Big Value Opportunity In Liberty Tax

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Liberty Tax (TAX) has carved out a successful niche as the discount option for tax return preparation. Despite its significantly smaller scale and brand awareness compared to competitors such as H&R Block (HRB) and Intuit (INTU), TAX still earns a comparable return on invested capital (ROIC). The beauty here is that the market values TAX at a considerable discount to HRB and INTU.

Low-Cost Option

At a glance, it appears as though TAX should struggle to compete in the tax preparation business. Its largest brick and mortar competitor, H&R Block, has a massive scale advantage, as its offices prepared 24.2 million tax returns last year compared to TAX's 2.2 million. Intuit (INTU) does not disclose the number of tax returns it prepared, but its Consumer Tax segment earned $1.5 billion in revenues last year, ten times what TAX earned.

How does TAX compete against companies with such large brand awareness and scale advantages? It successfully markets itself as the low-cost option and keeps its margins low. A 2013 survey estimated that the average cost per return at TAX was $180, 9% cheaper than the $198 average at HRB.

Similarly, both TAX's mid-tier and premium online services are 40% cheaper than the corresponding TurboTax services.

TAX has targeted the discount market by opening kiosks in Wal-Mart (WMT) stores each year. Prior to 2012, only HRB and privately held Jackson Hewitt operated in Wal-Mart stores, but TAX moved in after HRB's contract expired.

TAX's low-cost strategy is working, and it has been taking market share. Last year, TAX grew revenue by 8% and the number of returns prepared in its U.S. offices by 6%, while the IRS reported that tax receipts grew by only ~1.5%. HRB saw a 4% decline in the number of returns it prepared last year.

TAX is growing its online business rapidly, increasing its number of returns prepared by 29% compounded annually for the past three years.

Franchise Model Boosts Profitability

Understandably, TAX's low-cost strategy means its margins suffer compared to its competitors. TAX earned a 14% after-tax (NOPAT) margin last year, while HRB's NOPAT margin was 18%. INTU earned a NOPAT margin of 21%, which understates the profitability of its tax segment, the company's highest margin business.

Despite its lower margins, TAX actually earned a superior return on invested capital (ROIC) of 20% versus 18% for HRB last year. Higher capital efficiency offsets TAX's lower margins and drives the superior ROIC. Higher capital efficiency comes from franchising almost all of its 4,400 offices while HRB owns over half of its 12,000 offices worldwide. By not owning its offices, TAX keeps its invested capital low, and earns significantly more revenue per dollar of capital invested than HRB and INTU. Figure 1 compares TAX, HRB, and INTU on the basis of ROIC, NOPAT margin, invested capital turns (revenue per invested capital), and revenue growth.

Figure 1: TAX vs. The Competition

Company	Ticker	ROIC	NOPAT Margin	Invested Capital Turns	Revenue Growth
Liberty Tax	TAX	20%	14%	1.4	8%
H&R Block	HRB	18%	18%	1.0	4%
Intuit	INTU	25%	21%	1.2	1%

Sources: New Constructs, LLC and company filings.

As Figure 1 shows, TAX earns 40% more revenue per dollar of capital employed than does HRB, which helps offset TAX's narrower margins.

Where Do We Go From Here?

TAX has successfully carved out a profitable and growing niche for itself against larger, better-known competitors, and now it has significant growth opportunities ahead of it.

I do not worry about HRB or INTU, or other competitors trying to squeeze TAX out of its low-cost niche. Both HRB and INTU would have to incur pretty serious margin cuts to compete with TAX on price, and I do not think they can afford the hit to EPS those cuts would cause.

As a result, I think TAX can look forward to continued steady growth from its physical locations as the improving labor market steadily increases the number of filers each season. The increasing complexity of the Affordable Care Act might also push more tax filers to turn to a paid preparer.

The real growth opportunity, however, comes from TAX's online product, which is already growing at ~30% a year as mentioned above. TAX invested over $20 million last year in its new NextGen tax software, which should improve its online offering and allow for greater integration between the company's online and in-office products.

Encouragingly, TAX has plenty of cash it can use to invest in its business, either by furthering investing in software or supporting the opening of more new franchises. TAX has $38 million in excess cash, or about 35% of its current invested capital. If TAX can deploy new capital as efficiently as it has in the past, significant growth is possible.

Significantly Undervalued

Despite its comparable profitability to HRB and INTU and solid growth opportunities, TAX trades at a significant discount to its larger peer. At its current valuation of ~$34/share, TAX has a price to economic book value ratio (PEBV) of just 1.15, which implies that the company will grow NOPAT by no more than 15% for the remainder of its corporate life.

By comparison, HRB trades at a PEBV of 1.65 and INTU at 1.93. If TAX commanded a similar valuation to HRB, it would trade at ~$50/share, a 45% premium to its current valuation. A $50/share valuation implies 6.5% NOPAT growth compounded annually for 10 years, which seems entirely plausible based on TAX's profit growth opportunities. We don't have long-term data on TAX's past NOPAT growth, but INTU's consumer tax segment has grown revenue by 14% compounded annually for the past decade, and HRB has grown NOPAT by 24% compounded annually in the past two years.

If TAX can manage 9% NOPAT growth for 15 years, the stock is worth $80/share. That projection is probably on the optimistic side, but it reveals the upside—100+%—that is within the realm of possibility for this stock.

I don't see a great deal of downside risk for TAX at this price either. As Benjamin Franklin once said, "Nothing can be said to be certain, except death and taxes." TAX operates in a business with extremely reliable demand. Even if profits never grow again, TAX would only be overvalued by 15%. TAX offers investors potentially high rewards with fairly low risk.

Sam McBride contributed to this report.
Disclosure: David Trainer may buy TAX in the next 72 hours. David Trainer and Sam McBride receive no compensation to write about any specific stock, sector or theme.

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