# Introduction

## Synopsis

* Block is the largest player operating in a highly fragmented industry
* Product mix is diversified and growth has been achieved by M&As
* Strong brand and core competency in tax preparation
* Shift in customer demographics towards lower income filers
* Considering expansion in AFS industry

## Problem Statement

Address disconnect between H&R’s brand/core competency of tax preparation, and recent diversifications and plans to expand in AFS. Most important symptoms observed are:

* 30% churn rate and alarmingly increasing customer acquisition costs
* Declining number of customers

## Ethical Factors

* How to earn profits from the poorest population segment in a socially responsible manner
* How to help break the cycle of poverty rather than profiting from it

## Strategy

* Historically achieved product diversification via M&As rather than internal development
* Product mix expansion in financial services

# External Analysis

## Personal Tax

#### Structure

* Highly fragmented; Block is largest with 2 other major players
* Following chart shows market share in terms of # of customers:
* Clear demand for RAL, accentuated in lower income filers
* Customers are moving away from relying on relationships when choosing tax filer
* The PC based tax preparation market only has 2 major players:
* Block: Share 30%; revenues $88M, margins 10%
* Inuit: Share 70%; revenues $487M, margins 23.7% (more efficient)

#### Industry Economics

* Large and growing industry, highly seasonal: 13.4B$, 130M filings, 1-3% growth
* Firms have 2 main channels of revenues: Tax preparation fees & RALs fees
* Compensation for professional services is the largest cost driver
* The IRS implements ~425 changes per year to tax code, this implies training & changes to software
* With diminishing focus on relationships, downwards pressure on prices and technology adoption, shift towards online filing is expected.

#### KSF

* Cost efficiency in order for firms to be able to offer low prices
* Accessibility/Proximity to customers

#### Competitive Situation

Rivalry: High

* Competitor opening shop across the street and competing on price
* Rivals poach Block employees

New entrants: High

* 50k+ unbranded shops, low barrier to entry and very little setup costs (mostly variable)

Substitutes: Medium

* Relatives/friends can prepare returns, no certification required
* When refund (77% cases), no penalties for not filling taxes

Power of suppliers: Not applicable (service based industry)

Power of customers: Medium

* Easy to change tax accountants but migration of history can be tedious

#### Competitors

* 2 Branded competitors focus on price
* Non-branded competitors successful because of locality and community relationships

#### Ethical Factors

Stakeholders: Firms, Customers, Government

* Many customers belong to lower income segment of the population, firms need to balance profit goals with social responsibility
* Firm’s focus on increasing customer’s return has the adverse effect of reducing government revenues.

## Alternative Financing Services (AFS)

#### Structure

Check cashing:

* 10,000 outlets in the US, processing 180M checks for 1.9B% in fees
* Highly fragmented industry; largest player is ACE with 12% market share
* Walmart is entering the industry, which should put downwards price pressure on prices

Wire Transfer:

* Oligopoly, WU @75% market share, MoneyGram @15%
* 2001 revenues: 1B$, margins: 33%, expected CAGR 15%

Money Orders:

* Concentrated market: Travelers Express&First Data share 50% market, USPS 22%
* Total revenues: 1B$, growth 5.1%

Bill payment, ATMS, Unsecured lending:

* Growth 17.6%, 2.6B payments valued at $1.6T
* 324,000 ATMs, 263M cards, 1.36B Transactions

Payday Lending:

* By 2000, 65M loans, 2B$ revenues
* Typical fee 15$/2 week loan; 390% APR

#### Economics

* 6.4B$ industry, expected growth: 10%, pre-tax margins: 34%
* Customers average spend on AFS: $1000/yr (3.3% of income)

#### KSF

* Efficient operations
* Multiple location

#### Competitive Situation

Rivalry: High

New entrants: High

* Little setup cost required, much less regulated than for traditional financial services

Substitutes: High

* Traditional FIs charging more reasonable rates

Power of suppliers: N/A

Power of customers: Low

* Less educated, less means to switch provider

Overall, the AFS is not an attractive industry.

#### Competitive approach of competitors

* Competitive pricing
* Convenient locations

#### Ethical Factors

* By charging higher fees than typical FIs, industry players take advantage of lower income people
* Potential adverse effect of locking people into poverty cycle

# Internal Analysis

## Financial Analysis

#### Tax preparation services:

* Spending annually 115M$ in marketing to replace 5M departing clients
* Cost of incremental clients: 130$, estimated to grow at CAGR 20-25%. With annual ARPU of 149$ this business model might not be sustainable

#### AFS

* Customers paid 1B$ in fees to convert refunds to currency out of 29.1B$ in returns (3%)
* Revenues from refund related services: 500M$, 100$/customer (5% average refund)
* EFS center could bring in 197-267k$ in revenues with 20% margins
* ATMs used to clear checks with ACE partnerships are losing 28k$/year (***see Exhibit B***), tension is growing
* 21% Growth, pre-tax margins 28.7% (lower than industry 34%). Even though roughly 30% of Block customers use RALs, AFS only account for 6% of H&R Block’s total revenues:
* Recent EFS experiment is expected to be deployed in 1550 stores, generating increased revenues of 305-413K$ and profits of 61-82M$. (Exhibit C).

#### Product Mix

Revenues

* US Tax and Mortgage services represent the largest share of revenues with consistent growth, whereas Corporate Operations and Investment Services are generating losses with revenues trending downwards:
* In 2003, combined losses from these 3 business unite were 264M$, almost equivalent to incremental revenues expected from EFS stores

#### Asset Allocation

* US Tax and Mortgage services generate the largest ROA
* 68% of total assets are used up in operations that are generating losses

|  |  |  |  |  |
| --- | --- | --- | --- | --- |
| *2003 numbers* | Revenue | Identifiable Assets | % Total Assets | ROA |
| US Tax | $547 | $281 | 6.1% | 195% |
| Mortgage | $694 | $1,157 | 25.1% | 60% |
| Business Services | -$14 | $675 | 14.7% | -2% |
| Investment Services | -$128 | $1,489 | 32.4% | -9% |
| International Tax Operations | $10 | $33 | 0.7% | 30% |
| Corporate Operations | -$122 | $967 | 21.0% | -13% |

* Divestiture of these 3 BUs could free up 3.1B$ of capital which could be re-invested in expanding core products, and would generate an increase of income before taxes of 264M$ by cutting losses.

## Operations

* New senior management team, mostly recruited from Amex; a lending institution; could explain recent AFS focus
* Opening locations in 550 Walmarts is inconsistent with Block’s differentiation strategy and spending on marketing/branding

#### EFS

* Retrofitting 1,550/4,000 offices near public transit to offer AFS @50% lower costs than competition by leveraging existing stores and low customer acquisition costs

## Competitive Position

#### Tax business:

* High Brand recognition with 98% Americans recognizing H&R Block, yet 5M clients leave every year (30% churn rate); 50% US population already been a customer
* 58% of 16.3M customers earn less than 30k$/year
* Although revenues from tax returns is growing, # customers is decreasing. During the same period, # customers of branded competitors is growing. These competitors are value focused
* With only 12% market share, there is lots of growth potential in tax preparation

#### AFS

* Block reaches 38% of un/marginally banked individuals in US
* 47% customers expressed interest in refund check cashing; 39% interest in year round service, consistent with the 38% of customers who are marginally/unbanked
* RAL delivers funds to 4.6M customers; after introduction, customer demographic shifted towards lower income filers
* 2004, 4.3M clients purchase RALs for average 3k$ refund (1.5M instant RALs, 2.8M traditional)
* Perception of predatorily lending (settled lawsuit for 43.5M$ in 2003)

## Main Issues

* Miss-alignment between Block’s stated differentiation strategy and shift of customer demographics in lower income segment
* 68% assets used up in operations that are generating losses and not aligned with Block’s core business
* 30% churn rate, with customer acquisition cost approaching ARPU and growing at alarming rates
* Too many non-profitable non-core products is shifting focus away from core competency

## Ethical Considerations

Stakeholders: Shareholders, Employees, customers

* Focus on lower income markets requires proper balance between profits and social considerations
* Even though part of the slogan include “Save More”, it is nearly impossible for lower income segment of the population to achieve savings since incomes do not even cover basic needs
* Creating new AFS products does not help people break the cycle of poverty, but rather contributes to trapping them into AFS
* Divestitures would affect employees working in these business units
* Leaving offices open year round will provide better employment conditions for workers

# Strategic Alternatives

H&R Block is facing a misalignment between resource focus and core strategy. On one side it has one of the strongest brands in the country for its core competency (tax returns) and invests significantly in marketing, yet focus is on developing new non-core alternative financial products which consumes lots of resources and has the effect of shifting consumer base to low income segment of the population and potentially alienating branded higher income customers.

The biggest strategic choice faced by Block is:

* Continue product mix expansion by enhancing AFS offerings. This strategy would require a restructure of spending away from marketing and more focused on low cost product development and business processes optimization
* Refocus on tax preparation core business and reinforce brand image. In which case, it should move away from AFS and divest non-profitable non-core products.

# Recommendation

## Alternative 1: Re-focus

Pros:

* Proven success in tax filing already industry leader
* Tax business offers excellent margins (28.7%, up from 23% in 1999)
* With only 12% market share, there is tremendous room for growth. Since # of customers is the success metric used by shareholders to rate the company, this would benefit stockholder’s perceptions
* Product mix rationalization should simplify management and help focus
* Leverages strong brand recognition and core competency

Cons:

* Loss opportunity of incremental revenues from AFS
* Potential conflict with management’s vision since mostly form Amex
* Negative effects of divestitures on employees

## Alternative 2: Product mix extension towards AFS

Pros:

* Significant growth in AFS industry
* Leveraging existing stores therefore competitive advantage on costs
* Appealing to lower income individuals, a growing segment of population

Cons:

* Unattractive industry
* Hurts the brand
* No proven success in the industry and historical pore performance in non-core operations
* Locking people into AFS cycle rather than helping them migrate towards traditional FIs is only contributing to the problem, not helping them
* Increase legal exposure and risk of additional lawsuits (Already settled for predatory lending)
* Does not address declining number of customers

#### Stakeholder Analysis

|  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- |
|  | **Customers (Low Income)** | **Customers (med/high Income)** | **Shareholders** | **Employees** | **Franchisees** |
| **Refocus on core business** | Can be helped to break out of poverty cycle | Increased brand satisfaction and potentially service quality | Increase in customer base (primary success metric) and revenues | Less work because of seasonality of taxes and shift to online | Strengthen brand = benefits for franchises |
| **Expand EFS Offering** | Locked into poverty cycle, financially taken advantage of | Could be alienated because of brand perception | Revenue per customer should increase but not # customers | Opportunity to work year round and more diversity of duties | Decreases value of brand and appeal of franchise |

Both from a business standpoint as well as an ethical perspective, refocusing on core business is the best strategic alternative. Block’s core competency is tax preparation, not financial services. Block has a track record of not being able to operate successfully in areas away from its core business with 3 ancillary services BUs operating at loss.

As an industry leader, H&R Block has a social duty towards its customers. While not expanding to offer AFS services to extract more money from lower income filers, Block should none the less attempt to assist these individuals in breaking the poverty cycle. With refunds being a significant revenue source for these households, Block is in an influential situation where it can help customers start using conventional financial products at lower fees than AFS.

# Implementation

#### Re-Focus:

* Divest from the following BUs: business services, investment services and corporate operations. This will free up 3.4B$ in capital (assuming assets sold @ book value) to finance strategy implementation and generate 264M$ in additional profits by cutting losses
* Continue to increase the number of offices to enhance the convenience of service and market share. Expansion could be achieved by continuing to open offices in retail locations, providing synergies between Block and host retail. During off-tax season, retailer can re-use the space for additional store space.
* Find the root cause of 30% churn rate and address the issue (although declining brand perception could be to blame, no specific cause was provided in the case)
* Integrate people with accounting background rather than lending in upper management
* Invest in online platform (if possible attempt to acquire Inuit using capital freed up from divestitures)

#### Helping the pore

* Offer free use of tax software for people with income < 30k$; partner with community services to provide computer access to the software
* Develop an online training program to educate people on how to file taxes using Block software.
* End partnership with ACE and stop offering check clearing services. Instead, partner with FIs and offer customers to open a bank account and direct deposit the check into this account. Marketing campaign outlining benefits of FIs over AFS.
* For customers who do not want bank accounts, offer tax refunds in pre-loaded credit cards. The credit institutions will still earn money from commission charged to merchants when funds are spent, and the customers will not have to pay any fees. The credit cards could be made refillable such that customers could use them as permanent pre-paid credit instruments to start building credit history

# Exhibit A: H&R Block’s Cost of Capital

Data taken from 2003 financial statements, all numbers in M$

Annual Dividend Growth:

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Year | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 |
| Dividend | 84 | 95 | 105 | 108 | 115 | 125 |
| Growth |  | 13% | 11% | 3% | 6% | 9% |

Average Dividend Growth: 8%

Cost of Equity:

|  |  |
| --- | --- |
| Dividend Payment | $125 |
| Market Cap | $6,936 |
| Return | 2% |
| Growth | 8% |
| Cost of Equity | 9.8% |

Cost of debt:

|  |  |
| --- | --- |
| Interest Payment | $92.6 |
| Long Term Debt | $822.3 |
| Cost of debt | 11.3% |

WACC

|  |  |  |  |
| --- | --- | --- | --- |
|  | Liabilities | SH Equity | Total |
| Quantity | $2,940 | $1,664 | $4,604 |
| % of total Assets | 64% | 36% | 100.0% |
| Cost | 11.3% | 9.8% | 21.1% |
| Weighted Cost | 7.2% | 3.5% | 10.7% |

# Exhibit B: Profitability of ATMs

|  |  |  |
| --- | --- | --- |
| Revenues | |  |
|  | # ATMs | 200 |
|  | # checks cashed | 110000 |
|  | Total Value of checks | $220,000,000 |
|  | revenues from 3% commission | $6,600,000 |
|  | Average revenue/ATM | $33,000 |
|  |  |  |
| Costs | |  |
|  | Annual maintenance | $35,000 |
|  | Depreciation (15k$CAPEX/5y) | $3,000 |
|  | Cost of working capital (220k$@10.7%) | $23,540 |
|  | Total cost/ATM | $61,540 |
|  |  |  |
| P/L |  | -$28,540 |

# Exhibit C: EPS Experiment Effect on Income

The following tables show effect on income and profits, all numbers in ‘000

|  |  |  |
| --- | --- | --- |
| **Revenue/EFS Store** | **Total Revenues (1550 Stores)** | **Profits @20%** |
| $197 | $305,350 | $61,070 |
| $267 | $413,850 | $82,770 |

|  |  |  |  |
| --- | --- | --- | --- |
|  | **Operating Income** | **New Revenues W/ EFS** | **Increase** |
| Existing Revenues | $3,779,000 | $4,138,600 | 9.5% |
| Operating Income | $1,073,000 | $1,144,920 | 6.7% |

|  |  |
| --- | --- |
|  | Operating Margins |
| Existing | 28.4% |
| New W/EFS | 27.7% |