

Outerwall, Inc.
NASDAQ: OUTF

Analyst: Marianne Staudt
Sector: Consumer
Discretionary

BUY

Price Target: \$52.72

Key Statistics as of 5/7/2016

Market Price: \$39.21
Industry: Specialty Retail
Market Cap: \$675.54M
52-Week Range: \$24.81-85.26
Levered Beta: 2.17

Thesis Points:

- High price volatility leaves room for big gains.
- Market is overly pessimistic about Redbox segment and is discounting Outerwall stock as a result.
- Outerwall is a potential acquisition target, and is likely to be purchased at a premium, boosting stock price.

Company Description:

Outerwall Inc. began in 1992 with the inception of Coinstar. Since its inception, Outerwall has sought to provide value, simplicity, and convenience to customers and retailers with its kiosk brands. These brands have grown over time, and Outerwall continues to expand into new areas. Currently, its kiosk brands include Coinstar, Coinstar Exchange, Redbox, ecoATM, and Gazelle. Outerwall has a network of over 64,000 kiosks, mainly located in supermarkets, drug stores, mass merchants, financial institutions, convenience stores, and restaurants.



Thesis

Outerwall is currently one of the markets most disliked stocks. It has an incredibly high short interest and many analysts caution against this company due to its uncertain future. Outerwall's stock price has been extremely volatile, as the market struggles to understand what the company is really worth. With prices extremely low right now, this high price volatility leaves room for big gains. Additionally, the market is overly pessimistic about Outerwall's Redbox segment, and Outerwall stock is underpriced as a result. With high free cash flows and losses in certain segments that could serve as tax breaks, Outerwall is a potential acquisition target, and is likely to be purchased at a premium, boosting stock price.

Price Volatility

Outerwall's stock is down nearly 20% since December 2015, however recent news of an activist investor and the potential sale of the company, coupled with an increased dividend and plans to launch a digital movie streaming service, has helped shares rebound since hitting a low of \$24.50 per share, and will continue to increase prices in the coming months.

In recent years, the stock has gone from \$50 to \$80, down to \$60 and then back up to \$80, and now, sits around \$30. This extreme volatility could be a sign of mispricing, and shows that the market and shareholders don't really know what the stock is worth. While it is a difficult company to value due to its various segments, OUTER is definitely on the cheap side right now.

Shareholder Value

Outerwall is committed to increasing shareholder value. Typically, it has done this through share repurchases, however, recently, it has changed its strategy. It recently doubled its quarterly dividend to \$0.60 per share, giving a generous dividend yield of 5.86%. Additionally, Outerwall has recently been strategically reducing its total debt, which reduces shareholder risk. In Q1, the company opportunistically repurchased \$29.4 million in face value of its 6% senior notes due in 2019 for just \$23.4 million, as well as \$27.7 million in face value of its 5.875% senior notes due in 2021 for \$21.9 million in cash. Outerwall earned \$11 million by repaying these notes early, and reduced its total debt by over 9%.

Redbox

Redbox specializes in DVD, Blu-ray, and video game rentals via automated retail kiosks. The market is

extremely cynical about Redbox, but I believe there is still some potential and the market is overly pessimistic. For starters, 17% of Americans, over 50 million people, still have either no access to cable internet or only basic low speed internet with low data caps. This is particularly true in rural areas, where over 50% do not have access to cheap and fast internet. For them, Redbox is a cheap and easy source of entertainment.

Additionally, Redbox provides new released content at the cheapest price. If you want a new release, you either wait a year, or wait one month and rent at Redbox.

Redbox also has high variable cost, so even if the top-line struggles, costs will fall with it, and there won't be a huge impact on its bottom line.

Additionally, Outerwall recognizes that DVD rental is a declining business, and has made several adjustments to improve its value proposition. Redbox Playpass loyalty program gives customers points and rewards for renting games and movies. The program grew by more than 100% year-over-year and 19% from last quarter. It now serves 4 million customers. Playpass customers are Redbox's most loyal, and make up 50% of all online transactions and 13% of all rentals, so growing this program is crucial to Redbox's success in the future. The ability to rack up points and free rentals, as well as a potentially lower price point, is what differentiates them from their competition, and motivates viewers to rent through Redbox and not iTunes, Google Play, or another competitor.

This will be particularly relevant when Redbox Digital is released. There is no set release date yet, but Redbox digital movie streaming service promises big things in a time when people are switching from DVDs to streaming. Digital rentals are expected to grow nearly 30%, from 3.4 million rentals in 2015 to 4.4 million by 2019.

This would be a video-on-demand service as opposed to a monthly subscription plan, which is important because it won't be directly competing with Netflix or Hulu.

Outerwall has the capabilities to market this new service for free at any of its 35,000 kiosks, online at redbox.com, or via social media to its nearly 7 million followers.

Coinstar

Coinstar is a machine that gives cash or gift cards for coins. Coinstar is the rock for Outerwall's business, and continues to experience organic growth. In Q1, the segment earned nearly \$73 million, up 4.4% for Q1 2015, due to increased volume. Operating income also improved by \$2.1 million year-to-year, growing to \$24.6 million. Additionally, Coinstar segment operating margins increased 34%, due to reduced costs. The company is experiencing high demand both domestically and in

international markets, and is looking to further international expansion, which will further improve top-line growth.



Part of what makes the Coinstar business so strong is that it has very little competition. In order to compete in this business, you need scale and technical expertise to reach profitability. Coinstar has about 21,000 machines installed, which doesn't leave much room for a competitor. Rather than doing it themselves, as they do not have the scale to achieve profitability, Walmart's, grocery stores, and even banks would rather outsource to Coinstar and collect a fee.

EcoATM

In 2013, Outerwall purchased a 77% stake in ecoATM, for about \$350 million. EcoATM's kiosks allow you sell your old cell phones, tablets & MP3 players for cash. Its goal is to make recycling & trade-ins of used devices safe & convenient. However, since this acquisition, Outerwall has struggled to make ecoATM profitable. There are signs of improvement in this segment though, particularly following the company's acquisition of Gazelle, a very similar business model, last year. In Q1, ecoATM grew 113% from Q1 of 2015 to \$42.1 million, and the average selling price of devices sold improved my over \$5. At the end of the quarter, ecoATM had 2,540 kiosks, demonstrating a 400 kiosk increase from last year and 290 from the end of 2015. Additionally, operating losses decreased to just \$5.7 million. While this segment is still losing money, this demonstrates a significant improvement, and shows good signs moving forward. Outerwall hopes to have ecoATM achieve profitability in 2016, and this quarter's outperformance puts them on track to do just that. If ecoATM does become profitable, I believe this would have a significant positive impact on Outerwall's stock price, which has been discounted significantly due to ecoATM's failure to date.

Exploring "Strategic Alternatives"

In addition to increasing dividends and paying off debt, Outerwall is exploring strategic and financial alternatives to maximize shareholder value. The hedge fund Engaged Capital bought a 14.1% stake in company, and is taking the role of an activist investor. The hedge fund is pushing

the company to explore strategic alternatives, including selling the company. According to a Bloomberg article, Outerwall has received multiple offers in the \$90+ range. Outerwall's strong cash flows and potential tax loss assets make it an attractive acquisition target, and this is something management, with the aid of Engaged Capital is seriously considering moving forward. If Outerwall does sell at a large premium from current prices, all shareholders will reap the benefits, as the stock price will increase dramatically.

Financials

Despite market pessimism, Outerwall is still a profitable company. It reported \$59.3 in net cash from operating activities for 2016 Q1 and \$326.1M for the year. As a result of a strong Q1 2016, the company has revised its EPS estimates upwards—from \$5.00-\$6.30 to \$5.35-\$6.55. This is a very good sign moving forward in 2016. The company continues to produce solid cash flow and earnings, and expects FCF for 2016 to be between \$140 million and \$190 million.

Valuation

Capital expenditures have been significantly lower than actual depreciation. The depreciation period on many of their machines is 3-5 years, but often, these machines last double that time with minimal repair costs. This, I believe, is a large reason that the stock is underpriced. When depreciation is adjusted (I used historical levels to be conservative—although the argument could be made that depreciation will be even lower in the continuing period), there was a large impact on the valuation.

Conclusion

While Redbox is likely to continue to decline due to the shift from DVDs to streaming, Outerwall will still realize solid free cash flow through its other business segments. At today's prices, the market is valuing Outerwall as if free cash flows will decrease 13% annually. I believe this is overly pessimistic, especially considering Redbox Digital's imminent introduction and ecoATM's projected profitability in 2016. The market is overly pessimistic about Outerwall's future, and fails to recognize the value of each of Outerwall's segments. I believe shares should be purchased here, at \$39.21. I have set a 1 year target price of \$52.77; an over 30% return.

Outerwall Inc. (outr)

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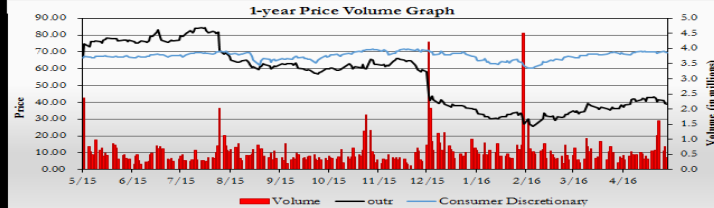
BULLISH

Analysis by Marianne Staudt
4/30/2016

Current Price: **\$39.21**
Dividend Yield: **0.7%**

Intrinsic Value: **\$39.87**
Target Price: **\$52.72**

Target 1 year Return: **35.13%**
Probability of Price Increase: **93%**



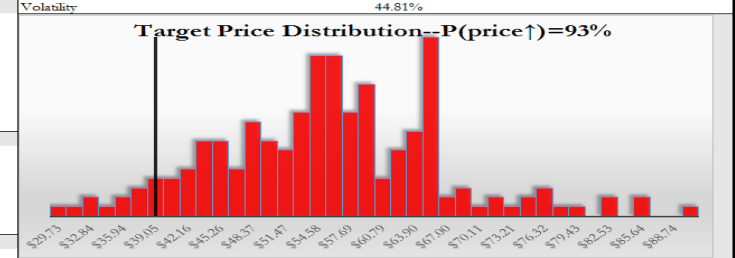
Description
Outerwall Inc., through its subsidiaries, provides automated retail solutions primarily in the United States, Canada, Puerto Rico, Ireland, and the United Kingdom.

General Information
Sector: Consumer Discretionary
Industry: Specialty Retail
Last Guidance: November 3, 2015
Next earnings date: July 28, 2016
Estimated Country Risk Premium: 6.00%
Effective Tax rate: 40%
Effective Operating Tax rate: 42%

Market Data	
Market Capitalization	\$675.54
Daily volume (mil)	0.32
Shares outstanding (mil)	17.23
Diluted shares outstanding (mil)	16.95
% shares held by institutions	110%
% shares held by investments Managers	83%
% shares held by hedge funds	43%
% shares held by insiders	2.48%
Short interest	44.46%
Days to cover short interest	13.91
52 week high	\$85.26
52-week low	\$24.81
Levered Beta	2.17
Volatility	44.81%

Past Earning Surprises	
Quarter ending	Revenue
3/31/2015	-2.56%
6/30/2015	-4.42%
9/30/2015	-7.45%
12/31/2015	0.70%
3/31/2016	-0.01%
Mean	-2.75%
Standard error	1.5%

EBITDA	
3/31/2015	3.58%
6/30/2015	-4.10%
9/30/2015	-11.11%
12/31/2015	5.89%
3/31/2016	-6.28%
Mean	-2.40%
Standard error	3.1%



Management	
Prusch, Erik	Chief Executive Officer and
Smith, Galen	Chief Financial Officer
Rench, Donald	Chief Legal Officer, General
Gaherity, James	President of Coinstar
Maquera, David	President of ecoATM
Kist, Jeffrey	Interim Chief Accounting Off

Profitability	
ROIC	10.9%
NOPAT Margin	8%
Revenue/Invested Capital	1.44
ROE	23.7%
Adjusted net margin	7%
Revenue/Adjusted Book Value	3.62

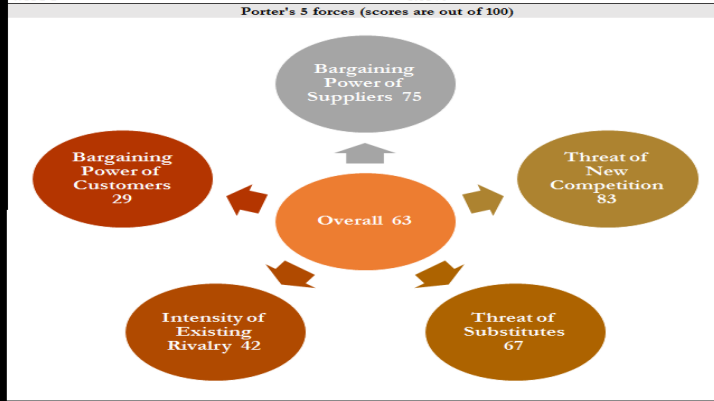
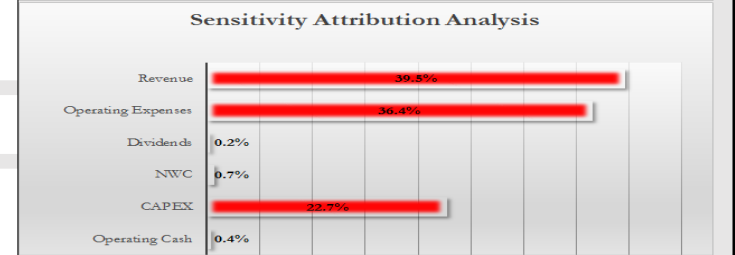
Invested Funds	
Total Cash/Total Capital	12.4%
Estimated Operating Cash/Total Capital	10.7%
Non-cash working Capital/Total Capital	-10.7%
Invested Capital/Total Capital	98.7%

Capital Structure	
Total Debt/Common Equity (LTM)	1.50
Cost of Existing Debt	3.68%
Estimated Cost of new Borrowing	5.35%
CGFS Risk Rating	C
Unlevered Beta (LTM)	1.11
WACC	8.03%

Peers	
Netflix, Inc.	
Comcast Corporation	

Total return to shareholders	
0%	per annum over 0y
-25.1%	per annum over 2y
-3.58%	per annum over 5y
0%	per annum over 0y
0%	per annum over 0y

Industry (LTM)	
20.06%	
7.0%	
2.85	
23.65%	
6.6%	
3.56	
20%	
N/A	
19%	
81%	
Industry (LTM)	
0.23	
7.35%	
7.35%	
A	
0.89	
8.87%	



Revenue growth	
Base Year	-7.9%
3/31/2017	-12.2%
3/31/2018	-9.3%
3/31/2019	-6.5%
3/31/2020	-3.6%
3/31/2021	-0.7%
3/31/2022	2.1%
3/31/2023	2.1%
3/31/2024	2.1%
3/31/2025	2.1%
3/31/2026	2.1%
Continuing Period	2.1%

Invested Capital	
Base Year	\$1,018.71
3/31/2017	\$1,173.38
3/31/2018	\$1,553.08
3/31/2019	\$1,401.49
3/31/2020	\$1,468.23
3/31/2021	\$1,583.40
3/31/2022	\$1,696.16
3/31/2023	\$1,689.18
3/31/2024	\$1,697.54
3/31/2025	\$1,723.32
3/31/2026	\$1,762.62
Continuing Period	

Valuation	
NOPAT margin	7.6%
ROIC/WACC	1.36
	0.91
	0.83
	0.85
	0.88
	0.93
	1.00
	1.00
	1.02
	1.03
	1.04
	1.06

Net Claims	
	\$899.88
	\$803.52
	\$608.80
	\$440.78
	\$295.80
	\$167.29
	\$51.17
	-\$67.23
	-\$188.58
	-\$312.84
	-\$439.44

Price per share	
	\$41.60
	\$54.68
	\$67.25
	\$79.14
	\$90.54
	\$101.51
	\$112.12
	\$122.33
	\$132.15
	\$141.54
	\$150.45