

Coinstar, Inc. (CSTR) Memo

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College/School: Arts & Sciences

Year: 2nd

Important Company Financial Data



Share Price: 63.45 (04/24/2012)

Market Cap: 1.95B

52 wk Range: 37.43-69.74

P/E: 19.45

Beta: 0.82

Short Interest: 36.6%

Current Ratio: 1.36

Debt/Equity: 71.07

Free Cash Flow: 227.28M

Thesis / Key Points

1. Unsustainable business model in a maturing company

Redbox

Coinstar has shown phenomenally fast growth in recent years, however year-on-year percentage growth has slowed down (Exhibit 2). Redbox is the major driver for Coinstar, constituting 85% of the total revenue. In October 2011, Coinstar raised the price of renting a Redbox DVD from \$1 to \$1.20, which caused the share price to plunge 10%. Since then, shares have rebounded due to better-than-expected quarterly performance. On 03-Feb-12, Coinstar agreed to acquire approximately 10,000 Blockbuster Express kiosks from NCR for \$100M, resulting in a large jump in share prices.

Coin counting

Revenue is generated through transaction fees, of which a certain percentage is shared with the retailer. With a recent increase in price from 8.9% to 9.8% per transaction, Coinstar is losing customers (Exhibit 1) and facing decreasing profits due to increased costs (Exhibit 3). Coinstar also faces competition from banks that offer free coin counting services to clients. Furthermore, the coin counting patent expires in September 2012, creating further downside pressure as competition expands into this space.

Seemingly bullish market sentiment

Coinstar has rallied since early February after the acquisition of Blockbuster kiosks was announced. However, the rally will not last long because of the unsustainable business model. Revenue growth is mainly due to lower than expected operating costs of Redbox and the expansion of Redbox locations. Furthermore, since FY-09, incremental rental of DVD's per day for every extra kiosks installed have remained volatile with total rental per machine per day remaining almost flat at 13 titles a day. The business seems to marginally decline or be flat despite installation of 10,600 extra kiosks since 1Q-10. This suggests that overall revenue has grown because of new Redbox installments; however, every new kiosk installed has not been marginally profitable to the firm (Exhibit 4). NCR has estimated that the DVD rental market would reach its saturation when there are 40,000 to 50,000 kiosks. Coinstar currently has 35,400 DVD kiosks. Therefore, once Coinstar stops adding new kiosks or when physical DVD market reaches saturation in the near future, Coinstar will cease to continue its impressive revenue growth.

2. Dying industry with decreasing demand

Redbox is "the last guy standing."---Jim Chanos, founder of hedge fund Kynikos Associates

The reason for Coinstar's high cashflow margins is because Redbox is the dominant player in the DVD renting market. However, surveys show that most people now prefer video streaming to DVD's. No matter how much Coinstar's revenues grow, the movement from physical to digital delivery of movie content is inevitable. The DVD market has been declining for the past two years. Thus, Coinstar's revenue growth will slow down and its comparative advantage of low pricing may disappear with the shift to video streaming. Investors have priced in the dominant position of Redbox, seen with the share price rising 100% after Blockbuster declared bankruptcy in September 2010. However, this control of the DVD rental market maybe overvalued due to the inevitable transition to digital delivery.

3. Threats from current and potential competitors

Netflix, one of Coinstar's biggest competitors, is already negotiating agreements with certain cable companies and Apple. There are many televisions offering apps that let users access services like Netflix. There are also many inexpensive sources for video streaming, such as Roku, which allows users to watch Hulu and stream movies from Amazon. Moreover, Apple and Google have developed their own systems for streaming movies. Other firms are also trying to enter this space, including Intel's attempt to come up with online TV. Samsung, Sony and Microsoft are also making efforts to expand their business to the field. The threat is that most of these firms have much more cash to acquire content and compete in video streaming market. Big technology firms might also have the competitive advantage to devise ways to stream online video at prices competitive to those of Redbox. With these established companies catering to customers' preference of the more convenient video streaming (Exhibit 5), DVD is heading towards its demise. Coinstar's Redbox business will fade away as media shifts from physical to digital distribution.

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4. Painful expansion to video streaming

On 03-Feb-12, Coinstar announced its joint venture with Verizon to provide online streaming service. The share price is up 28% since then, however it will have to face Netflix and its 23 million subscribers, according to Bloomberg. It will be difficult for Coinstar and Verizon to produce a great digital library full of content that users want to see, especially with the strong presence Netflix already has. Coinstar will make an initial cash investment of \$14 million into the venture may eventually contribute \$450 million. Securing content will also cost hundreds of millions of dollars for Coinstar. Furthermore, consumers are less likely to spend money for another monthly subscription if they are satisfied with one system. Competitors like Netflix and Amazon have both the brand name recognition and trust from their consumers, making it painful for Coinstar to compete with these two companies.

5. Limit of cutting costs to generate profits

Coinstar mentioned that some of the main drivers of the operating income were due to lower interchange fee negotiated for the 2 months ending December 2011, better than expected elasticity to price increase, less income tax expense, and lower amortization costs. These cost cutting measures will not be a suitable replacement for the lack of growth in revenues. Furthermore, with \$227.28 million of free cash flow on hand, future expenses in the joint venture with Verizon may be a burden for Coinstar.

Misperception

- **There is a massive price difference in digital vs. physical for movie rentals that is not likely to change anytime soon.**
Video streaming charges \$3 -\$4 per title as opposed to Redbox which only charges an average of \$1-\$2 per title. Therefore, incentive for studios to maintain Redbox's 28-day window is high. In January 2012, Warner, one of the major DVD providers to Redbox (15% of total DVD's) decided to not continue its relationship with the firm, because it refused to reduce the number of days related to its DVD release to Redbox clients. This forced CSTR to acquire titles from outside thereby increasing its costs for DVD acquisition.
- **DVD renting service will still be preferable for consumers for a long time.**
In Coinstar's announcement of preliminary financial results for the first quarter in 2012, it noted that the revenue growth was driven by stronger than anticipated consumer demand at Redbox, reflecting, in part, better than anticipated consumer acceptance of the price increase for Redbox standard definition DVD rentals implemented in October 2011. However, from consumer feedbacks and the survey that I conducted, people are not using Redbox regularly and most do not use it at all. Even though Redbox's are in convenient locations, people are reluctant to rent videos when it is more convenient to watch videos online at a slightly higher price. The trend of video streaming is shifting Redbox customers' decisions.

How It Plays Out

With low pricing strategy and installation of new kiosks, Coinstar's revenues grew phenomenally over the years. Better than expected performance with expansion of kiosks and the joint venture with Verizon are already reflected in the increasing share price. However, Coinstar has seen a slowdown in per kiosk growth, and faces a difficult transition to the digital delivery space. Also, investors may have understated the high risk of having a joint venture with Verizon. Coinstar's entrance to an already crowded market does not warrant the significant price jumps seen after the joint venture announcement. As the DVD rental market soon reaches its saturation point and the demand for DVD rental decreases, Coinstar is facing increasing risks in DVD rental market (Exhibit 6). MII should initiate a short position in the second half of FY2012 after Coinstar releases 2012 Second Quarter Results but before the joint venture with Verizon takes off. The reason is that if the joint venture does not succeed, the market will soon respond to the failure, causing the share price to decrease. Another reason is that consumers' preferences are shifting from renting DVD's to using video streaming services. Coinstar will lose its comparative advantages and become a matured business heading towards the trough.

Risks / What Signs Would Indicate We Are Wrong?

- The strong first quarter of 2012 came as a result of increased consumer demand at its Redbox movie kiosks for big movies such as "Moneyball" and "Puss and Boots". It also indicated that the 20% price increase for its Redbox DVD rental last November did not result in customer defections.
- Coinstar had a strong 2011 in which it managed to double profits as margins peaked at 5.6%.
- Movement from physical to digital delivery of movie content may take longer than expected to happen, especially if Redbox's locations are convenient and preferable for customers.
- Coinstar's joint venture with Verizon may be successful, thus bringing profits and the future major business for Coinstar.
- There might be significant changes in Coinstar's business expansion that may drive up profit margins, such as Coinstar's new coffee machine business.

Signposts / Follow-Up

- Coinstar plans to report final results for the 2012 first quarter on April 26, 2012, after market close.
- Detailed plan and performance of Coinstar's joint venture with Verizon.
- Potential expansion of Redbox kiosks and consumers' preference.
- Changes in market demand for Coinstar's Coin Counting machines.

Company Description

CSTR owns and operates self-service Redbox kiosks that enable consumers to rent or purchase movies and video games; and self-service coin-counting kiosks where consumers can convert coin to cash, a gift card, or an E-certificate. As of December 31, 2011, CSTR had 35,400 Redbox kiosks in 29,300 locations and 20,200 coin-counting kiosk in 19,900 locations in the United States, Canada, Puerto Rico, Ireland, and the United Kingdom. CSTR was founded in 1991 and is headquartered in Bellevue, Washington.

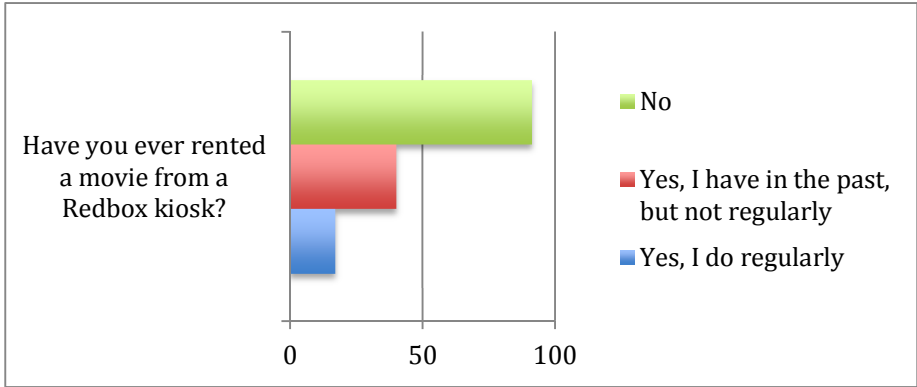
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Exhibit 1: VAR Research

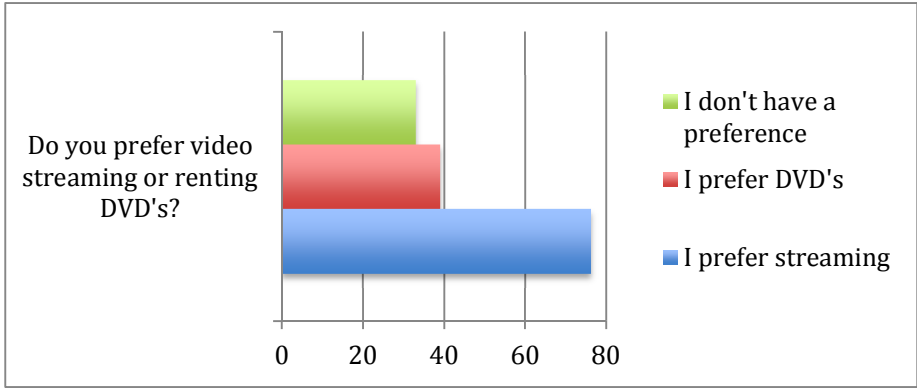
Name	Position
Elizabeth Larrick	Senior Marketing Manager, Coinstar, Inc.
Douglas Greiner	Compass Point Research & Trading, Analyst
Steve Frankel	Vice President, Senior Research Analyst, Dougherty & Company
Paul Coster	CFA, J.P. Morgan Securities
Jim Chanos	Founder, Kynikos Associates

Consumer survey:

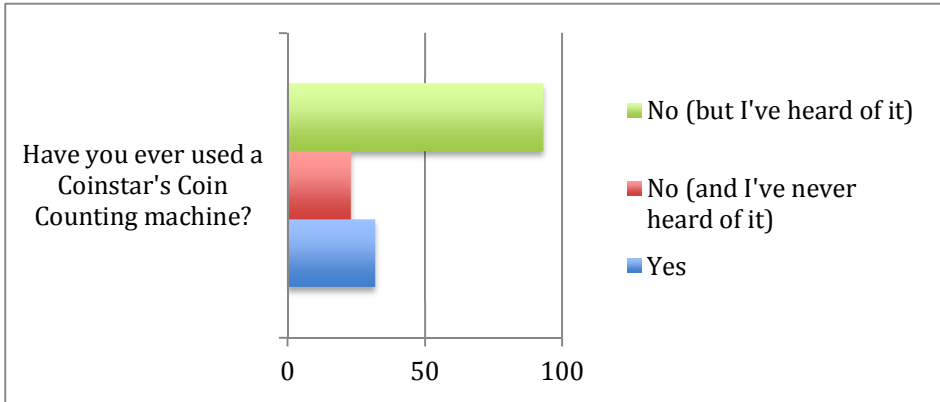
Target market: United States
 Gender: Males and Females
 Age Range: 18-60 years old
 Total Responses: 148



61.49% of participants have never rented a movie from a Redbox kiosk. Only 11.49% of participants use Redbox service regularly.



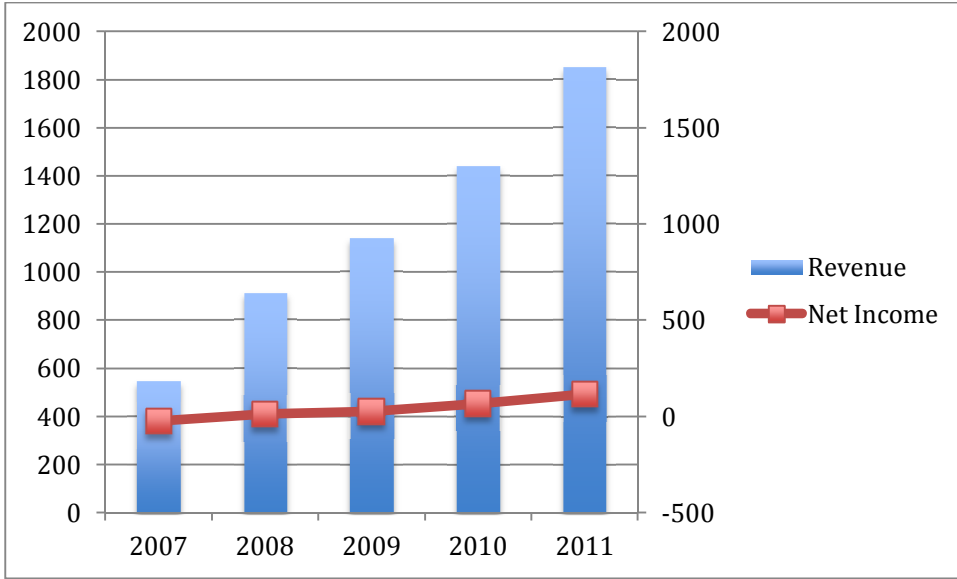
51.35% of participants prefer video streaming, comparing to 26.35% of participants preferring renting DVD's



62.84% of participants have never used a Coinstar Coin Counting machine even if they know the service. Only 21.62% of participants have actually used a Coin Counting machine.

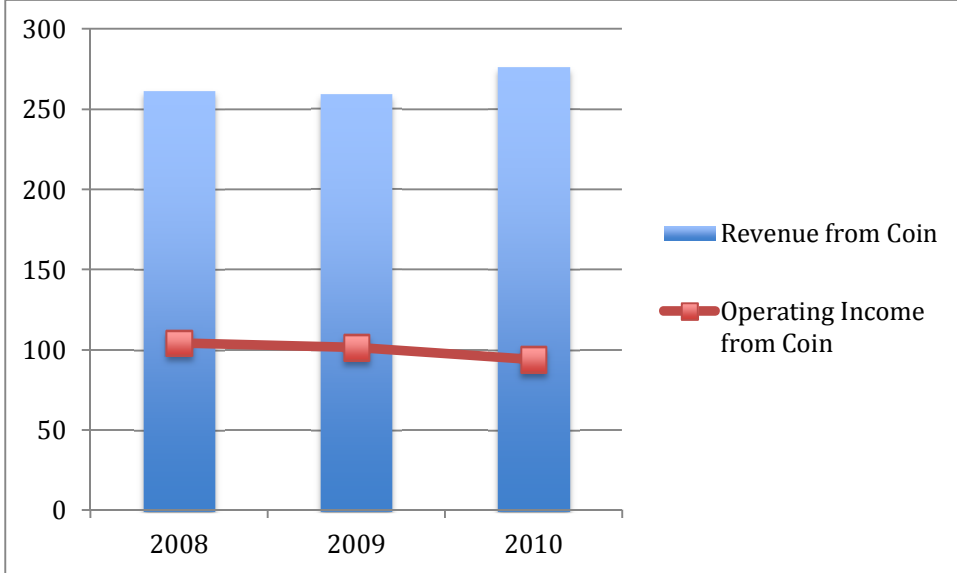
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Exhibit 2: Coinstar's Revenue and Net Income (\$ Millions)



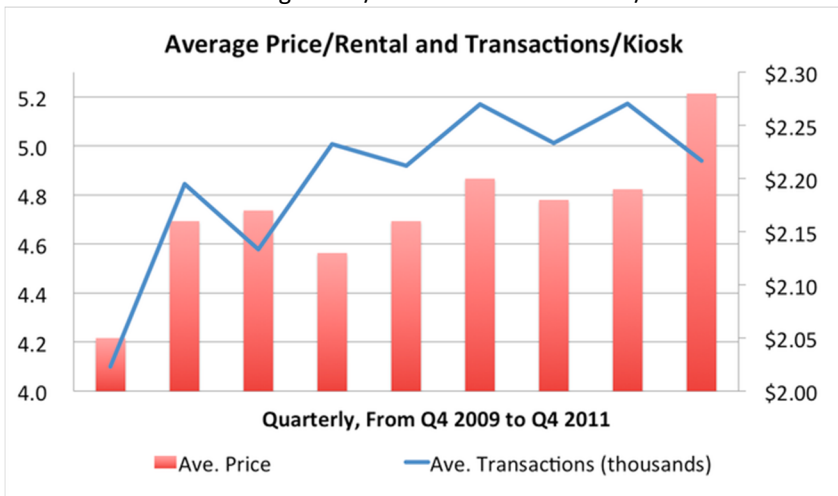
Coinstar has seen phenomenal growth in revenues over the past few years. However, net income only counts a very small portion of revenue growth, showing lack of profitability.

Exhibit 3: Revenue and Operating Income from Coin Counting segment (\$ Millions)



Even though the revenue from Coin Counting segment slightly increased, the operating income from the segment decreased. The graph shows the decreasing profitability of Coin Counting business.

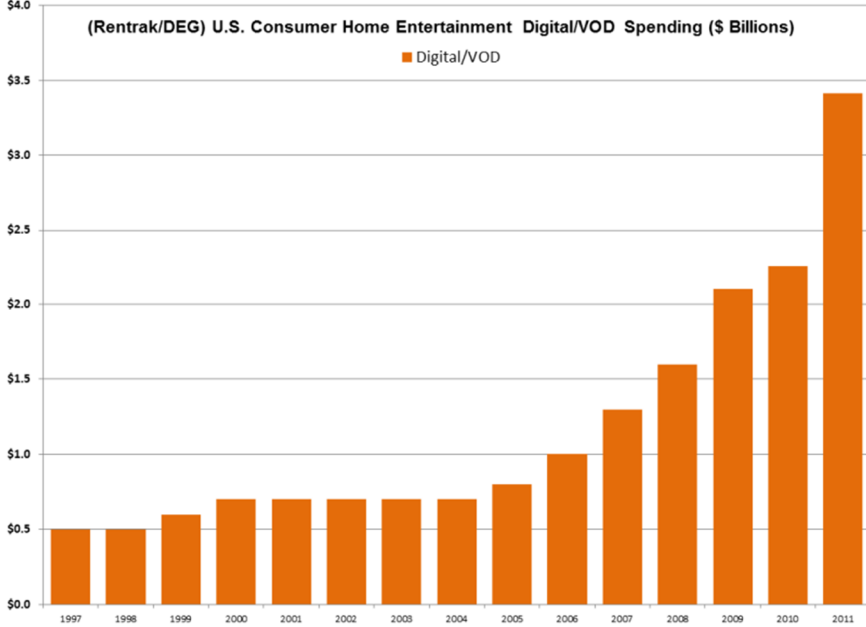
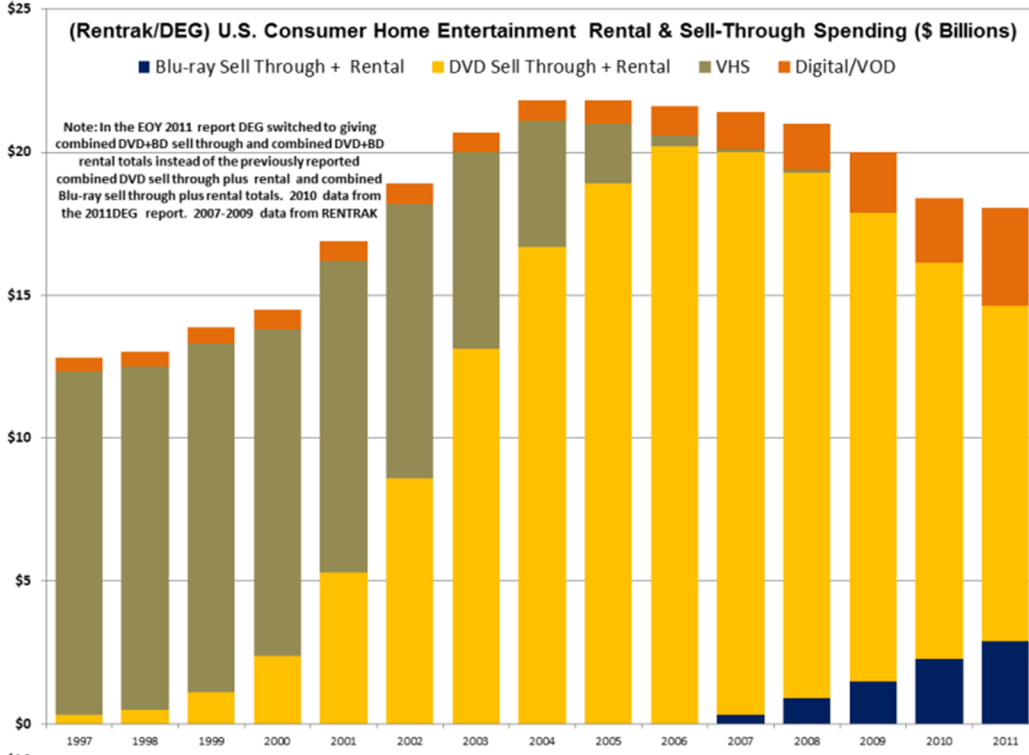
Exhibit 4: Redbox's Average Price/Rental and Transactions/Kiosk



The graph shows the trend of DVD rental market: average transactions per kiosk is decreasing while average price per rental is increasing.

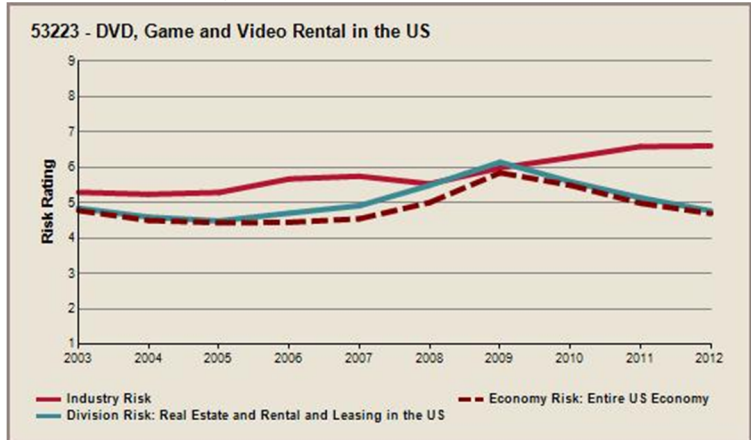
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Exhibit 5: U.S. Consumer Home Entertainment Rental & Sell-Through Spending (\$ Billions)



These two graphs show that consumers are spending less on DVD's and more on Digital/VOD (Video on Demand). Also, the total spending of rental & sell-through home entertainment is decreasing.

Exhibit 6: Risk Rating of DVD, Game and Video Rental in the US



The industry risk of DVD, Game and Video Rental is increasing while the entire US economy risk is decreasing.

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Ideas for the Club

Increase investment activities

I participated and was finalist of MII Undergraduate Stock Pitch Competition last semester. I learnt a lot on making good investment recommendations. I think besides stock pitch competition, MII could also hold investment competitions. For those who do not want to trade their own stocks in real life, they can use stock simulators (such as the one at investopedia.com) to practice their investments ideas. MII may hold a one-year portfolio competition to encourage members to get a deeper understanding of real life investments. For the members who are interested in starting their real portfolios, MII can hold discussion panels on tips of trading stocks.

Enhance member involvement in the club

I really like the associate system to get members engaged a lot more in MII. However, some members still feel not that involved in terms of researching and providing investment ideas. I would suggest that after every weekly general body meeting, associates should meet with their analysts and keep the team updated on the research. During application process, we should let applicants know the expected time commitment to be an active member (analyst) and a general member. Members can choose to be "active" or "general" depending on their schedule for each semester. This will give members lots of freedom and thus those who are willing to commit more efforts will work much more efficiently.

Also, instead of checking the names as sign-up for each meeting, members may email at least one question that they have for the pitches presented at the meeting. This will encourage members to not only be present at meetings but also be engaged in the pitches. It would also provide whoever is doing the pitch with more valuable feedbacks.

Invite alumni for guest speeches

At least once every semester, MII could invite MII or UVA alumni to deliver guest speeches and network with current members. This would provide members with great opportunities to learn from industry experts. The alumni may also be valuable resources when members are doing VAR.