

Equity Research

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Financials

H&R Block, Inc.

H&R Block on the Block? Sale to Private Equity Appears Feasible, But ...

In what felt like the umpteenth time, an unconfirmed media report emerged on Friday that H&R Block (HRB) was preparing to sell itself, a headline that caused a modest uptick in the stock. While we were not surprised that the stock failed to gain more traction in the report's aftermath, we have held for some time that the notion that HRB could attract a bid from private equity is not farfetched.

- ▶ We had been a proponent of HRB shares for most of the three years we had covered the stock, finally moving to the sidelines after the company's shares last September reached \$36, the level we believe could be justified by the earnings impact of the net leverage it announced it would add to facilitate share buybacks following the completion of the sale of its bank to BOFI Holdings (BOFI, Not Rated).
- ▶ We had viewed HRB as primarily a financial-engineering play driven by buybacks rather than one based on the company's operating performance, which had stagnated for three years before adding another disappointing tax season in 2016. Looking back over that period, we believe it was no coincidence that HRB's tax preparation business began to sag after the company stopped offering refund anticipation loans (RALs) in the face of pressure from various state attorneys general, as it appears in retrospect that it had materially boosted its operating results by offering consumers access to cash for which they paid a lofty annual percentage rate (APR).
- ▶ Our view that the upside on HRB shares was limited was based in part on management's steadfast refusal to lever up beyond the point at which the company would lose its investment grade credit ratings, an approach for which they have not provided a good explanation even as it would significantly benefit shareholders without much cost.
- ▶ **Valuation:** Based on our P/E multiple valuation analysis for HRB, we believe that H&R Block's valuation is within +/- 15% from current levels over the next 12 months. BTIG does not put price targets on Neutral-rated stocks.

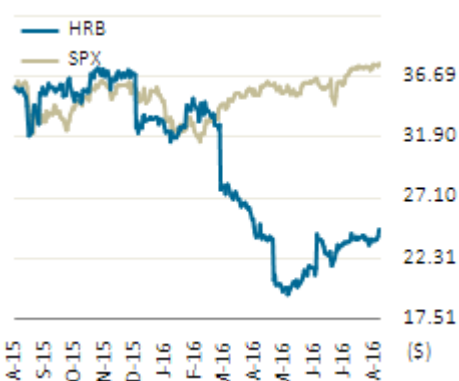
HRB

\$24.56

NEUTRAL

52 week range \$19.46 - \$37.40
Market Cap (m) \$5,492

Price Performance



Source: IDC

Estimates

	1Q16 A	2Q16 A	3Q16 A	4Q16 A	FY16 A	1Q17 E	2Q17 E	3Q17 E	4Q17 E	FY17 E	FY18 E
Sales	138	128	475	2,297	3,038	140	131	484	2,343	3,099	3,176
EBITDA	(138)	(181)	(78)	1,209	812	(132)	(166)	(60)	1,255	898	948
Diluted EPS (Adj.)	(0.36)	(0.54)	(0.35)	3.13	1.49	(0.55)	(0.66)	(0.38)	3.54	1.84	2.10

Source: BTIG Estimates and Company Documents (\$ in millions, except per share amount)

Please Read: Important disclosures and analyst's certification appear in Appendix

- ▶ Management told us that investment grade ratings allowed HRB to access the commercial paper market during the working capital ramp-up ahead of tax season, but we think the required funding could be easily accessed by expanding the company's revolving credit facility.
- ▶ Adding to our concern about HRB's ability to reverse its operating fortunes was the re-emergence of RALs in the tax preparation space – without the company's participation in their revival. Indeed, in the wake of a report detailing HRB's underperformance through the first part of the 2016 tax season, CEO Bill Cobb attributed the weakness in part to the fact that branded competitors such as Liberty Tax (TAX, Not Rated) and Jackson Hewitt, as well as some independents, had introduced so-called "refund advances" ahead of the season.
- ▶ Management had spent much of 2015 highlighting their target of sustained 4%+ revenue growth, but following the release of a tepid 4Q16 report on June 9 – HRB assisted channel volumes declined by 6% during the 2016 tax season – they offered vague directional promises about using the savings from expense reductions to fund initiatives aimed at boosting their client count. Moreover, they said they would not provide details about planned initiatives to drive increased tax preparation volumes in 2017 until HRB's Investor Day in December, ensuring that uncertainty about their plans would remain for another half a year.
- ▶ With all of that said, HRB shares now trade almost 35% below the high of \$37.53 they reached early last November even after a recent rally of more than 26% off of their May lows. The shares trade at 12.9x consensus estimates for FY18 earnings per share of \$1.91, a fraction of the multiple that some sell-side analysts had been assigning the stock not too long ago when the prospect of a significant boost to the company's tax preparation volumes from the tax-filing requirements of Obamacare had appeared more realistic and had stirred enthusiasm for the shares. HRB also had \$897mm in cash as of April 30 and it generated \$432mm in free cash flow during FY16.
- ▶ As such, we find it feasible that private equity firms with a focus on the consumer finance space would consider a bid for HRB. The stock does not appear expensive at current levels, management has maintained leverage at levels supportive of investment grade ratings, and the company throws off a healthy amount of free cash flow. Additionally, the company appears to provide the kinds of opportunities for operational improvement – the ability to rationalize its network of 3,599 franchise and 6,614 company-run offices, to better exploit the opportunity to serve Hispanic communities, and to leverage its Emerald prepaid debit card, among others – sought by private equity players.
- ▶ A private equity firm could lever up HRB beyond the currently targeted levels, using the company's ample free cash flow to support the increased debt burden. It also could reintroduce RALs in the form offered by its branded peers: the new loans are offered as "free" to consumers and lack the high upfront fees associated with the original

RALs, but consumer advocates suspect that the fees of \$35 to \$45 per loan charged to preparers by issuers are passed on to consumers through higher tax preparation fees. Such a move could at least provide HRB with a more level playing field as it seeks to restore its market share.

- ▶ With that said, the current political environment could give private equity firms pause for now. As we noted on April 5, Republican presidential candidate Donald Trump's comments about tax policy and HRB last August mean his candidacy also represents a threat to the company and the stock. "I want to put H&R Block out of business," Trump said in response to a question about his tax simplification policy. While Trump's poor recent performance in the polls, or the belief that such commentary would be unlikely to translate into policy action if he were to be elected, may help to address private equity investors' reservations, his comments could cause such investors to put their thoughts about making a bid for HRB on hold until after November's U.S. presidential election provides clarity.
- ▶ HRB has also faced a threat from the Democratic side of the aisle since April 13 when Sen. Elizabeth Warren (D-MA) introduced a bill that would allow U.S. taxpayers with less complex tax situations to avoid having to file returns and instead receive pre-prepared returns from the IRS with their bill or refund already calculated. Warren's office estimated that between 8mm and 60mm households would no longer need to file returns if her bill were to become law, saving them an estimated \$2bn and 225mm hours that would have been spent preparing their returns.
- ▶ Moreover, Warren's bill – which was co-sponsored by seven senators including former presidential candidate Sen. Bernie Sanders (D-VT) – would direct the IRS to develop a free, online preparation and filing offering that would enable those with more complex returns to file directly with the government without having to rely on a third party such as HRB. While the bill is currently before the Senate Finance Committee and such legislation is likely to be on hold until after the presidential election, it represents another reason why private equity firms may approach a bid for HRB with some caution.
- ▶ In sum, we did not view Friday's reports about HRB putting itself up for sale as sufficiently credible to move from the sidelines on the name. However, we believe the potential for a bid from private equity is realistic enough that investors who are short HRB – short interest represents just under 9% of its float – should consider finding other short candidates with less likelihood of getting bought at a premium that could translate into significant losses on their positions.

Income Statement

H&R Block (HRB) - Operating Model \$ millions	Apr-14 2014A	Jul-14 1Q15A	Oct-14 2Q15A	Jan-15 3Q15A	Apr-15 4Q15A	Apr-15 2015A	Jul-15 1Q16A	Oct-15 2Q16A	Jan-16 3Q16A	Apr-16 4Q16A	Apr-16 2016A	Jul-16 1Q17E	Oct-16 2Q17E	Jan-17 3Q17E	Apr-17 4Q17E	Apr-17 2017E	Apr-18 2018E
Services revenue	2,570.27	115.47	115.44	406.44	2,013.70	2,651.06	118.43	113.42	389.50	2,032.58	2,653.94	120.80	115.69	397.29	2,073.23	2,707.01	2,774.69
Royalty, product and other revenues	454.02	18.11	19.19	102.63	287.67	427.60	19.28	15.00	85.04	264.90	384.22	19.67	15.29	86.74	270.19	391.90	401.70
Total revenues	3,024.30	133.59	134.63	509.07	2,301.37	3,078.66	137.72	128.42	474.54	2,297.48	3,038.15	140.47	130.98	484.03	2,343.43	3,098.92	3,176.39
Compensation and benefits	816.62	51.86	69.38	186.66	544.59	852.48	55.79	62.69	181.92	544.80	845.20	56.07	63.01	182.82	547.52	849.42	862.16
Occupancy and equipment	362.78	83.31	87.63	92.30	115.39	378.62	89.86	95.05	96.20	124.02	405.12	90.08	95.29	96.44	124.33	406.14	410.20
Provisions for bad debt and loan losses	80.01	4.36	0.39	39.28	30.96	74.99	2.01	1.18	35.73	36.47	75.40	1.60	0.95	28.59	29.18	60.32	60.92
Depreciation and amortization	93.26	25.09	28.43	29.18	29.17	111.86	27.08	28.36	28.80	31.67	115.91	27.15	28.43	28.87	31.75	116.20	117.36
Other	219.71	33.12	35.88	47.26	96.29	212.53	38.78	39.12	49.87	116.17	243.93	38.97	39.31	50.12	116.75	245.15	247.60
Cost of revenue	1,572.38	197.73	221.70	394.68	816.39	1,630.49	213.51	226.40	392.51	853.13	1,685.55	213.87	226.98	386.84	849.53	1,677.22	1,698.24
Marketing and advertising	238.76	8.15	12.51	87.57	165.46	273.68	8.53	12.97	93.71	182.56	297.76	8.57	13.03	94.18	183.47	299.25	302.24
Compensation and benefits	249.78	60.96	54.35	60.38	62.83	238.53	54.67	61.59	63.65	48.86	228.78	54.81	61.75	63.81	48.99	229.35	232.79
Depreciation and amortization	22.35	8.60	10.50	14.11	14.73	47.94	13.01	13.99	16.51	14.18	57.69	13.04	14.03	16.55	14.22	57.84	58.31
Other selling, general and administrative	122.54	19.49	20.01	27.49	26.36	93.35	21.98	47.30	28.00	37.90	135.18	22.04	23.65	28.07	37.99	111.75	112.31
Selling, general and administrative	633.43	97.20	97.38	189.55	269.38	653.50	98.19	135.85	201.87	283.50	719.41	98.46	112.45	202.61	284.66	698.18	705.65
Total operating expenses	2,205.81	294.93	319.08	584.23	1,085.77	2,283.99	311.70	362.25	594.39	1,136.63	2,404.96	312.33	339.43	589.45	1,134.19	2,375.41	2,403.89
Operating income	818.49	(161.34)	(184.45)	(75.15)	1,215.61	794.67	(173.98)	(233.83)	(119.84)	1,160.85	633.19	(171.86)	(208.45)	(105.41)	1,209.23	723.51	772.50
Other incomes	36.32	0.52	-	0.30	0.49	1.31	0.43	10.51	3.06	3.71	17.70	-	-	-	-	-	-
Interest expense on borrowings	(55.28)	(13.80)	(13.84)	(9.05)	(8.56)	(45.25)	(8.58)	(14.18)	(23.57)	(22.63)	(68.96)	(22.63)	(22.63)	(22.63)	(22.63)	(90.53)	(90.53)
Other expenses	(32.41)	(1.20)	(2.28)	(6.97)	2.53	(7.93)	(4.99)	(0.21)	(6.14)	(1.12)	(12.45)	-	-	-	-	-	-
Income (loss) from continuing operations before tax	767.12	(175.82)	(200.57)	(90.87)	1,210.06	742.81	(187.11)	(237.72)	(146.50)	1,140.81	569.48	(194.49)	(231.08)	(128.05)	1,186.60	632.98	681.97
Income tax expense (benefit)	267.02	(66.97)	(87.35)	(55.55)	465.93	256.06	(90.60)	(95.20)	(67.85)	439.58	185.93	(73.91)	(87.81)	(48.66)	450.91	240.53	259.15
Net income (loss) from continuing operations	500.10	(108.85)	(113.23)	(35.31)	744.13	486.74	(96.51)	(142.52)	(78.65)	701.23	383.55	(120.58)	(143.27)	(79.39)	735.69	392.45	422.82
Net income (loss) from discontinued operations	(24.94)	(7.38)	1.23	(1.64)	(5.29)	(13.08)	(3.15)	(2.49)	(3.08)	(0.56)	(9.29)	-	-	-	-	-	-
Net income (loss)	475.16	(116.23)	(112.00)	(36.95)	738.84	473.66	(99.66)	(145.01)	(81.73)	700.66	374.27	(120.58)	(143.27)	(79.39)	735.69	392.45	422.82
Diluted EPS - continuing operations	1.81	(0.40)	(0.41)	(0.13)	2.62	1.76	(0.35)	(0.54)	(0.34)	3.14	1.53	(0.55)	(0.66)	(0.38)	3.54	1.84	2.10
Diluted EPS - discontinued operations	(0.09)	(0.03)	0.00	(0.01)	(0.02)	(0.05)	(0.01)	(0.01)	(0.01)	(0.00)	(0.04)	-	-	-	-	-	-
Diluted EPS	1.72	(0.42)	(0.41)	(0.13)	2.60	1.71	(0.36)	(0.54)	(0.35)	3.13	1.49	(0.55)	(0.66)	(0.38)	3.54	1.84	2.10
Diluted shares outstanding	276.03	274.58	275.11	275.19	283.67	277.14	275.77	266.27	231.90	223.62	250.82	219.62	215.62	211.62	207.62	213.62	201.37
Net income (loss)	475.16	(116.23)	(112.00)	(36.95)	738.84	473.66	(99.66)	(145.01)	(81.73)	700.66	374.27	(120.58)	(143.27)	(79.39)	735.69	392.45	422.82
Discontinued operations	24.94	7.38	(1.23)	1.64	5.29	13.08	3.15	2.49	3.08	0.56	9.29	-	-	-	-	-	-
Income taxes	267.02	(66.97)	(87.35)	(55.55)	465.93	256.06	(90.60)	(95.20)	(67.85)	439.58	185.93	(73.91)	(87.81)	(48.66)	450.91	240.53	259.15
Interest expense	55.28	13.80	13.84	9.05	8.56	45.25	8.58	14.18	23.57	22.63	68.96	22.63	22.63	22.63	22.63	90.53	90.53
Depreciation and amortization	115.60	33.69	38.93	43.29	43.90	159.80	40.09	42.35	45.30	45.85	173.60	40.19	42.45	45.42	45.97	174.03	175.66
EBITDA	938.00	(128.34)	(147.80)	(38.53)	1,262.52	947.86	(138.44)	(181.19)	(77.62)	1,209.29	812.04	(131.66)	(166.00)	(60.00)	1,255.20	897.54	948.17
Revenue growth	4.1%	5.0%	0.2%	154.8%	-10.2%	1.8%	3.1%	-4.6%	-6.8%	-0.2%	-1.3%	2.0%	2.0%	2.0%	2.0%	2.0%	2.5%
Operating margin	27.1%	-120.8%	-137.0%	-14.8%	52.8%	25.8%	-126.3%	-182.1%	-25.3%	50.5%	20.8%	-122.3%	-159.1%	-21.8%	51.6%	23.3%	24.3%
EBITDA Margin	31.0%	-96.1%	-109.8%	-7.6%	54.9%	30.8%	-100.5%	-141.1%	-16.4%	52.6%	26.7%	-93.7%	-126.7%	-12.4%	53.6%	29.0%	29.9%
EBITDA Growth	7.3%	-12.8%	4.5%	-87.2%	-17.4%	1.1%	7.9%	22.6%	101.5%	-4.2%	-14.3%	-4.9%	-8.4%	-22.7%	3.8%	10.5%	5.6%
Tax rate	34.8%	38.1%	43.5%	61.1%	38.5%	34.5%	48.4%	40.0%	46.3%	38.5%	32.6%	38.0%	38.0%	38.0%	38.0%	38.0%	38.0%

Source: BTIG Estimates and Company Documents

Appendix: Analyst Certification and Other Important Disclosures

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I, Mark Palmer, hereby certify that the views about the companies and securities discussed in this report are accurately expressed and that I have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

I, Giuliano Bologna, hereby certify that the views about the companies and securities discussed in this report are accurately expressed and that I have not received and will not receive direct or indirect compensation in exchange for expressing specific recommendations or views in this report.

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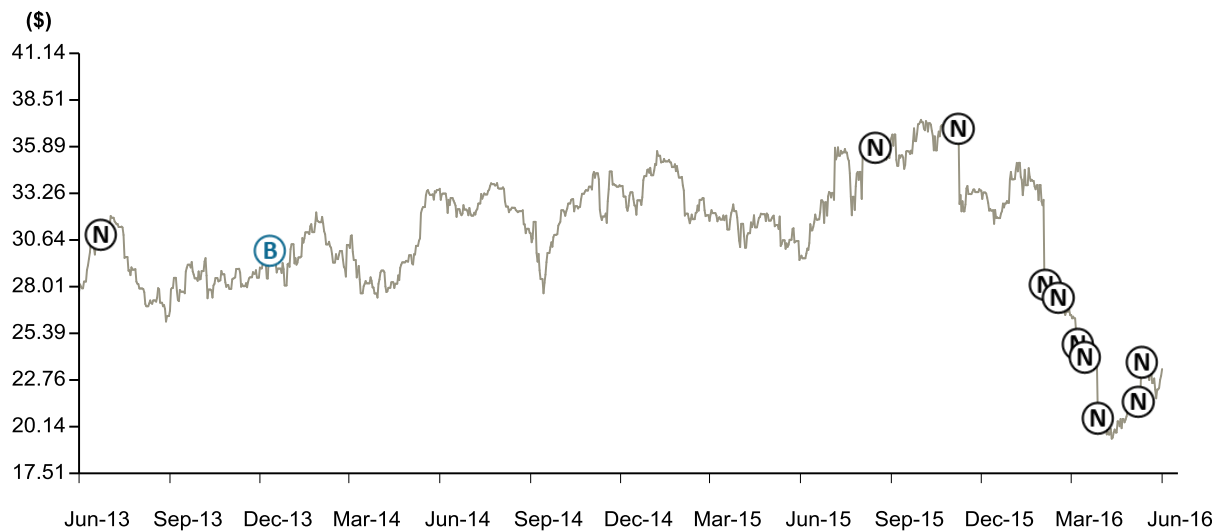
Company Valuation and Risk Disclosures

H&R Block, Inc. (HRB, Neutral)

Valuation: Based on our P/E multiple valuation analysis for HRB, we believe that H&R Block's valuation is within +/- 15% from current levels over the next 12 months. BTIG does not put price targets on Neutral-rated stocks.

Risks: The primary risks to achieving our rating include: the fact that increased U.S. unemployment could negatively impact H&R block's tax preparation business, potential mortgage putback exposure to the H&R Block parent company, upcoming debt maturities, legislative and regulatory risks, and seasonality.

H&R Block, Inc. (HRB)



Note: Closing Price and Target Price have been adjusted for corporate actions.

Date	Closing Price (\$)	Target Price (\$)	Analyst	Rating
22-Oct-12	17.74	23	Mark Palmer	Buy
31-Jan-13	22.77	27	Mark Palmer	Buy
22-Jul-13	30.92		Mark Palmer	Neutral
09-Jan-14	30.03	36	Mark Palmer	Buy
14-Sep-15	35.83		Mark Palmer	Neutral

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