Seeking Alpha α

Elevate: It's Really Not As Bad As You Think

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Summary

Elevate is trading at a heavy discount, given regulatory uncertainties and the closing of its U.K. business.

The company offers a good product and is committed to maintaining high levels of profitability.

For investors with higher risk tolerance, Elevate could deliver upwards of 12% annual returns.

Thesis Summary

Elevate Credit Inc. (NYSE:ELVT) provides payday loans in the United States. Given the recent closure of the U.K. business and regulatory concerns, the stock trades at a steep discount, only 3x earnings. Nonetheless, we consider these concerns to be overblown. Furthermore, Elevate has shown a strong commitment to maintaining profitability and, through its technology and partnerships, offers a competitive line of products. For those investors with a higher risk appetite, Elevate could return upwards of 12%.

Company Overview

Elevate Credit provides payday loans for consumers in the U.S. In other words, it provides loans to borrowers who can't get financing from traditional sources. These loans are generally shorter in maturity and carry high interest rates. The company was recently forced to shut down its UK operations due to regulatory pressure but continues to operate domestically. To begin, let's look at the most recent income statement and balance sheet.

As we can see above, revenues for over the last six months have fallen by close to 10%. However, this has been outpaced by the fall in operating expenses. Marketing costs have been essentially reduced to 0, and the company has also made significant reductions in the labor force and benefits. Elevate has also benefited from lower interest expenses and achieved higher income from operations over the first two quarters of 2020. However, total income and EPS was much lower due to the effects of losses from discontinued operations, which are directly related to the closing of the U.K. business.

Having said this, let's have a look at the balance sheet:

Elevate has increased its cash position vis-a-vis last year. We can see total assets have decreased substantially in the form of loans receivable. On the other hand, liabilities have decreased to a similar tune, mostly through fewer notes payable. As of writing this, D/E stands at a healthy ratio of 2.89, and financial leverage is 4.10 (data from Morningstar). The company has made an effort

to reduce its debt burden. A sign, perhaps, of lower growth, but a tailwind for financial stability and profitability.

Market Outlook

Without a doubt, the payday loan market is a controversial one, to say the least. These companies walk a very thin line between providing much-needed credit to customers who have no other choice and abusing their position to extract usury interest rates. This has fueled the rise of regulation in many countries and U.S. states. Here's a simplified picture of the current regulatory landscape.

According to data from poverty-action.org, payday loans are usually $500 or less and carry interest rates of up to 400%. Under the Trump administration, it seems the payday market has seen some deregulation, as certain regulatory protections were lifted back in July. In terms of size, we are looking at a market of around $90 billion.

The competitive landscape for this market is certainly an interesting one. Data from 2019 suggests there are a staggering 23,000 companies offering payday loans. For reference, this is twice as many as the number of McDonald's restaurants. Having said this, it is important to understand that the "payday loan market", so to speak, is for the most part an isolated credit market. What we mean is that these companies don't compete with traditional banks or even credit unions. The terms offered and service are differentiated enough that there is rarely an overlap. Credit unions aren't interested and, in fact, often can't compete with the services provided by payday loan companies. This was discussed in great depth in this report by the Cato Institute.

SWOT analysis

In this section, we will discuss the strengths and opportunities, as well as the threats and weaknesses of the company.

Beginning with strengths, the most encouraging point we can make about Elevate is its outstanding commitment to reducing costs during the pandemic and the resulting improvement in profitability metrics. The company cut its U.S. staff by 17% and eliminated all bonuses for 2020 as well as reduced executive salaries and board compensations.

As a result, what we have is a much larger EBITDA margin than in the past. Other contributing factors were lower marketing costs and fewer loan losses, as we can see in the next graph:

The "quality" of the loans has increased noticeably in the last few years. This is the flip side of the main weakness the company has and will have, which is lower loan originations. The outlook for revenue growth continues to be gloomy in the short term. According to the earnings call presentation, CFO Chris Lutes expects around half the growth volume as last year in the final quarter of 2020. The longer-term outlook will depend on several political factors, including the potential for further stimulus and benefits down the line. Ultimately, the strength of the business comes from the way the recently appointed CEO views the business. Rather than focusing directly on growth, Jason Harvison is focused on increasing profitability and offering better

products and services through advanced technology. Elevate also offers value through its partnerships with banks, as it can leverage all its data. Having been in business for many years now, this grants the company a certain “moat” against new competitors.

In terms of opportunities and threats, we can identify two very clear scenarios that will affect the future of the company. Given a Trump win, the company would continue to enjoy a favorable regulatory environment. If Joe Biden wins, however, we could expect a tightening of regulation. In any case, even in this latter scenario, the regulation would take a few years to be implemented, and the effects would not be felt until much further down the line.

Overall, the biggest problem for investors is that it is unclear how the market will evolve in the coming years, and even management has pulled its guidance. Having said this, we believe too much pessimism may be cooked into the price. Even under a low growth scenario, profitability can sustain positive cash flows and EPS.

Valuation

After everything that we have analyzed, we have come up with a valuation for ELVT’s common stock using our potential cash flow method.

The valuation method is based on our estimates of potential unlevered free cash flow to common shareholders. To do this, we analyze some key ratios regarding investment, revenue, and operating expenses.

As an indicator of investment levels that drive revenue, we look at the level of long-term assets for operations, as per our interpretation of the different items on the balance sheet, and recent spending on R&D, and use the recent trend for their relation with previous and future revenues to estimate the levels of investment and revenue in the future. We do the same for operating expenses (excluding R&D) and working capital, relative to revenue. Note that we may include some items in the operating expenses which are not considered operating in the official income statement but we consider a regular part of the company’s activity.

We also use recent trends in ratios to estimate the rest of the items, which include financial income or expenses (based on the net level of debt, as per our interpretation of the balance sheet), minority interest (based on the level of net income) and dividends to preferred equity (based on the level of preferred equity), and the level of net debt, based on the recent trend in leverage.

The final valuation is a sum of the discounted value of future unlevered free cash flow to common shareholders, minus the current level of debt. To evaluate cash flow potential, we assume a net investment of 0 in the fifth year of the forecast, which we use to calculate terminal value. We assume cash flow growth will drop gradually over the 10 years following the forecast from the revenue growth level of the fifth year to a long-term level of 2%. If the growth rate is already below 2%, we use the lower rate as a perpetual one. Finally, we match the discount rate to the current price of the stock to produce an expected rate of return.

We add manual changes to some items or ratios based on qualitative analysis and information from the latest quarterly reports. For ELVT, we have diminished revenue expectations for 2020 to $500 million and projected a run of modest growth from there on.

We find that ELVT, even with a significant fall in revenue (33% in 2020, as estimated), and without returning to previous levels of revenue (growth declining gradually from 2.6% to 2% after 2020), is well equipped to provide significant cash returns if it can maintain profitability and balance sheet structure. Our estimate is a potential long-term return of over 12% at the current price.

Takeaway

While many believe companies like Elevate are predatory lenders, we view their operations as beneficial for the overall customer. Furthermore, lending has become a very precise and exact science, thanks to financial technology and data. Elevate thrives in this and has shown that it can provide flexible products and services while keeping good loan profitability. The closure of the business in the U.K. and the possible change in administration have led many investors to question the future of the company. We, on the other hand, see this as a good value investing opportunity for investors with a higher tolerance for risk.

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