

An Overview of Transformations



To **Transform** is to make a thorough or dramatic change in the form, appearance, or character of; to change in composition or structure; to change character or condition.

Breach Inlet Capital seeks to invest in small cap companies when transformational events are beginning, yet remain unnoticed by the market and therefore not reflected in the company's share price. As the transformation unfolds and its benefits become evident, this acts as a natural catalyst to drive a company's share price higher. Transformations come in various forms, but are often the result of a material change in company leadership, strategy, and/or assets.

The small cap market is a fertile ground for transformations. There are thousands of small caps and many are not widely covered by analysts/investors leading to uncovered opportunities. Also, small caps are often transforming in their quests to become much larger companies.

We identify transformations through an extensive and repeatable investment process that combines thoughtful qualitative research with thorough quantitative analysis. If company leadership is experienced and incentivized, this significantly increases the odds that the transformation will be a success. Hence, a meaningful part of our diligence focuses on evaluating management and the Board. By building confidence in the company's leaders, we can gain conviction that a transformation will be fruitful. Below are two examples of small cap transformations in our portfolio today.



ECN Capital (TSE: ECN) certainly qualifies as a transformation. The company formed through its separation from Element Fleet (TSE: EFN) in 4Q16. At that time, ECN provided rail and aircraft leasing, which has high capital-intensity, no-growth, and limited barriers to entry. Hence, the company generated only a 6% return on equity, negative FCF, and falling earnings in 2016.

In 2017-2018, ECN transformed by divesting these legacy assets and acquiring three tech-enabled business service providers including: Service Finance (“SF”), Triad Financial (“TF”), and Kessler Group (“KG”). SF originates and services home improvement loans, TF originates and services manufactured housing loans, and KG manages credit card portfolios. Importantly, these businesses do not fund or take credit risk on the loans/portfolios and only originate to prime consumers.

Post-transformation, ECN now has low capital-intensity, high-growth, and significant barriers to entry. As a result, the company produces 15-20% return on equity, significant FCF, and high earnings growth. The company guided to doubling earnings per share (“EPS”) from 2020 to 2022 and hinted at raising that guidance.

ECN is the third public company started by CEO Steve Hudson. His last two businesses grew to over \$5b in equity value and ECN is only ~\$1.5b today implying the company has a long growth runway. As the third largest ECN shareholder with over \$100mm of stock, Steve is certainly incentivized to execute.



Rent-A-Center (NASDAQ: RCII) After a 30-month hiatus, Mitch Fadel returned to Rent-A-Center (NASDAQ: RCII) as its CEO in January 2018. In three short years, he quadrupled RCII’s profits (as measured by EBITDA) and eliminated its significant debt burden by improving the profitability of RCII’s stores. These actions completed the company’s first transformation.

Now, Mitch has turned his focus to RCII’s virtual rent-to-own (“VRTO”) segment and transforming the company into a high-growth FinTech platform. In the traditional rent-to-own (“RTO”) model, customers visit RCII-branded stores to lease products – such as furniture, electronics, or appliances. With VRTO, RCII offers RTO through a point-of-sale solution at partner retailers’ stores and websites. RCII’s strategy to deploy VRTO to other retailers’ stores/websites represents a transformational expansion of RCII’s addressable market. Further, VRTO shares the same attractive dynamics as traditional RTO, but VRTO is capital-light (no stores) and higher-growth (untapped white space at retailers).

To accelerate its second transformation and expansion of its VRTO segment, RCII completed the acquisition of Acima in February 2021. Acima is the second largest and most profitable VRTO business. With Acima, RCII has guided to ~tripling its 2020 cash EPS from ~\$3 to ~\$9 by 2023. Mitch has a track record of beating his guidance, yet RCII trades for only ~7x 2023 cash EPS guide.

EZCORP

EZCORP (NYSE: EDPW) We appreciate that the investment profession is one of continuous learning. Several years ago, we invested in EDPW because new management appeared to be transforming the business through acquisitions and operational improvements. Unfortunately, that transformation was derailed when the controlling shareholder/chairman put his financial self-interests ahead of management's strategy and shareholder value. The disappointing outcome reiterated the importance of aligned company leadership. In the case of ECN and RCII, the Board and management have proven to be very much aligned with its shareholders.

To learn more about our thesis on ECN and RCII as well as other transformations in our portfolio, please subscribe by completing the form on the Insights or Contact tabs.

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