



## Stock Pick of the Week: Outerwall Inc. (OUTR)

With the advent of streaming video services such as Netflix and Amazon Live, DVD rentals have been declining. However, this company, which mainly operates through its DVD segment, has built a unique business model that primarily serves the off-line video market. This market is shrinking but will remain alive for the foreseeable future because of its price and convenience advantages. With a remarkably profitable business, strong potential for profit growth, and a significant undervaluation, this week's Stock Pick of the Week is Outerwall Inc. (OUTR: \$80/share).

### Investors Are Too Quick to Judge

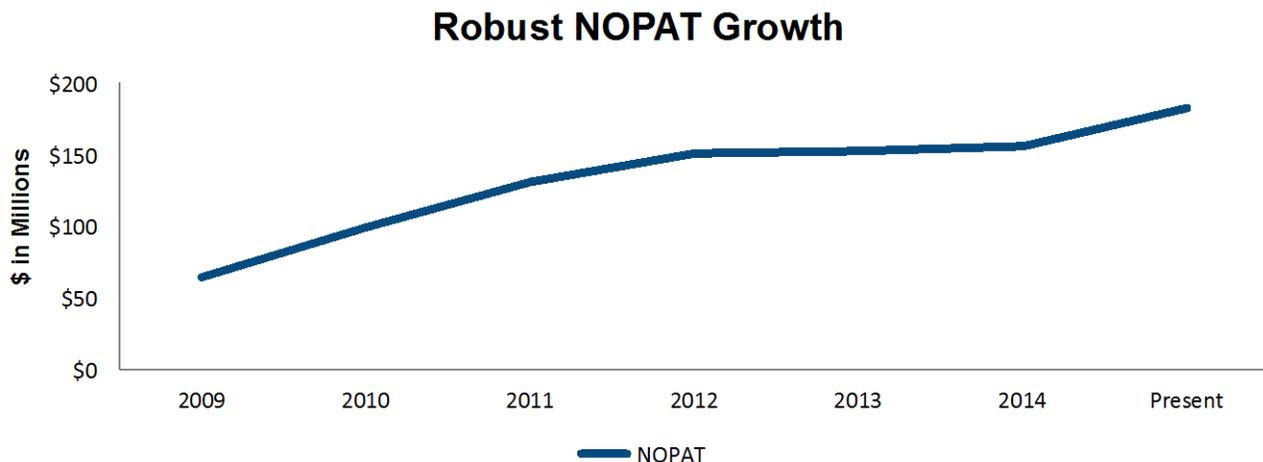
With over 37% of shares outstanding sold short, Outerwall is the [tenth most shorted stock in the NASDAQ](#). Ever since Blockbuster's bankruptcy in 2010, the market has had extremely low expectations for DVD rental providers and high praise for streaming services. OUTR shares are down almost 6% since mid June, and many investors have all but written off Outerwall as just another doomed rental provider. Buying into this common misconception risks overlooking the fundamental strength of the business and missing an excellent investment opportunity.

### Outerwall Is No Stranger to Profit

Outerwall operates two main segments, Redbox and Coinstar, which make up 82% and 14% of revenue in 2014, respectively. The remaining revenue was generated through Outerwall's "new ventures" segment, which includes ecoATM. Despite concerns regarding the DVD industry, Redbox has demonstrated impressive profit growth throughout its history.

Since 2009, when Outerwall took full control of Redbox, after-tax profit ([NOPAT](#)) has grown by 19% compounded annually. Over the same time period, revenue has grown by 15% compounded annually.

Figure 1: Long-Term Profit Growth



Sources: New Constructs, LLC and company filings

While revenue and profit growth has slowed over the past two years, 2015 has been promising. In 1Q15, Outerwall reported 2% year over year revenue growth and 32% growth in operating income. Outerwall also earns a return on invested capital ([ROIC](#)) of 14%, which has almost doubled since 2009.

### Pricing Power and Margin Expansion

While other companies scramble to build out online streaming services, Redbox caters to consumers seeking a convenient and affordable way to watch new movies. Despite increasing DVD and Blu-Ray prices to \$1.50 and \$2.00, respectively, Redbox still offers the lowest prices. On demand offerings cost upwards of \$6 per movie and

video subscription services charge anywhere from \$7 to \$20 monthly. Redbox has room to raise prices significantly while still charging less than most of the competition.

Redbox pricing power comes from its low cost advantage. Netflix, often viewed as the company's largest threat, provides a vast library of TV shows and older movies, which create [huge content costs](#). Redbox limits costs and differentiates its offerings by stocking its small kiosks with mainly recent DVDs. This specialized, limited selection attracts consumers with the newest and most exciting titles while avoiding the costs of carrying older, seldom watched titles.

Moreover, Redbox kiosks require little cost to set up, take down, or operate. Low set-up and take-down costs enable the company to be nimble about where to place the kiosks. This flexibility helps Redbox safeguard its margins as unprofitable locations can be removed quickly. Expect margins to increase as management is looking to [remove between 1000 to 1900 unprofitable kiosks](#) in 2015.

### **Providing Cheaper & Better Access to HD Movies**

Although DVDs may be losing their luster, Blu-Ray discs are becoming a more attractive revenue stream due to the demand for HD quality movies. [53% of Americans living in rural locations and 17% of all Americans](#) do not have access to Internet capable of streaming high quality video. For these consumers, Redbox provides access to videos they wouldn't otherwise have.

### **Creating a Diversified Revenue Stream**

Redbox also offers video games, which tap into a consumer base that may not overlap with the DVD renting crowd. Renting has broad appeal to video gamers: casual players can rent a game to play with friends for a day or two, while more serious players can save money by finishing a game even within a few days and avoid paying full retail price.

In addition, Outerwall's ecoATM presents an intriguing business prospect. Only in its early stages, ecoATM grew revenues by 24% in 1Q15 over the prior year. The business segment has been unprofitable while Outerwall scales up locations and improves efficiency, but it has great potential. [Gartner](#) projects that 120 million secondhand smartphones will be resold in 2017, up from 57 million in 2014. Staking a claim in this growing industry will help offset any decline in DVD rentals by creating a huge potential growth avenue for Outerwall. The company has proven its ability to turn self-service kiosks into profitable entities and there's little reason to expect different with ecoATM.

### **Impact of Footnotes Adjustments and Forensic Accounting**

To reveal the true economic performance of Outerwall, we look deeper into the company's 10-K report. For 2014, we made the following adjustments:

Income Statement: we removed \$58 million (2% of revenue) in [reported non-operating expenses](#) in our assessment of NOPAT. The net effect of income statement adjustments after removing [non-operating income](#) was \$48 million.

Balance Sheet: we made \$432 million worth of adjustments to calculate [invested capital](#). The largest adjustment made when calculating invested capital was the addition of \$135 million (12% of net assets) due to [asset write-downs](#).

Valuation: we made \$1.2 billion worth of adjustments with a net effect of \$957 million. The largest adjustment we made to Outerwall's shareholder value was \$61 million (4% of market value) to reflect the claim on cash flows due to [off balance sheet operating leases](#).

### **Buying Opportunity**

The overblown fears of the DVD business decline have left OUTR greatly undervalued. At its current price of \$80/share, OUTR has a price to economic book value ([PEBV](#)) ratio of 0.6. This ratio implies the market expects Outerwall's NOPAT to permanently decline by 40%. While Outerwall's profits could see a slight decline along with the industry, we believe this expectation is extremely pessimistic. Outerwall currently has an economic book per share value, or no growth value of \$125.

Even if Outerwall's NOPAT margins decline to 9% (currently 11%) and the business is only able to [grow NOPAT by 2% compounded annually for the next decade](#), the stock is worth \$106/share. At this price, Outerwall would



still be trading well below its economic book value. There is huge upside in OTR at current prices, regardless of the DVD market's expected decline.

*Disclosure: David Trainer, Kyle Guske II, and Max Lee receive no compensation to write about any specific stock, style, or theme.*

## ***New Constructs® – Profile***

---

### ***How New Constructs Creates Value for Clients***

1. **Superior Recommendations** – Our [stock picks](#) consistently outperform. See our track record in our [stock-picking accolades](#) and [Proof Is In Performance](#) reports.
2. **More Accurate Research** – Our [patented Research Platform](#) for [reversing accounting distortions](#) and [discounted cash flow analysis](#) leverages better data to deliver smarter research.
3. **Time Savings** – We check the fine print in thousands of corporate filings so you don't have to. As reported by [Barron's](#), our expertise in analyzing SEC filings delivers [Hidden Gems and Red Flags](#) that drive long-term stock-picking success.
4. **Transparency** – We are proud to share the results of our analysis of over 50,000 10Ks. See the [Corporate Disclosure Transgressions](#) report we provided the SEC. Our reports detail all data and assumptions. Company Models enable users to change them.
5. **Objectivity** – New Constructs is an independent research firm, not tied to Wall Street or investment banking services. Our models are driven by comprehensive high-quality data not stories. See our [presentation to the Senate Banking Committee](#), the SEC and many others in DC.

### ***Our Philosophy About Research***

Accounting data is not designed for equity investors, but for debt investors. [Accounting data must be translated into economic earnings](#) to understand the profitability and valuation relevant to equity investors. Respected investors (e.g. Adam Smith, Warren Buffett and Ben Graham) have repeatedly emphasized that accounting results should not be used to value stocks. [Economic earnings](#) are what matter because they are:

1. Based on the complete set of financial information available.
2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

### ***Additional Information***

Incorporated in July 2002, [New Constructs](#) is an independent publisher of investment research that provides clients with consulting and research services. We specialize in quality-of-earnings, forensic accounting and discounted cash flow valuation analyses for all U.S. public companies. We translate accounting data from 10Ks into economic financial statements, i.e. [NOPAT](#), [Invested Capital](#), and [WACC](#), to create [economic earnings models](#), which are necessary to understand the true profitability and valuation of companies. Visit the [Free Archive](#) to download samples of our research. New Constructs is a [BBB accredited](#) business and a member of the [Investorside Research Association](#).

## DISCLOSURES

---

New Constructs®, LLC (together with any subsidiaries and/or affiliates, "New Constructs") is an independent organization with no management ties to the companies it covers. None of the members of New Constructs' management team or the management team of any New Constructs' affiliate holds a seat on the Board of Directors of any of the companies New Constructs covers. New Constructs does not perform any investment or merchant banking functions and does not operate a trading desk.

New Constructs' Stock Ownership Policy prevents any of its employees or managers from engaging in Insider Trading and restricts any trading whereby an employee may exploit inside information regarding our stock research. In addition, employees and managers of the company are bound by a code of ethics that restricts them from purchasing or selling a security that they know or should have known was under consideration for inclusion in a New Constructs report nor may they purchase or sell a security for the first 15 days after New Constructs issues a report on that security.

New Constructs is affiliated with Novo Capital Management, LLC, the general partner of a hedge fund. At any particular time, New Constructs' research recommendations may not coincide with the hedge fund's holdings. However, in no event will the hedge fund receive any research information or recommendations in advance of the information that New Constructs provides to its other clients.

## DISCLAIMERS

---

The information and opinions presented in this report are provided to you for information purposes only and are not to be used or considered as an offer or solicitation of an offer to buy or sell securities or other financial instruments. New Constructs has not taken any steps to ensure that the securities referred to in this report are suitable for any particular investor and nothing in this report constitutes investment, legal, accounting or tax advice. This report includes general information that does not take into account your individual circumstance, financial situation or needs, nor does it represent a personal recommendation to you. The investments or services contained or referred to in this report may not be suitable for you and it is recommended that you consult an independent investment advisor if you are in doubt about any such investments or investment services.

Information and opinions presented in this report have been obtained or derived from sources believed by New Constructs to be reliable, but New Constructs makes no representation as to their accuracy, authority, usefulness, reliability, timeliness or completeness. New Constructs accepts no liability for loss arising from the use of the information presented in this report, and New Constructs makes no warranty as to results that may be obtained from the information presented in this report. Past performance should not be taken as an indication or guarantee of future performance, and no representation or warranty, express or implied, is made regarding future performance. Information and opinions contained in this report reflect a judgment at its original date of publication by New Constructs and are subject to change without notice. New Constructs may have issued, and may in the future issue, other reports that are inconsistent with, and reach different conclusions from, the information presented in this report. Those reports reflect the different assumptions, views and analytical methods of the analysts who prepared them and New Constructs is under no obligation to insure that such other reports are brought to the attention of any recipient of this report.

New Constructs' reports are intended for distribution to its professional and institutional investor customers. Recipients who are not professionals or institutional investor customers of New Constructs should seek the advice of their independent financial advisor prior to making any investment decision or for any necessary explanation of its contents.

This report is not directed to, or intended for distribution to or use by, any person or entity who is a citizen or resident of or located in any locality, state, country or jurisdiction where such distribution, publication, availability or use would be contrary to law or regulation or which would be subject New Constructs to any registration or licensing requirement within such jurisdiction.

This report may provide the addresses of websites. Except to the extent to which the report refers to New Constructs own website material, New Constructs has not reviewed the linked site and takes no responsibility for the content therein. Such address or hyperlink (including addresses or hyperlinks to New Constructs own website material) is provided solely for your convenience and the information and content of the linked site do not in any way form part of this report. Accessing such websites or following such hyperlink through this report shall be at your own risk.

All material in this report is the property of, and under copyright, of New Constructs. None of the contents, nor any copy of it, may be altered in any way, copied, or distributed or transmitted to any other party without the prior express written consent of New Constructs. All trademarks, service marks and logos used in this report are trademarks or service marks or registered trademarks or service marks of New Constructs.

Copyright New Constructs, LLC 2003 through the present date. All rights reserved.