Jacob Ma-Weaver, CFA September 22, 2014

Last Price	Diluted Shares Out	Market Cap	Net Debt/ (Cash)	Enterprise Value	Daily Avg Liquidity	Borrow Availability
USD	mm	USD mm	USD mm	USD mm	USD mm	Shares
$72	**9.9**	**709**	**532**	**1241**	**14**	**>300,000**

Cost to Borrow	Short Interest	Days to Cover	P/E TTM	Tangible Book Value	P/Tangible Book	FCF Yield TTM
APY	% of outst.	As of 8/29	x	Per share	x	%
~2%	**41**	**32**	**6.7**	**$24**	**3.0**	**13.5**

Souces: FactSet, prime brokerage data, company filings, proprietary estimates.

I am short WRLD with a target equity value of zero.

This will be a little different from most disclosed short theses. I am not going to hyperventilate about what a terrible company WRLD is nor accuse anyone of deliberate malfeasance. There is no need. Candidly, I do not think my analysis breaks any new ground on the company. WRLD is one of the most heavily shorted stocks traded on US exchanges for good reason. I believe shares will ultimately prove to be worthless.

Sometimes the buyside consensus turns out to be correct. Nevertheless, there is still meaningful borrow availability and liquidity along with continued sellside support. The stock is actionable today.

WRLD has been a popular target of short sellers since at least 2009, when it was first profiled by Citron Research. The company provides high-interest credit products through retail storefronts in 14 states and Mexico. 75% of World's loan portfolio carries an interest rate greater than 36%. It is not even particularly controversial to note that its lending practices are abusive and unsavory—they are illegal in most states. ProPublica extensively documented exploitative behavior and detrimental consequences to borrowers in areas where the company operates under permissive state laws. Consumers and short sellers have been waiting for years for the government to step in. The Consumer Financial Protection Bureau (CFPB) established by Dodd-Frank created the first potential federal oversight of the industry, but until recently it had focused on other priorities.

With a CFPB investigation now underway, there remains only a debate over the timing and extent of federal intervention. The seemingly low valuation on an earnings basis is a bit of a red herring, as WRLD must continue as a going concern to justify any premium to book value. WRLD has been a difficult stock to short profitably over the past few years. I think it is finally timely.

Rather than dwell on why World's operations have generated scrutiny and if that scrutiny is deserved, my focus is on the likely financial consequences. I examine the earnings and balance sheet impact of six potential catalysts, several of which could result in bankruptcy, before closing with a brief discussion of risks to the short.

I. Cyclicality and risk of covenant breach

If WRLD were any other balance sheet-driven financial company not operating under a cloud of regulatory risk, the impact of the credit cycle would be my primary concern. Absent legal worries, World's portfolio of consumer loans is dangerously exposed to the strength of the economy. As of June 30, 2014 WRLD holds a portfolio of $780 million ($1,164 million gross of provisions and unearned charges) in subprime credit exposure, against $532 million of net debt secured by substantially all the firm's assets. WRLD provides credit to low-income consumers, the unbanked, those with poor credit history, and others who are otherwise unable to access credit. Debates over whether or not this does borrowers a service aside, the borrowers represent very high default risk. Since 2002, WRLD has never recorded net charge-offs below 13.3%.

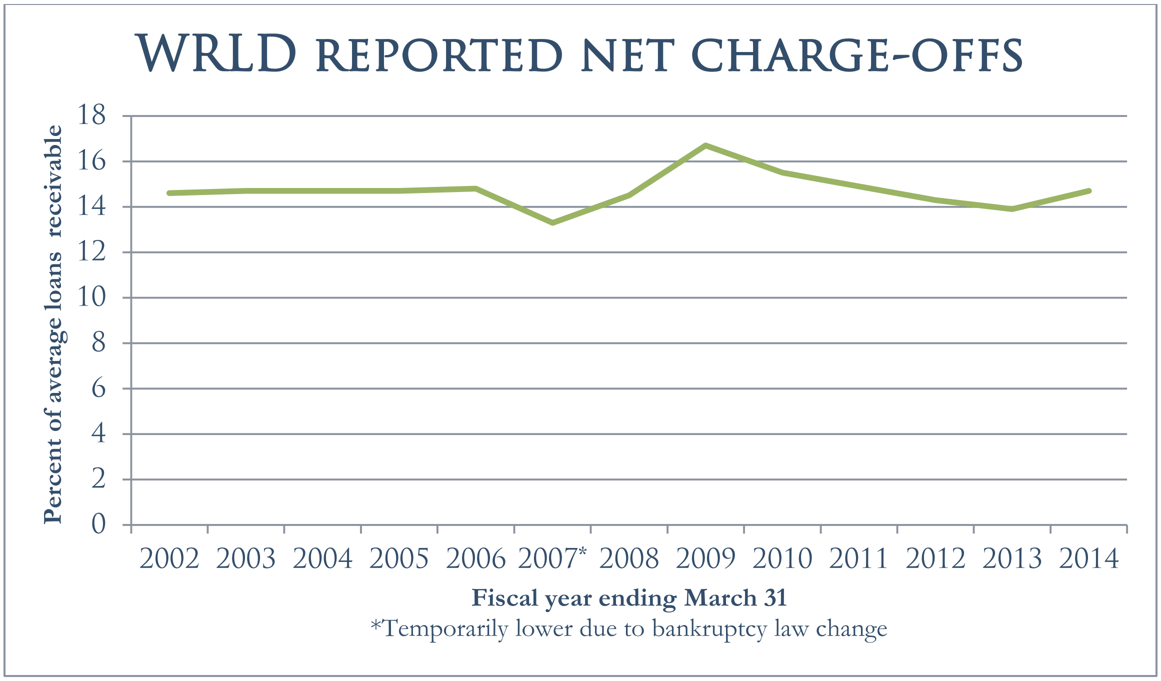
WRLD's primary credit facility nominally has up to $680 million in availability. However, it contains a $265 million minimum net worth covenant, which excludes goodwill and intangible assets. As of June 30, WRLD had just under $275 million in equity by this definition, leaving less than $10 million of headroom. (The net worth calculation adjusts for under-provisioning, leaving management with little near-term discretion). WRLD has been aggressively buying back stock and has leveraged itself to within inches of the covenant.

In principle, default rates will increase during periods of economic distress. Every 100 bps increase in the net charge-off ratio above provisions would reduce net worth by about $8 million. It would take only an approximately 8% increase in WRLD's charge-offs above expectations over the next twelve months to violate the covenant. In the next downturn, it is therefore questionable whether WRLD will have any borrowing capacity available, and the lending syndicate could have the right to accelerate maturity of its debt.

Recently, several leading indicators of credit experience have been trending for the worse. Past-due loans have risen from 8.4% of gross receivables in Q1 2013 to 8.7% at March 31 and 9.3% at June 30. WRLD has been only modestly building its net provision for loan losses from 7.6% at year-end 2012 to 7.7% in 2013 and 7.8% in 2014. The provision build is negligible relative to historical experience with increased charge-off rates, which rose as high as 16.7% in 2009.

In other words, WRLD does not have the financial capacity to absorb much of a change in the lending environment, let alone a full-blown recession.

Furthermore, this analysis takes management at its word that charge-offs have accurately reflected the experience of the loan portfolio. Over the past 12 years including two recessions, charge-off rates have been startlingly stable in the neighborhood of 14%. One possible explanation for this experience is the company's policy of encouraging borrowers to refinance loans before they become delinquent, after as few as two payments. 76% of the current gross loan book was refinanced, and last year, 75% of new loan originations were refinancing transactions. The practice is one of the reasons WRLD has drawn scrutiny, as it calls into question whether refinanced loans are in fact collectible. As long as refinancing continues, there is little way to know for sure. The company notes that only 1.5% of originations are refinancing of already-delinquent loans. However, the obvious question is whether repeated refinancing suggests that the principal balance of loans that otherwise would have eventually have been written off are being rolled into new loans.



As long as WRLD continues as a going concern, refinancing may be able to delay high default rates. In liquidation, it is possible that charge-off rates would be significantly higher.

In an economic downturn that caused WRLD to breach its net worth covenant, lenders could force WRLD into liquidation. In such a scenario, tangible book value of $24 would represent a ceiling for any equity recovery. Equity value would be wiped out if refinancing has been masking higher default rates, as I suspect.

Scenario fair value: $0 - $24 in bankruptcy.

II. CFPB action against credit insurance

One of the key potential concerns from regulators is credit insurance, a large profit center for WRLD. WRLD receives large commissions from a credit insurer for the sale of accident and health insurance tied to its loans. Regulators have been concerned that the policies are unnecessary, high-cost, aggressively marketed, and poorly understood by consumers. As with high-interest loans, there are a patchwork of state laws that ban credit insurance in some jurisdictions, but the CFPB is now responsible for setting national standards. According to disclosures from a public insurer, commissions can exceed 60% of the policy premium. Moreover, WRLD adds the premiums to loan balances, generating additional interest charges.

Elsewhere in the financial industry, credit insurance was an early target for the CFPB. Its first enforcement actions were large monetary penalties and refunds against Discover and Capital One for deceptive marketing practices related to credit insurance. It has subsequently issued judgments against several other issuers for similar practices, none of which are as high-pressure as the in-person sales pitch given to WRLD's customers. The CFPB also expressed concerns about the financing of credit insurance premiums in the home equity market.

It is plausible that following its investigation, the CFPB may require WRLD to refund credit insurance premiums, enjoin WRLD from continuing to offer the product, or prohibit financing of the premiums.

Although credit insurance is an add-on product, any of these actions would have a dramatic impact on World's income statement.

In fiscal 2014, WRLD earned $50.4 million in credit insurance commissions, representing 30% of its profit before tax. At a minimum, this amount could disappear. However, because WRLD finances the premiums, a significant portion of its reported interest income may also be due to credit insurance. Citron Research estimated that at a 64% average premium and 64% average interest rate, the reported income from credit insurance could be double the commissions alone.

WRLD has suggested that its lowest-rate loans would not be profitable at all without credit insurance, so the 24.6% of its loans carrying a stated interest rate between 21-36% (the lowest category in its filings) could also be at risk. Based on the current loan balance in the category and assuming a default rate consistent with the rest of the portfolio, lower-interest loans generate $19-79 million of interest charges, net of charge-offs. If these loans never took place, and WRLD lost its credit insurance commission earnings stream, profit before tax could fall by $70-130 million, about 40-75%.

If the CFPB cracks down on credit insurance, WRLD is not really trading at a 6.7x P/E. It could be trading as high as 28x forward earnings.

Scenario fair value: $20-64, assuming an 8-10x earnings multiple and only the loss of credit insurance.

III. CFPB rulemaking limiting refinancing transactions

When the CFPB acts, it is unlikely to consider credit insurance alone. Public comments by agency staff and its white papers on the payday lending industry evidence a particular concern over credit products that create a "cycle of debt" for unwary consumers. The agency is tasked with trying to help prevent debt dependency, which can arise from repeated reliance on short-term lending products at high interest rates. Whether or not one agrees with the politics of its approach, the CFPB is empowered through its rulemaking process to place significant limits on practices it deems to be abusive.

Popular opinion in the industry has held that the CFPB is targeting payday lending, not the installment lending offered by WRLD. On the surface, payday loans appear more ripe for abuse, given their shorter tenor and security interest in a borrower's future income (through postdated checks or payroll deductions). WRLD uses payroll deductions only in Mexico, and otherwise generally offers longer-duration loans that are not considered "income anticipation" loans like a payday loan. Industry observers have been clear that the CFPB's priority since 2012 has been payday loans, followed by installment lending at some yet-to-be-determined future date. However, the terms "payday" and "installment" are not well-defined.

With World's receipt of a Civil Investigative Demand (CID) in March 2014, the payday/installment nomenclature appears to be a distinction without a difference. Given the slow pace of the rulemaking process, I had been somewhat hesitant to short WRLD prior to March. The CFPB CID changed that. **It now appears that WRLD could be affected by the imminent payday lending rulemaking process.**

The CFPB has expressed concerns over repeated refinancing of payday loans, suggesting that it may act to prohibit a second loan within a 14-day window following loan repayment. This has important implications for World's refinancing business. The CFPB may write broad rules that limit repeated refinancing of a loan, independent of their stated duration. A longer-term loan that is refinanced every few months may not be distinguishable from a "payday" loan that is refinanced every few paydays. Moreover, some of World's loans clearly have an "income anticipation" purpose if not name, particularly around holiday bonuses. The company's business is highly seasonal, with nearly 40% of operating income and significantly higher repayment rates generated during the post-Christmas quarter.

Some consumer advocates have already recognized the false distinction. The Center for Responsible Lending issued a letter to the CFPB in May that explicitly asked that the forthcoming payday rule cover installment lenders. Proposed rules are anticipated before year-end, and should the CFPB defines payday loans narrowly, it could still issue rules governing installment lenders later.

As mentioned previously, refinancing represents 75% of World's originations. 83.9% of originations in fiscal 2014 were to former customers, and the company's risk disclosures include an acknowledgement that regulatory action could prevent it from continuing to operate. As with a covenant breach, CFPB action to prevent refinancing could lead to WRLD no longer continuing as a going concern. In run-off, World's equity in loans that were not refinanced would be worth some amount between zero and tangible book value, depending on the repayment experience.

Scenario fair value: $0 - $24 in run-off.

IV. Increased competition from payday lenders and others

Even without the regulatory overhang, World's core business is not as strong as it once was. Perhaps unsurprisingly, the major payday lenders are increasingly offering competing installment loans. Ostensibly the firms are just responding to opportunities in the marketplace, but several analysts have recognized the moves as a naked regulatory arbitrage. If the CFPB cracks down on payday loans, then installment loans offer a form of diversification. Importantly, while CFPB officials have expressed some public support for installment lending generally, in contrast to payday lending, it is the repeated refinancing and aggressive marketing practices at WRLD and elsewhere that obviate the distinction between the two.

In 2013, Cash America (CSH) more than doubled revenues from installment loans, and was continuing to grow its installment business at 60% y/y in the most recent quarter. Advance America and EZCorp (ESPW) have also been increasing their installment exposure state-by-state in recent years. While WRLD remains dependent on brick-and-mortar loan sales, some competitors offer fully online applications. While the target market for installment loans in many cases also lacks Internet access, competitors are gaining market share.

The new entrants, along with continued economic weakness among lower-income Americans, have led to a significant slowdown in World's loan growth. In stark contrast to CSH, average net loan growth in the June quarter was just 4%, with 2.7% same-store revenue growth.

Other competitive threats are on the horizon. Peer-to-peer lending platforms such as Lending Club offer loans as small as $1,000. Better underwriting technologies exist, such as ZestFinance, which enables installment loans for larger institutions using statistical analyses. Competing lenders may adapt technology to better serve higher-risk consumer pools. With more efficient competing alternatives, there is little reason for a WRLD retail storefront to continue to exist in terms of maintaining consumers' access to credit. A regulator contemplating rules that would put WRLD out of business may be comforted by the willingness of other lenders to serve the installment market.

I expect the competitive environment for installment lending to continue to remain challenging for WRLD. Loan growth will likely remain slow, and WRLD could eventually witness fee and interest rate compression.

Even in the absence of regulatory intervention, I believe WRLD shares warrant a low multiple given constrained growth prospects and an appropriate risk premium for its high leverage. Historically the company grew through entering new states, which I think remote in the current regulatory environment.

Without regulatory action, fair value for WRLD represents a fundamental downside case for the short position. Ex-growth, an 8-10x multiple on free cash flow (cash from operations less capex and net issuance including refinancing) could be appropriate. In other words, the current share price does not appear to discount much in the way of regulatory intervention.

Scenario fair value: $65-81 based on TTM free cash flow.

V. CFPB monetary penalties or legislative action

Though more difficult to handicap, there is also the possibility the CFPB could simply fine WRLD. The investigation of its business practices may be independent of the broader industry rulemaking process. Some of the behavior alleged by ProPublica is illegal. If the CFPB finds that World's collections practices, marketing, or disclosures violate the Truth in Lending Act or other laws, the financial penalties could be significant. Previous fines and required consumer refunds of larger institutions have amounted to hundreds of millions of dollars. Any meaningful fine would at a minimum cause WRLD violate the net worth covenant. Given its stated mission and priorities, I believe it is unlikely the CFPB will give WRLD a clean bill of health. It is possible the company's critics have overstated the negative aspects of its operations, but WRLD is hardly a model of corporate citizenship. The CFPB has historically had a zero-tolerance policy in imposing penalties on significantly better-run organizations. That the CFPB has chosen to investigate WRLD at all leads me to believe that it is highly probable the company will suffer some form of regulatory penalty once the investigation is completed.

Separately, other legislative action could yet impact WRLD. Efforts to pass a federal usury cap have been unsuccessful for years. While unlikely, it is possible Congress could simply legislate WRLD out of existence by capping interest rates at 36%, as has been proposed. Similar efforts in states where WRLD operates are always a risk. Over half of revenues are generated in World's 4 largest states, any of which could impose new limitations on its business at any time.

Scenario fair value: $0?

VI. Accounting and management red flags

This would not be a complete short thesis without taking note of the numerous red flags present at the company. Individually, none of these issues is indicative of wrongdoing, but collectively, they represent indicators that the company may be mismanaged and that potential financial misstatements—whether intentional or not—could go undetected.

- Employee turnover is very high at 30% annually, which may also be indicative of poor morale.
- Two senior executives of long-standing, the COO and CFO, resigned late last year with little notice. The CFO was said to be "retiring" at the age of 43.
- WRLD had a weakness in its internal controls in 2013 relating to its treatment of loan losses. Though the accounting adjustments were ultimately minor, the allowance for loan losses is a key element of management's discretion and an area of potential concern for reasons discussed above.

- WRLD's longstanding auditor, KPMG, chose not to continue auditing the company after this year.
- Insiders have been consistent, high-volume sellers of stock without making open market purchases.

Scenario fair value: ?

Risk Factors

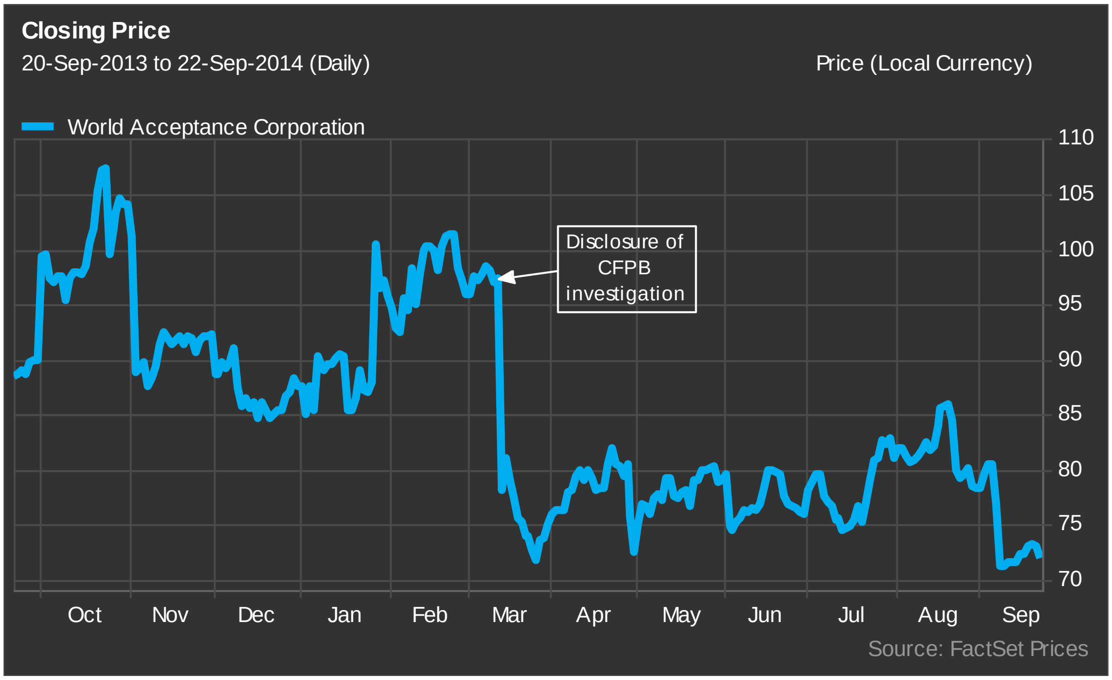
Due to state licensing requirements, WRLD is an unlikely acquisition target. However, there are other risks for short sellers. Perhaps the most significant is the technical risk presented by the high short interest. As much as half the float is currently sold short by some estimates. The risk of forced buy-ins or other undesired covering is magnified by high short interest. The risk of a short squeeze is not trivial. A significant lender could recall shares, a manipulative transaction could take place via the options market, or the company could announce unanticipated good news. If I am completely wrong in my assessment of the CFPB's approach, an announcement that the investigation has concluded without any findings of wrongdoing would likely trigger a rush for the exits that would drive prices well above the fundamental value of the business.

Meanwhile, WRLD executives are incented on the basis of EPS targets, and they continue to buy back as much stock as the credit facility allows. The current $25 million authorization supports the share price in the near term, but covenants limit additional purchases in advance of cash generation. WRLD also has a few ancillary businesses I haven't discussed. The Mexico operations and the tax prep business together represent less than 10% of revenue. They could represent some residual value in the event of US regulatory action, but even if they grow unexpectedly, they represent a limited upside risk.

This report has not discussed the basic profitability of installment lending at usurious interest rates, but it to the extent defaults are minimized, the business generates high returns on capital and significant cash from commissions, fees, and ongoing charges. In recent years, the cash flow from performing loans at WRLD has comfortably exceeded even the large amounts required to be reinvested in refinancing and originations. WRLD has generated $172 million in cumulative free cash flow over the past three years, 24% of the current market cap. Of course, if the business is not a going concern, cash flows cannot exceed the gross unearned interest and principal in the loan portfolio. But in the meantime, WRLD appears quite profitable.

To the extent the company continues to generate cash, timing—always one of the hardest parts of short selling—is especially critical for WRLD. Even though cash generation may decline due to loan losses and competition, the company will continue to devote its excess cash flow to buybacks. Unless and until the CFPB acts, the company will keep bidding up its shares in a sort of game of chicken with short sellers.

That's a game I expect short sellers to win.


Closing Price
20-Sep-2013 to 22-Sep-2014 (Daily)
Price (Local Currency)
World Acceptance Corporation
Disclosure of CFPB investigation
110
105
100
95
90
85
80
75
70
Oct
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Dec
Jan
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Apr
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Source: FactSet Prices