THE GLOBE AND MAIL

VOX

Forget the futurists ... Coinstar is a cash machine

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From Saturday's Globe and Mail
Published Friday, Apr. 08, 2011 5:33PM EDT
Last updated Monday, Apr. 11, 2011 6:57AM EDT

With the wild dogs chewing on the bones of Blockbuster Inc. in U.S. bankruptcy court this week, much of the credit for the fall of the once-dominant video giant has gone, rightly, to Netflix NFLX-Q.

There is another company responsible for much of Blockbuster's woes, however: Coinstar Inc., CSTR-Q operator of the expanding RedBox chain of video rental kiosks. It is Coinstar, more than Netflix, that will benefit as Blockbuster continues to crater. And the good news: A recent earnings miss that shaved a third of its recent highs makes the company's stock a much more reasonable buy.

The company is named for its profitable legacy business: The Coinstar machines that offer consumers a payment, less a fee, after they dump a bucket of loose change into a sorter. It is RedBox, however, that has come to dominate the company, with 80 per cent of the company's revenue.

It has also provided a compelling growth story, as RedBox kiosks, found outside retail partners such as McDonald's, have grown from fewer than 8,000 three years ago to roughly 36,000 today, according to Piper Jaffray & Co. analyst Michael Olson. Consumers who considered Blockbuster's significant late-return fees to be usurious flocked to RedBox's flat $1-a-day model.

A steady increase in revenue per kiosk – Mr. Olson estimates the figure will top $40,000 (U.S.) this fiscal year – combined with roughly 1,500 new kiosks each quarter, has provided impressive top-line growth. Revenue has doubled to $1.44-billion in 2010 from $650-million in 2008.

Still, the stock has become a favourite of the short-seller set, with more than a third of the shares outstanding sold short. RedBox "dominates an industry that is fast becoming obsolete – physical content delivery," blogger Viking Capital writes on the Seeking Alpha website in an article called "Why Coinstar is a Better Short than Netflix." He continues: "As movies-on-demand and Internet streaming of media become more and more prevalent, the DVD industry will accelerate its secular decline."

In the long run, that is likely true, but as they say, in the long run, we'll all be dead. The high-speed Internet connections necessary for streaming – plus, of course, the monthly subscription fees for content – are beyond the economic reach of millions of U.S. households, and will remain so for a number of years.

Sadly, Coinstar management has been suckered into pandering to the techno-futurists. For months, management has been promising shareholders it will find a "partner" to deliver a RedBox movie-streaming option.

The absence of news on that front, couple with a disastrous fourth quarter in which the company mismanaged its inventory and missed guidance, has taken a chunk out of the company's stock. It dropped from a 52-week high of an unreasonable $67 to the high $30s; it has rebounded moderately, closing on Friday at $48.42.

That's around 23 times trailing earnings, when a loss from discontinued operations is disregarded. Company guidance for 2011 is earnings per share of $2.60 to $3.10, suggesting a current year multiple of 15 at the high end of the range.

Happily, all of the company's machines, from RedBox to Coinstar, are, well, cash machines: The analysts at Pacific Crest Securities note that over the past 12 months, Coinstar has generated $4.24 in free cash flow per share, a cash flow yield that tops 9 per cent at current prices. The Pacific Crest analysts expect slowing kiosk rollouts – and, therefore, lower capital expenditures – to produce $5.61 in free cash flow in 2012.

That points to what may be the best strategy for Coinstar: Abandon the pretensions of competing with Netflix, Amazon, and who knows what other tech giants in the business of streaming, and concentrate on its core business of serving walk-up customers. (Indeed, Coinstar has a number of kiosk pilot projects in the works for future growth, including consumer electronics, coffee, digital photos and women's fashion accessories.)

The company is best served as being one of the fastest-growing cash flow stories, rather than a second-tier growth company struggling to keep up. Coinstar has made its fortune in the physical world, not in the cloud, and there are still plenty of riches to be found on the sidewalk.

Special to The Globe and Mail
