

Equity Research

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Financials

H&R Block, Inc.

HRB Swoon Extends to "Year Round" Plan in 1Q17 as Revival Plan Reveal Pushed Off; Reducing Estimates

While this month marked the re-emergence of the buyout rumors about H&R Block (HRB) that have popped up from time to time during the past few years, giving the stock a modest boost, the 1Q17 report the company released today after the market close was a reminder of the operating struggles that weighed on its shares during much of the past year.

- ▶ HRB's fiscal first quarter typically represents less than 5% of annual revenues and less than 15% of annual expenses. However, management during the past couple of years had raised expectations around such off-season quarters by making "year round" – the generation of more robust revenues in the quarters that do not overlap with the tax season – an area of emphasis as it laid out its strategic plans.
- ▶ As such, HRB's 1Q17 report was a disappointment as it posted an adjusted loss per share of \$0.55, trailing the consensus estimate of an adjusted loss per share of \$0.53 while matching our estimate. The miss was driven by lower-than-expected revenue of \$125.2mm versus the consensus estimate of \$132.8mm and our estimate of \$140mm.
- ▶ **We are reiterating our Neutral rating on HRB** while reducing our FY17 and FY18 earnings per share estimates to \$1.74 and \$1.88 from \$1.84 and \$2.10, respectively.
- ▶ Our EPS estimate reduction is based on our lowered expectations for revenue growth in each of the years given continued uncertainty about client retention, with FY17E revenue growth of 1.0% down from our prior estimate of 2.0%, and FY18E revenue growth of 1.5% down from our prior estimate of 2.5%.
- ▶ **Valuation:** Based on our P/E multiple valuation analysis for HRB, we believe that its valuation is within +/- 15% from current levels over the next 12 months. BTIG does not assign price targets to Neutral-rated stocks.

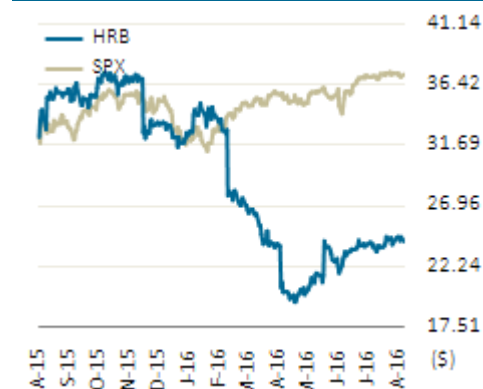
HRB

\$24.20

NEUTRAL

52 week range \$19.46 - \$37.40
Market Cap (m) \$5,336

Price Performance



Source: IDC

Estimates

	1Q16 A	2Q16 A	3Q16 A	4Q16 A	FY16 A	1Q17 A	2Q17 E	3Q17 E	4Q17 E	FY17 E	FY18 E
Sales	138	128	475	2,297	3,038	125	130	479	2,320	3,055	3,100
EBITDA	(138)	(181)	(78)	1,209	812	(141)	(165)	(67)	1,228	855	872
Diluted EPS (Adj.)	(0.36)	(0.54)	(0.35)	3.13	1.49	(0.56)	(0.65)	(0.39)	3.45	1.73	1.88

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

- ▶ We had noted in the aftermath of HRB's 4Q16 report that management had said they would not provide details about their planned initiatives to revive flagging tax preparation volumes – the company has lost about 1mm clients since the swoon began – until its investor day in December, allowing uncertainty about their plans to persist. However, management announced during today's conference call that they had opted not to hold the investor day after all given their concern that it would provide competitors with a preview of the company's planned changes. The upshot is that the year-end catalyst that some investors in HRB shares had been anticipating will not happen.
- ▶ HRB's report featured a couple of silver linings. Management said they were on track to execute their cost-reduction plans, with the majority of the cuts expected to be realized after 1Q17. Additionally, the company announced that Sand Canyon Corporation, the legally separate entity at which the representation and warranty liabilities related to the former Option One are housed, had reduced its accrual for contingent losses related to those liabilities by \$40mm sequentially to \$26mm.
- ▶ However, we believe the most encouraging takeaway from HRB's report was management's refusal to dismiss the possibility that during the 2017 tax season it will once again offer refund anticipation loans (RALs). In the wake of a report detailing the company's underperformance through the first part of the 2016 tax season, CEO Bill Cobb had 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. Those competitors issued approximately 1mm of such advances during the course of the season, management later said.
- ▶ Cobb in response to a question about whether HRB would offer RALs in 2017 said management would "continue to look at that." We believe that comment, combined with management's decision not to disclose the changes it would make for the upcoming tax season prior to its start, means that the probability of HRB once again offering RALs during the coming year has increased markedly.
- ▶ HRB during 1Q17 bought back approximately 2mm shares of its stock for \$48.6mm. The company has used approximately \$2bn of the \$3.5bn share repurchase program approved by its board of directors in August 2015.

Income Statement

H&R Block (HRB) - Operating Model	Apr-14	Apr-15	Jul-15	Oct-15	Jan-16	Apr-16	Apr-16	Jul-16	Oct-16	Jan-17	Apr-17	Apr-17	Jul-17	Oct-17	Jan-18	Apr-18	Apr-18
\$ millions	2014A	2015A	1Q16A	2Q16A	3Q16A	4Q16A	2016A	1Q17A	2Q17E	3Q17E	4Q17E	2017E	1Q18E	2Q18E	3Q18E	4Q18E	2018E
Services revenue	2,570.27	2,651.06	118.43	113.42	389.50	2,032.58	2,653.94	112.38	114.55	393.40	2,052.91	2,673.24	114.07	116.27	399.30	2,083.70	2,713.34
Royalty, product and other revenues	454.02	427.60	19.28	15.00	85.04	264.90	384.22	12.80	15.14	85.89	267.55	381.38	12.99	15.37	87.18	271.56	387.10
Total revenues	3,024.30	3,078.66	137.72	128.42	474.54	2,297.48	3,038.15	125.19	129.70	479.29	2,320.45	3,054.62	127.06	131.64	486.48	2,355.26	3,100.44
Compensation and benefits	816.62	852.48	55.79	62.69	181.92	544.80	845.20	52.36	62.07	182.82	547.52	844.77	53.14	63.00	185.57	555.74	857.44
Occupancy and equipment	362.78	378.62	89.86	95.05	96.20	124.02	405.12	94.43	94.10	96.44	124.33	409.29	95.37	95.04	97.41	125.57	413.39
Provisions for bad debt and loan losses	80.01	74.99	2.01	1.18	35.73	36.47	75.40	1.42	0.95	28.59	29.18	60.13	1.43	0.96	28.87	29.47	60.73
Depreciation and amortization	93.26	111.86	27.08	28.36	28.80	31.67	115.91	27.47	28.43	28.87	31.75	116.51	27.74	28.71	29.16	32.07	117.68
Other	219.71	212.53	38.78	39.12	49.87	116.17	243.93	35.42	38.72	50.12	116.75	241.02	35.78	39.11	50.62	117.92	243.43
Cost of revenue	1,572.38	1,630.49	213.51	226.40	392.51	853.13	1,685.55	211.09	224.27	386.84	849.53	1,671.72	213.46	226.82	391.62	860.76	1,692.66
Marketing and advertising	238.76	273.68	8.53	12.97	93.71	182.56	297.76	7.56	13.03	96.52	188.03	305.14	7.64	13.16	97.48	189.92	308.20
Compensation and benefits	249.78	238.53	54.67	61.59	63.65	48.86	228.78	57.52	61.75	63.81	48.99	232.07	58.38	62.67	64.77	49.72	235.55
Depreciation and amortization	22.35	47.94	13.01	13.99	16.51	14.18	57.69	13.82	14.03	16.55	14.22	58.61	14.36	14.50	14.65	14.79	58.31
Other selling, general and administrative	122.54	93.35	21.98	47.30	28.00	37.90	135.18	19.93	23.65	28.07	37.99	109.64	20.02	23.77	28.21	38.18	110.18
Selling, general and administrative	633.43	653.50	98.19	135.85	201.87	283.50	719.41	98.82	112.45	204.95	289.23	705.46	100.41	114.10	205.12	292.61	712.23
Total operating expenses	2,205.81	2,283.99	311.70	362.25	594.39	1,136.63	2,404.96	309.91	336.72	591.79	1,138.76	2,377.18	313.86	340.92	596.74	1,153.37	2,404.90
Operating income	818.49	794.67	(173.98)	(233.83)	(119.84)	1,160.85	633.19	(184.72)	(207.02)	(112.50)	1,181.70	677.45	(186.80)	(209.28)	(110.26)	1,201.89	695.55
Other incomes	36.32	1.31	0.43	10.51	3.06	3.71	17.70	2.97	-	-	-	2.97	-	-	-	-	-
Interest expense on borrowings	(55.28)	(45.25)	(8.58)	(14.18)	(23.57)	(22.63)	(68.96)	(21.47)	(21.47)	(21.47)	(21.47)	(85.86)	(21.47)	(21.47)	(21.47)	(21.47)	(85.86)
Other expenses	(32.41)	(7.93)	(4.99)	(0.21)	(6.14)	(1.12)	(12.45)	(0.33)	-	-	-	(0.33)	-	-	-	-	-
Income (loss) from continuing operations before tax	767.12	742.81	(187.11)	(237.72)	(146.50)	1,140.81	569.48	(203.55)	(228.49)	(133.97)	1,160.23	594.23	(208.27)	(230.75)	(131.72)	1,180.42	609.68
Income tax expense (benefit)	267.02	256.06	(90.60)	(95.20)	(67.85)	439.58	185.93	(82.52)	(86.82)	(50.91)	440.89	220.63	(79.14)	(87.68)	(50.06)	448.56	231.68
Net income (loss) from continuing operations	500.10	486.74	(96.51)	(142.52)	(78.65)	701.23	383.55	(121.03)	(141.66)	(83.06)	719.34	373.59	(129.13)	(143.06)	(81.67)	731.86	378.00
Net income (loss) from discontinued operations	(24.94)	(13.08)	(3.15)	(2.49)	(3.08)	(0.56)	(9.29)	(2.65)	-	-	-	(2.65)	-	-	-	-	-
Net income (loss)	475.16	473.66	(99.66)	(145.01)	(81.73)	700.66	374.27	(123.67)	(141.66)	(83.06)	719.34	370.95	(129.13)	(143.06)	(81.67)	731.86	378.00
Diluted EPS - continuing operations	1.81	1.76	(0.35)	(0.54)	(0.34)	3.14	1.53	(0.55)	(0.65)	(0.39)	3.45	1.74	(0.63)	(0.71)	(0.41)	3.72	1.88
Diluted EPS - discontinued operations	(0.09)	(0.05)	(0.01)	(0.01)	(0.01)	(0.00)	(0.04)	(0.01)	-	-	-	(0.01)	-	-	-	-	-
Diluted EPS	1.72	1.71	(0.36)	(0.54)	(0.35)	3.13	1.49	(0.56)	(0.65)	(0.39)	3.45	1.73	(0.63)	(0.71)	(0.41)	3.72	1.88
Diluted shares outstanding	276.03	277.14	275.77	266.27	231.90	223.62	250.82	220.48	216.48	212.48	208.48	214.48	205.48	202.48	199.48	196.48	200.98
Net income (loss)	475.16	473.66	(99.66)	(145.01)	(81.73)	700.66	374.27	(123.67)	(141.66)	(83.06)	719.34	370.95	(129.13)	(143.06)	(81.67)	731.86	378.00
Discontinued operations	24.94	13.08	3.15	2.49	3.08	0.56	9.29	2.65	-	-	-	2.65	-	-	-	-	-
Income taxes	267.02	256.06	(90.60)	(95.20)	(67.85)	439.58	185.93	(82.52)	(86.82)	(50.91)	440.89	220.63	(79.14)	(87.68)	(50.06)	448.56	231.68
Interest expense	55.28	45.25	8.58	14.18	23.57	22.63	68.96	21.47	21.47	21.47	21.47	85.86	21.47	21.47	21.47	21.47	85.86
Depreciation and amortization	115.60	159.80	40.09	42.35	45.30	45.85	173.60	41.28	42.45	45.42	45.97	175.12	42.10	43.22	43.80	46.86	175.98
EBITDA	938.00	947.86	(138.44)	(181.19)	(77.62)	1,209.29	812.04	(140.80)	(164.56)	(67.09)	1,227.66	855.21	(144.70)	(166.06)	(66.45)	1,248.75	871.53
Revenue growth	4.1%	1.8%	3.1%	-4.6%	-6.8%	-0.2%	-1.3%	-9.1%	1.0%	1.0%	1.0%	0.5%	1.5%	1.5%	1.5%	1.5%	1.5%
Operating margin	27.1%	25.8%	-126.3%	-182.1%	-25.3%	50.5%	20.8%	-147.6%	-159.6%	-23.5%	50.9%	22.2%	-147.0%	-159.0%	-22.7%	51.0%	22.4%
EBITDA Margin	31.0%	30.8%	-100.5%	-141.1%	-16.4%	52.6%	26.7%	-112.5%	-126.9%	-14.0%	52.9%	28.0%	-113.9%	-126.1%	-13.7%	53.0%	28.1%
EBITDA Growth	7.3%	1.1%	7.9%	22.6%	101.5%	-4.2%	-14.3%	1.7%	-9.2%	-13.6%	1.5%	5.3%	2.8%	0.9%	-0.9%	1.7%	1.9%
Tax rate	34.8%	34.5%	48.4%	40.0%	46.3%	38.5%	32.6%	40.5%	38.0%	38.0%	38.0%	37.1%	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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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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