Aaron's Inc. – Long
Sententia Capital Management
October 2014

ticker: AAN | mkt cap: $1.76b | price: $24 | intrinsic value: $35

Stock Information (*as of October 2014*)

Aaron's, Inc. operates as a specialty retailer of consumer electronics, computers, residential furniture, household appliances, and accessories in the United States and Canada. It is engaged in the lease ownership, lease, and retail sale of various products. The company offers products of various brands. As of July 15, 2014, the company had approximately 2,130 company-operated and franchised stores. The company was founded in 1955 and is based in Atlanta, Georgia.

Price	$ 24.20	Net Debt	595
52 Week Low	$ 24.14	Enterprise Value	2,352
52 Week High	$ 36.74	% Insider Ownership	7.37%
Shares Out	72.6	% Short Interest	8.60%
Market Cap	1,757	% Dividend Yield	0.3%

Key Metrics	2010	2011	2012	2013	2014E
Returns (%)					
ROIC	39.6%	40.1%	38.6%	39.8%	32.8%
ROA	7.9%	6.6%	9.5%	6.6%	5.1%
ROE	12.1%	11.7%	15.2%	10.6%	10.2%
Multiples	2010	2011	2012	2013	2014E
EV/EBITDA	10.8x	11.0x	11.0x	10.8x	8.2x

Income Statem	2010	2011	2012	2013	2014E
Revenue	$1,876	$2,022	$2,213	$2,235	$2,690
growth	*7.0%*	*7.8%*	*9.4%*	*1.0%*	*20.4%*
EBITDA	$239	$276	$296	$274	$287
margin	*12.7%*	*13.6%*	*13.4%*	*12.3%*	*8.4%*
Net Income	$118	$114	$173	$121	$122
margin	*6.3%*	*5.6%*	*7.8%*	*5.4%*	*5.3%*

Valuation

Cases (2015)	**EBITDA**	**EV/EBITDA**	**EV**	**Price**
Low Case	270	9.0x	2,430	$25
High Case	340	11.0x	3,740	$43
Base Case	**310**	**10.0x**	**3,100**	**$35**
Margin of Safety				**30%**
Upside				**43%**

Balance Sheet	2010	2011	2012	2013	2Q2014
Cash and Equi	72	176	130	231	18
Total Debt	42	154	128	128	613
Debt/Equity	4.3%	15.7%	11.3%	11.3%	51.5%
Current Ratio	2.2x	2.0x	2.3x	2.4x	2.2x
Shares	82	79	77	76	73
BV per Share	$ 11.93	$ 12.31	$ 14.79	$ 14.92	$ 16.37

Recommendation:
Aaron's Inc. a buy at $24 with an intrinsic value of $35, representing a 30% margin of safety with 40%+ upside.

Key Points:

Why Undervalued?
- Low-end consumer weakness
- Market dislocation

Company Highlights
- Consistent performer with positive SSS, revenue growth, BV growth from 2002 through 2013
- Positioned to continue with recent virtual RTO acquisition in Progressive Financial
- Trading at 8.2x and 7.5x EV/EBITDA for 2014e and 2015e compared to 11x median

Industry Trends
- Virtual RTOs are expanding to broader retailers to increase conversion rates
- RTO business model has proven stable and consistent over the long-run

Catalyst
- Progressive expansion
- Earnings showing margin expansion through cost cutting initiatives
- Potential buyout offer

Executive Summary

Overview

Aaron's Inc. (AAN) is a well-positioned company in the rent-to-own (RTO) industry. The Company will enter its 65th year of operation primed to evolve with its recent acquisition of Progressive Financials, a virtual RTO company, along with management's steps in focusing on its current store footprint while reducing costs. The stock is trading at a 30% margin of safety to its intrinsic value and below a recent buy-out offer, representing a compelling risk-reward opportunity.

Summary

Aaron's is the second largest retailer in the RTO industry but maintains a stronger business model that has proven stable and consistent over its competitors in various economic conditions.

Most recently, the company has come under pressure as lower consumer traffic has affected the broader retail stores, leading to negative same store revenue for the first time in over ten years. This short-term headwind presents an opportunity to invest in a proven company that is primed to grow with its recent acquisition of Progressive Financials. Progressive is a leading virtual RTO company that will provide Aaron's with top and bottom line growth immediately and in the years ahead.

This virtual RTO operator comes with a stable base of retailers and is expanding rapidly to the broader market as retailers are seeking to increase conversion rates on the lower foot traffic. Progressive, and Aaron's, is positioned well as the build out of this network is lower cost and more efficient with no kiosks or support personal required as compared to other competitors.

At the current pace, the core segments can remain pressured and the company will continue to grow. Progressive provides Aaron's the ability to maintain operations while working on lowering costs and increasing efficiencies in the core store footprint. When you add marginal expansion of the core business, this becomes an incredibly attractive opportunity.

At $24, the company is trading below a $30 buy out offer presented at the beginning of the year from Vintage Capital. Since them, the PE firm has taken two board seats. Aaron's is a proven performer over time and adding Progressive while maintaining the optionality of the HomeSmart in addition to improving efficiencies presents a solid risk-reward dynamic, as a base case shows the intrinsic value of $35, with a high case of $40.

Potential Catalyst

The catalyst will be earnings in the coming quarters, which will reflect Progressive's growth, reduced costs and stabilizing core segments through the reporting of revenue and EBITDA expansion. A less likely but possible catalyst may also come from another potential bid for Aaron's.

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Variant Perception

Behavioral

We are prepared to take advantage of price dislocations in the short-term to position ourselves for longer-term appreciation. Aaron's is an example of such an opportunity. The current price allows you to purchase a stable/growing business at a discounted price to its long-term prospects, offering an attractive risk-reward opportunity.

Why is Aaron's Undervalued?

Short-term dynamics

Market and Company dynamics

The current market volatility coupled with weakness in the low-end consumer space has presented an opportunity to acquire Aaron's at a discount. Aaron's has proven to be a steady performer in various economic environments and any short-term pressures should be taken advantage of. This dislocation is masking the growth prospects of recently acquired Progressive, a virtual-RTO company, which will add to top and bottom line growth for Aaron's.

Valuations

EV/EBITDA, SOTP, P/E

There are a several dynamics that can be taken in to consideration for the valuation of Aaron's: pressure in the core business, growth of newly acquired Progressive, potential breakeven/contribution of the HomeSmart segment, and finally the small investment into UK based Perfect Homes. We do not have a confident stance on the last two so we will not assign an initial value and will focus on the core and Progressive segments alone.

EV/EBITDA

Currently, Aaron's is trading at 8.2x and 7.5x EV/EBITDA for 2014E and 2015E, compared to 11x average for the past 5 years.

We have broken the scenarios from Low representing zero growth for 2015 and a compressed multiple; Base representing

		Low	Base	High
EV/EBITDA	**2014e**	**2015**	**2015**	**2015**
Aaron's	*220*	*220*	*235*	*250*
Progressive	*50*	*60*	*75*	*90*
EBITDA	270	280	310	340
Multiple	9.x	9.x	10.x	11.x
EV	2430	2520	3100	3740
Net Debt	595	595	595	595
Market Cap	1835	1925	2505	3145
Shares	72.6	72.6	72.6	72.6
Price	**$25.28**	**$26.52**	**$34.50**	**$43.32**

**Does not include HomeSmart or Perfect Home*
***Does not reflect potential share repurchases*
****Does not reflect potential cost cuts*

marginal core and Progressive growth with a higher multiple; and High representing steady core growth with a high end of Progressive growth at the average multiple. The values range from $25 to $43, ranging from low to high valuations.

SOTP

Our SOTP breaks out the separate business units to better represent their contribution and earnings growth. We assign a lower multiple to Aaron's core stores, higher for franchise units, and up to 15x for the faster growing Progressive. The SOTP is only used to highlight the segments to show a comparison to the base valuation.

SOTP	Stores	EBITDA	Multiple	EV
Aaron's	1266	180	8.x	1440
Franchise	787	55	11.x	606
Progressive		70	15.x	1050
HomeSmart	83	0	10.x	0
Perfect Home				15
Total				**3110.99**

Net Debt	595.1
Market Cap	2516
Share Out	72.6
Price	**$34.65**

P/E

Our P/E valuation uses the last 10 year average of 16x. Our low case shows a compressed multiple with zero growth, ranging to 17x multiple for higher growth scenario, with a base case of 16x at $35.

P/E	Low	Base	High
EPS	$1.60	$2.20	$2.50
Multiple	14.x	16.x	17.x
Price	**$22.40**	**$35.20**	**$42.50**

We attempted to be conservative in our estimates and did not account for share repurchases, cost cutting initiatives or the potential contribution of the HomeSmart division.

Aaron's Inc.

Operations, Divisions, Progressive, Synergies, Financials, Management

Aaron's provides "quality of life enhancing merchandise that they (the credit constrained customers) might not otherwise be able to afford, without incurring additional debt or long-term obligations." *(2012 annual report)*

Operations

Aaron's is based in Atlanta and has over 2100 stores (1250 company, 775 Franchise and 80 HomeSmart) in the US and Canada. The company is vertically integrated through its manufacturing warehouses, providing furniture, bedding and accessories to its core stores. The product mix for 2013 was furniture 36%, consumer electronics 29%, appliances 22%, computers 9%, housewares 4%.

The company caters to the low-income consumer with a majority of its customers earning less than $50k year. These lower end customers are generally limited in their credit and Aaron's provides them a service to own products through 12 or 24-month payment options. The customer is also able to purchase at retail price within 120 days.

A typical transaction consists of Aaron's purchasing a TV for $1000. They list it for $1400 and advertise for monthly payments of $100 a month for 24 months. The customer can pay it off within 120 days or over the 24 months. 48% of customers pay the product off and keep the product. These transactions provide Aaron's with high margins and also stable income over the longer payment cycles.

Divisions
Aaron's operates company owned stores that are typically 9k in square feet, open 6 days a week and operate with an average of 10 associates. New stores cost about $750k and takes one year to become profitable. The company has grown this segment from 68 in 1982, to 857 in 2006, to over 1250 stores today.

For their franchise model, Aaron's focuses on welcoming various retailers and often has sold and purchased stores to and from franchisees. They have grown the segment from 392 stores in 2005 to over 750 stores today. On average, a franchise adds $7k in EBIT, paying franchise fees ranging from $15 - $50k and 5 or 6% royalty payments of the weekly cash collection.

The HomeSmart division was started in 2010 and operates on a smaller footprint store of 5k square feet. These stores cater to a lower end consumer than the core Aarons stores, focusing on weekly and bi-monthly payment concepts. 34% of customers are on monthly terms while 59% are weekly. Currently, the division has been a drag on profits but is expected to breakeven and contribute in 2014 and 2015.

Woodhaven, the manufacturing segment, provides Aaron's with vertical integration for its home furnishings. The segment is relatively small, with $100m in items, but provides an efficient way to adjust to customer demands in its exclusive line while providing a higher margin product. This segment produces products at cost to Aaron's stores.

Perfect Home Holdings is Aaron's first step into the UK market. Aaron's paid $15.4m in 2011 for an 11.5% stake in the company and had an option to increase this holding. The company has grown from 45 stores to a current footprint of 67 stores. Aaron's decided to extend the relationship through mid-2015 but has not stated longer-term intentions. Should Aaron's not pursue the venture, the Company will receive the original investment back.

Progressive
Aaron's made its largest investment to date in 2014. It paid $700m with a combination of cash, debt and notes, for Progressive Financials, a leading virtual RTO provider. The company works with 5,500 retail partners and over 15,000 'doors' (locations).

Progressive brings an attractive growth rate, building revenue from $228m in 2012, to $403m in 2013. Annualized for 2014, Progressive is expected to contribute $650m to Aaron's. The Company believes this to be a billion dollar revenue generator in the coming years.

From talking with Progressive personnel, a typical transaction brings in high margins, similar to the RTO industry. For a $1000 item, the company pays in full and charges the customer $1100 for the 90-day early payout option. Should the customer continue on the 12 month plan, this will increase to 1.8x the original amount, or $1800. Progressive notes that the customer keep rate is 80% for their products. To date, Progressive has an 11% EBITDA margin, which can be expected to increase as synergies are realized. Progressive has also stated an 8-10% charge-off rate.

Progressive is not the only virtual RTO provider, as Rent-A-Center (RCIII) created AcceptanceNOW in 2010. The differentiator is Progressive does not require capital investment through equipment (kiosk) or personal (employee to man kiosk) like AcceptanceNOW. Retailers can access the Progressive software through their point of sale systems. Progressive can also integrate into the retailer's systems, which would allow them to become an automatic option through the retailer's own application process. The integration takes a little more time but has a greater impact on the retailer's conversion rate.

This conversion is key as the majority of consumer retailers are experiencing lighter foot traffic. Big Lots is a recent Progressive customer. They have stated that 80% of their customers are rejected for credit. As they have implemented Progressive, 60-70% of these customers are approved and recaptured. This is an attractive opportunity for both Big Lots, Progressive, and the wider market.

In addition to Big Lots, Progressive services Sleepy's, Mattress Firm, ArtVan, and is also in the testing phase with several more large retailers.

Worth noting is Progressive's relationship with Cricket and Metro PCS locations. This can provide a great entry way for the two cell phone providers to enter Aaron's locations, which is similar to the cell phone initiative announced by RCII earlier this year.

Progressive has been busy and is expected to continue this progression. As noted by a current employee, they've "been hiring like crazy."

Synergies

Aaron's.com

Aaron's has a website but it is non-contributing as a revenue stream as it only serves to point the customer to current locations. Progressive provides Aaron's with a tool to capture customers online and the company will look to launch this in early 2015.

"Offer" to pick up (Repossession)

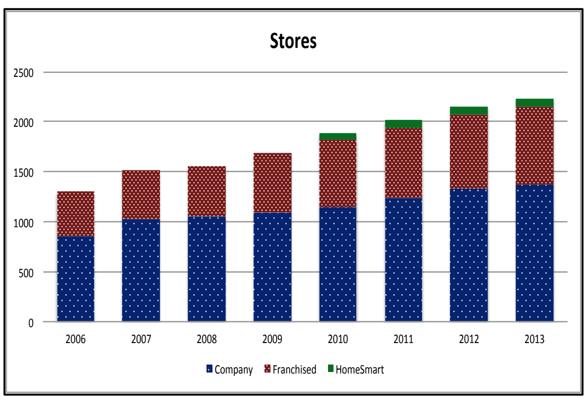
Progressive has stated 8-10% charge off rates. Currently, Progressive does not maintain a cost effective mechanism to repossess items. Aaron's presents such an opportunity, both through customer service practices and physical locations. Both parties will be able to 'offer' to pick up the items if the customer is unable to continue to make payments. Aaron's has experienced that many customers will take this option as they can re-engage the item at a later time with minimal fees, allowing them to continue the purchase process. These items can be re-rented, which will reduce costs and contribute to margins.

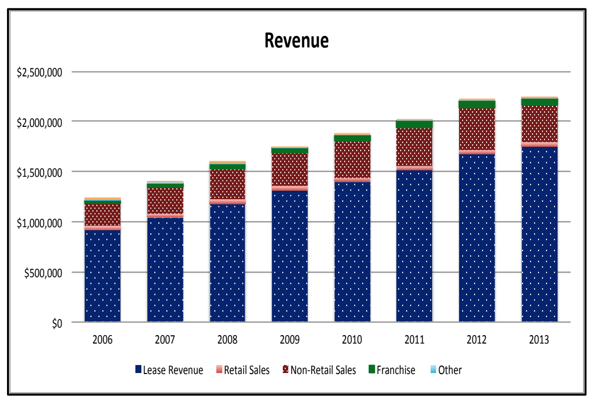
If Aaron's can help reduce Progressive charge-offs from 8% to 6% alone, this could equate to $0.20 cents per share on $800m of Progressive revenue.

Progressive reports a 10-13% EBITDA margin. We anticipate this to rise as costs synergies are expressed, but we keep an 11% EBITDA margin for our valuations.

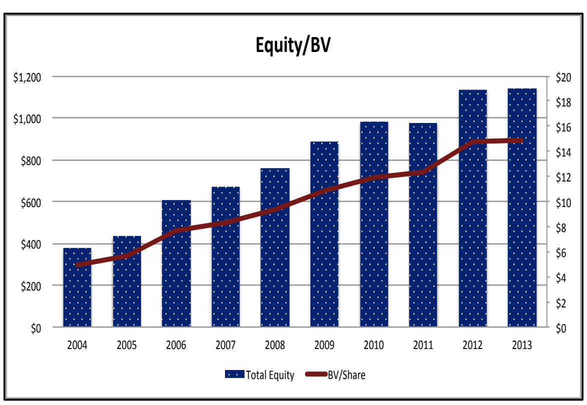
Financials
- "you are what your numbers say you are." (2010 Annual Report)

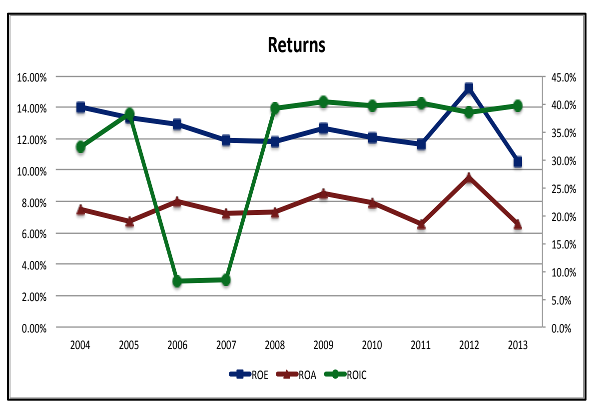
Below are snapshots that show the growth of Aaron's from 2004-2013. Throughout this time, same store sales ranged from 1% to 8%, with only two years, 2007 and 2013, below 2.5%.





Returns throughout the time were steady for ROE (10.6% - 15%), ROA (6.6% - 9.5%) and ROIC (8% - 40%). ROIC should be noted that other than 2006 and 2007, which had higher costs due to construction delays, the ROIC ranged from 32% to 40%.





Management

There has been some key management changes in the past year, most notably Ron Allen, the outgoing CEO. Mr. Allen has been CEO since 2010, when the founder's son, Robin Loudermilk, stepped down due to health issues. During this time, the company has been under steady decline, which was highlighted during the recent shareholder dispute with Vintage Capital. Since welcoming Vintage representatives to the board, Mr. Allen has decided to retire. The long standing CFO, Mr. Gilber Danielson, is interim CEO while the board undergoes a search for a permanent replacement.

Industry

RTO Market, Competitor

RTO Market

The RTO industry is dominated by Rent-A-Center and Aaron's, who comprise over 60% of the market. RCII is the largest RTO operator in the US with over 40% market share, operating over 3,000 stores in the US, Canada and Puerto Rico, and over 1,300 AcceptanceNOW kiosks.

The RTO business model has proven consistently effective over time. This year however, the industry has come under pressure. This consumer pressure isn't specific to the RTO industry, but the low-end consumer at large and can be seen through recent weakness in retailers such as Conn's and Wal-Mart.

The increased pressure of the economic environment is a double-edged sword as it pressures the low-end customer, but continues to restrict credit, which makes the RTO model attractive to the same customers. In the short-term, we anticipate some pressure but see continued stability in the long run.

Although Rent-A-Center and Aaron's are the dominant forces in the RTO space, they have some significant differences in their business models, which are highlighted below.

Competitor

Weekly vs Monthly Rental Plans- A majority of RCII's plans are weekly while Aaron's are monthly.

Keep Rate- The monthly plans tend to be higher end consumers, which is also reflected in the 45%+ keep rate for Aaron's. RCII has a 25% keep rate. This is important to note as it impacts the stability of the revenue stream as a higher keep rate is consistent with completion of plans and less 'offers' to pick up merchandise.

Pricing- Aaron's sources some of its furniture from its Woodhaven segment and maintains dynamic pricing. Until this recent quarter, RCII used a cost plus margin pricing strategy. RCII has announced that it will move to dynamic pricing and both companies have stated their intentions to selectively increase prices.

Virtual RTO-
RCII created AcceptanceNOW in 2010 and now operates 1,400 locations with retail customers Ashley Furniture, Rooms to Go, and Conns. RCII has grown its kiosk program from zero to 1,400 locations in 3.5 years. They are also investing in a virtual option that will take some time and capital to bring to bear in the coming year.

Aaron's recently purchased Progressive, which is a kiosk free service for customers in 5,500 retail locations. Although Progressive has more 'doors' at 15,000, they are a mix of big and small locations so are not directly correlated to revenue size. This is evident in AcceptanceNOW revenue of $500m in 2013 and Progressive with $400m.

Distribution Model- Aaron's has 17 fulfillment centers in the US, not including their Woodhaven division, with most stores within 250 miles of these centers. To date, RCII has a direct-to-store model. The distribution model is more cost effective and RCII has stated the intention to transition to this model in the coming years.

Footprint- Aaron's has a larger footprint with core stores at 9k square feet vs 5k square feet for RCII. This added footage provides a larger selection to Aaron's customers. In addition to Aaron's core and Franchise stores, they have initiated the HomeSmart division that competes with RCII stores. The HomeSmart stores are typically 5k square feet and focus on weekly and bi-weekly rental plans.

Growth opportunities-
Virtual RTOs- Both companies are focused on expanding their footprint. At this time, only Progressive is kiosk and personnel free, however RCII has begun to invest in this model.

International- RCII is in the early stages of expanding into Mexico. Initial growth has been promising but the company is still working through the nuances of a new market. Aaron's has been limited with only Perfect Holdings in the UK.

In general, RCII is more mature with its amount of locations, but it's shifting its business model to align with Aaron's for distribution and pricing. Aaron's vertical integration and distribution model give it a good advantage and its Progressive and HomeSmart divisions will add significantly to the bottom line.

Major Shareholders

Vintage Capital- 10.1%- Value oriented PE firm led by Brian Kahn.
Shapiro Capital Management- 10.8%- Value Equity Strategy.

Shapiro is a recent investor, filing a 13G in October of 2014. Vintage has taken a more aggressive approach with an unsolicited buyout offer in February of this year to acquire Aaron's at $30.50/share. Backed by Starboard, an activist fund, Vintage exchanged letters with Aaron's. After several months of contentious exchanges, Vintage and Aaron's settled their differences with Aaron's expanding the board by two seats for Vintage personnel, including Brian, re-instating the 25% shareholder threshold for a special meeting, and de-classifying the board.

One point to highlight is Vintage's majority interest in Buddy's Home Furnishing, a regional RTO competitor in the Southeast. During the exchange, Aaron's pointed out this connection as the motivation for the perceived low-end offer by Vintage.

The recent structural changes on the board and the addition of Vintage Capital as board members further aligns the Company with long-term shareholders.

Financials

Stock Repurchase

Since 2010, the company has reduced their share count by 11%, repurchasing 9.2m shares, equating to over $280m returned to shareholders. The most recent repurchase was the accelerated share repurchase plan that was announced December 2013. The cash flow has largely come from taking advantage of delayed tax payouts, which will largely be reversed in the next couple of years. As the stock has traded in a band near $25, prior to this year's takeout offer, the repurchases may prove to be prudent.

Keys to getting the investment right

Business Focus, Progressive

Core Business Focus

Growth in the RTO industry can hurt profits, have low initial returns on capital and consume cash. Due to the recent weakness in the low-end consumer market, Aaron's is slowing its core growth strategy. The business will generate free cash flow as it focuses on current store footprint. Management stabilizing the business through the focus on the current store dynamics is a key to getting this investment correct. Management has announced that they will focus on closing non-performing stores and opening only selective locations. This zero growth phase will benefit the company by increasing cash flow and allowing them to focus on cutting costs. Although we have been conservative on reducing costs in our models, management's efforts should be tracked to ensure execution of the stated plan is followed. They expect to cut $50m in costs in 2015.

Progressive Growth

Progressive provides a very attractive growth dynamic, both internally and externally, to Aaron's top and bottom line. Progressive will act as a bridge to Aaron's core business and is expected to account for a majority of the earnings in the coming years. The segment is key to accelerating Aaron's revenue and profit in the short and long term

The Bear Case

Shift in RTO consumer behavior, Economic improvement

A bear case points to a potential structural shift in the RTO landscape due to a change in low-end consumer behavior. Although this is a possibility, it is more likely not isolated to the RTO space, but low-end consumers in general as evident in other retailers. In either case, this argument doesn't take into consideration the growth opportunities of the virtual RTO market, which retailers are building out on to increase conversion rates of the reduced foot traffic. Aaron's is primed for this market through the acquisition of Progressive.

A separate bear argument is that as the economy improves, the low-end consumer will no longer frequent the RTO stores. We can look back to 2005 to see that Aaron's model had SSS growth through the entire cycle, including the improved economic landscape from 2005-2008. Additionally, as the economy improves, interest rates will rise, which will lead to credit constraints for low-end customers.

Key Risks

Management, Execution

The main key risks will be management shifts and execution. Aaron's has proven a stable business model that should be adjusted slightly to improve efficiencies and take out cost. A cause for concern will be any drastic changes to the business model by an incoming CEO.

Premortem

Progressive, Management

There was too much emphasis placed on Progressive growth and synergy possibilities. The segment proved flawed in their expansion and coupled with flat core growth, it wasn't enough to move the multiples.

We gave the business model too much benefit. Previous management proved their worth as the new management has had a negative impact on operations.

"People often ask me how I came up with the name 'Aaron's.' The answer is quite simple – I wanted to be first in the phone book."
– R. Charles Laudermilk, Sr
Aaron's Founder
(2010 Annual Report)