complete, the trading freeze might be lifted and insiders will be free to make purchases of shares at the current depressed valuation which could increase investor confidence.

Predictions on capital allocation

If the sale of Grupo Finmart is able to generate a significant amount of capital for the company, the next question will be how they spend it? The management of the company has indicated to us that they do not wish to buy back shares as they would rather reinvest in the company's operations and share buybacks goes against the business philosophy of the board of directors. Therefore, we can expect that some of the cash would be used to improve stores or make acquisitions of smaller pawn chains or independent stores. I predict a second way they may use capital is to buy back the senior convertible bonds of the company which currently trade at a significant discount to par. Currently, the bonds trade at a yield of 12.99%. The public is able to view the prices of corporate bonds through FINRA's free market data website (finra-markets.morningstar.com). Buying back bonds would also be in line with current management incentives which are based on EBIDTA and net debt.

Valuation

Sum of the parts: EZCORP acquired a small pawn chain with 12 stores in February 2015 for an aggregate price of $16.5 million or $1.4 million per US pawn store. In 2007, they acquired 20 stores in Mexico for a total cost of $15.5 million or $0.8 million per Mexican store. I believe that EZCORP's total pawn business is worth more than the sum of its individual stores due to the benefits of scale, so we can assume that each of the stores is worth at least as much as they paid for the locations. Cash America, the largest pawn chain in the US, made acquisitions of pawn stores in the US in 2013 at prices between $1.8 to $2.5 million per store. Estimating the value of EZCORP's pawn business at $722M (516 * $1.4 million) for the US Stores and $190M (237 * $0.8 million) for Mexico would appear conservative.

Additionally, EZCORP's 32% stake in Cash Converters, whose market cap is at $246 million Australian Dollars (AUD), is worth about $61 million USD.

There is likely value in Grupo Finmart, but on account of Grupo's nonrecourse debt of $160 million, the opaque nature of its financial situation, and to be conservative in our valuation we can ignore it and assign no value to the Grupo Finmart segment. However in the 10-K filing made by the company on September 30, 2015, the company did estimate a fair value for the Grupo Finmart segment of $98.5 million.

A significant liability the company has are the senior convertible bonds of EZCORP which have a face value of $230 million (though their carrying book value and current price are lower).

$$EZCORP\ fair\ value\ estimate: \$722M + \$190M + \$61M - \$230M = \$743M$$

At a total value of $743M that gives a conservative target share price of $14.64.

Comparison to competitors by revenue: Another simple way of estimating the value of the company is to do a comparison to the other two large pawn chains First Cash Financial Services Inc (FCFS) and Cash America International (CSH). Since the three companies have greatly differing levels of financial leverage, we should compare them using enterprise value (enterprise value = market cap – cash + debt).

	CSH	**FCFS**	**EZPW**
Enterprise Value	$1104 M	$1495 M	$561 M
Revenues (TTM)	$1029 M	$705 M	$734 M

Data as of 4/15/2016

Cash America

$$\frac{EV}{Revenues} = \frac{1104}{1029} = 1.07$$

First Cash Financial Services

$$\frac{EV}{Revenues} = \frac{1495}{705} = 2.12$$

EZCORP

$$\frac{EV}{Revenues} = \frac{561}{734} = 0.76$$

If EZPW traded at the same average ratios of revenues to enterprise value as their two competitors (EV/Rev=1.60), EZPW would trade at a share price of $16.50. It is clear that EZCORP is deeply discounted relative to their competition.

Summary

Our investment thesis of EZCORP can be summarized to four elements: 1) complicated accounting restatement and business restructuring created large nonrecurring expenses which will not continue, 2) Joe Rotunda will bring about an encore performance with US Pawn, 3) simplification of business lines will attract new investors, and 4) valuation is extremely cheap. We will continue to closely monitor developments with the company and its restructuring.

If we are successful with EZCORP, it will not be the first time Blue Tower's investors have profited after an initial loss. We had similar experiences in the last two years with Sberbank of Russia and Ebix. Blue Tower has a broad mandate and a patient investor base which allows us to make focused bets on stocks punished by negative headlines. This gives us a significant behavioral edge over other firms. I thank you for your continued confidence in our strategy.

Sincerely,

Andrew Oskoui, CFA
Portfolio Manager