Summary

Outerwall (OUTR), in its core offering owns Redbox, Coinstar and ecoATM. Their kiosks are located in supermarkets, drugstores, mass merchants, convenience stores, financial institutions, malls and restaurants. As of September 30th, 2015, per the picture below, represents their kiosks locations and counts.

	Kiosks	Locations
Redbox	40,790	33,310
Coinstar	21,110	19,910
ecoATM	2,210	1,980
All Other	110	110
Total	64,220	55,310

Source: [3Q15 Report]

We believe that OUTR represents a decent short of no more than 1% of an enterprising/advanced investor’s portfolio. The thesis is predicated upon continual secular headwinds, in their core business segment (Redbox), with no sign of letting up. In the TTM, revenues have declined, comparable machine sales are falling, and further new store kiosks growth has stalled. To counteract secular headwinds, management has unsuccessfully tried to expand in new markets and into the Video on Demand industry. Guidance has been lowered, key executives are leaving and insiders have been selling at a healthy clip.

Because OUTR is already selling at a TTM discount/undervaluation, we believe that enterprising/advanced investors should not short any more than 1% of his or her portfolio (being defensive is just as, if not more important than being offensive). However, we also believe that these secular headwinds will continue to damper the topline and its core business will die off (in due time). Thus, to us, OUTR represents the classic value trap.

A further and more detailed explanation of how OUTR may represent a decent short and value trap is explained below.

Their Niche, Competitive Advantage and Popularity is Diminishing

In the past, OUTR has relied heavily on, and had very little competition renting same day DVD releases. The advantage existed because many studios did not want to make their new releases available for streaming, that is, until they milked the market via DVD/Blu-ray sales. This core advantage allowed OUTR to exhibit double digit bottom line growth, with high competition is now disappearing.

There have been Seeking Alpha authors, who in the past have touted about how the new release of San Andreas and Jurassic World will help support revenue growth or stabilization. However, what was not mentioned was that both of these movies were just made available via streaming as same day DVD release. Redbox's competitive advantage is being taken away.

We can even go further to show you how this could really drastically hinder the topline. Streaming/Renting Jurassic World through Amazon Prime costs a mere $5.99/HD and $4.99/SD. This is for a 48 hour rental. At a Redbox, customers can rent a Blu-ray for $2/day and a DVD for $1.50/day. In our perspective,despite the streaming or online service being much more expensive directly, we believe it is cheaper indirectly. We come to this conclusion when we start to think about the opportunity costs.

The opportunity costs of going out and renting a Redbox Blu-ray/DVD are; time, gas, and returning it. In our opinion, individuals value efficiency and time more than a couple of bucks. It is much more efficient to sit at home and stream a movie than spending your time going out and renting one from a Redbox. Not only will you have to spend your time driving, and going into a store to rent a Redbox, but you will have to pay for gas it took to go to the store. Granted, nationwide low gas prices should in theory spur Redbox demand indirectly (low probability), it will still cost money to drive to the store. Then you have to return the rental eventually, which will cost more time and gas.

All in all, we believe that the efficiency of streaming or Video on Demand, is a game changer. It is very hard to deny, especially for the bulls, that Redbox is facing secular headwinds. These are the same type of secular headwinds that hit Brick and Mortar DVD rental stores. Do the winds whisper value trap?

We also believe that the trend of going out and renting a DVD from Redbox is losing popularity. When the service was first available, it was new, and everyone had to try it. Trends and popularity have tendency to diminish, thus the law of diminishing returns.

A Break Through into the Instant Service has failed

In 2013, Redbox launched their program "Redbox Instant" in which they partnered with Version (VZ). On October 19th, 2014, the Version partnership was officially withdrawn. Redbox Instant never really gained any traction and overall, management was not pleased with its investment.

Because the user engagement of the platform was a failure, the company shut the program down on October 7th, 2014.

We believe that this is a big deal. Management has shown us that competition is too fierce in the VOD market. Redbox is known as the DVD rental company (they may have doomed themselves). They are very good at renting DVD's, however, Netflix (NFLX) and Amazon (AMZN) own the VOD market. In our opinion, OUTR doomed themselves from being known as the DVD rental guys, mixed with harsh competition from more popular services from NFLX and AMZN.

With the company's already failed instant service, we find it very unlikely that management will invest FCF into another attempt, into the instant business model. In fact, management has already proven to investors that they are venturing into other businesses, in order to create topline growth. They proved this when management went out and did an assets acquisition from Gazelle, Inc.

On October 24th, 2015, OUTR started acquiring Gazelle, Inc. Gazelle provides an on-line service for the sale and purchase of used mobile phone, computers and tablets. In the asset agreement, OUTR will buy $18mm worth of assets and liabilities off of Gazelle. This proves to us that management is leaving the instant service behind and focusing on another business model. However, you will soon learn that management has historically failed at adopting new, profitable business models.

In the Past the Company has historically failed at Entering New Markets

OUTR has historically failed at new business concepts and wasted a decent amount of shareholder value in the past. Ventures such as; Redbox Instant, RedBox Canada, Rubi, Crisp Market, Star Studio and Orango, have all failed. Not only did these concepts/ventures fail, but ecoATM, a relatively new venture, recently took an $85.9mm non-cash goodwill impairment charge. The ecoATM concept has not met up to management's expectations and suggests that the concept will continue to disappoint. There is potential for a further $178mm more goodwill to this segment in the future as well. We believe that further goodwill impairment charges will further fuel the downside.

The company also has two startups, SampleIT and SoloHealth (only a 10% stake) that are currently unprofitable. This is a further suggestion that OUTR's topline will continue to experience declining numbers. If management does not replace Redbox's revenues with another profitable business model, there could be a further decline in revenue. Thus far, management has not demonstrated to the shareholders that they will be able to do this.

Key Executives have Left the Firm Recently

Executives such as former President of Redbox, Mark Horak and Chief Accounting Officer, Peter Osvaldik have recently left OUTR in late 2015. We believe that these two key executives can see the writing on the wall. In fact, Osvaldik left OUTR to pursue another financial position. What is interesting to us is that Horak announced his departure at OUTR in the same PR in which they announced revised earnings guidance. This is a huge suggestion that Horak does not believe in the future of the Redbox business model, a rather harsh bearish sign.

A prolific amount of insider sales supports our writing on the wall theory even further.

Insider Transaction History

Date	Name-Position	Transaction	Shares	Price Range ($)	Shares Held	Mkt Value
11/18/15	Gaherity James Officer	Sale	950	65.32 – 65.32	9,866	$62.1 K
5/26/15	Smith Galen C Chief Financial Officer	Sale	4,112	79.12 – 79.12	26,150	$325.3 K
5/21/15	Osvaldik Peter Officer	Sale	852	77.50 – 77.50	3,340	$66.0 K
5/20/15	Eskenazy David M Director	Sale	1,337	75.47 – 75.47	6,333	$100.9 K
	Rench Donald R Officer	Sale	7,218	76.72 – 76.72	27,358	$553.8 K
5/15/15	Gaherity James Officer	Sale	300	76.15 – 76.15	10,816	$22.8 K
5/12/15	Stipp Maria D Officer	Sale	4,367	73.46 – 73.46	14,650	$320.8 K
3/4/15	Woodard Ronald Brow... Director	Sale	1,337	65.50 – 65.50	5,633	$87.6 K
	Pinckney James S Officer	Sale	908	66.12 – 66.12	3,216	$60.0 K
2/19/15	Pinckney James S Officer	Sale	1,126	67.36 – 67.36	3,684	$75.8 K

Source: NASDAQ

Yes, insiders can sell for any reason (bills, to pay taxes, etc), however, these are rather high monetary sells. What strengthens this case is that there have not been any insider purchases in the past year. This is not definite, but we can reasonably speculate that management does not have high hopes for the future success of OUTR (based on key executives leaving, insider sales and lack of insider buying).

The Downside Could be Capped

The risk of shorting OUTR is that the downside may be capped. Yes, OUTR is facing secular headwinds and yes, the company has started to see a drop in the topline. However, the company remains profitable on an EPS and FCF standpoint and will most likely continue to do so as well.

From 2010-2014, the company, on average, has generated $206.8mm in FCF. At the current price, this is a FCF yield of 26.42%. Based on the simplicity and high margins of the business model, and managements restated guidance (revenues of $2.165-2.19bn and continuing operating earnings of $7.65-8.15/share), we believe that FCF will continue to be strong going forward. In fact, because of the business model, as the topline shrinks, the bottom line should have a tendency to grow (due to lower operating costs associated with checking the machines and repairing machines).

Management also continues to rapidly buy back shares. In fact, since 2012 the company has decreased their share count by 43.75%. To us, it appears as if management will continue buying back shares as well. Their last repurchase program, started February 3rd, 2015, allowed the company to repurchase $250mm of common stock. Thus far, the company has bought back 1,840,318 shares at an average price of $67.10/share, with a total purchase price of $123.5mm. The company still can repurchase $126.5mm more shares. With a market cap of $751mm, this represents almost 6% of the shares outstanding.

What could also cap the downside is the fact that OUTR has a relatively strong balance sheet and is currently undervalued on a TTM basis. With a TTM EV/EBITDA and TTM EV/Revenue of 2.69x and 0.59x, respectively, it may be unorthodox to see a tremendous decline in the near-term. The risk for short sellers is that OUTR’s forward guidance is already priced into the shares. Thus, the company is not the typical overvalued short sale (a margin of safety exists for deep value investors due to low multiples). This is a risk in it of itself for the bears.

Finally, OUTR doesn't appear to have any irregular accounting mishaps. In general when we look for companies to sell short, our typical interest is in companies with suggestions of accounting fraud/deception (for example; channel stuffing). We see no sign of irregular accounting practices when looking at OUTR's historical financial statements.

What we are proposing is that OUTR could make a decent short if secular headwinds continue to hinder the topline of its Redbox business. Management has provided guidance for the 2015 results. However, we believe that management does not have experience forecasting a decline in the topline (for they have only experienced growth until recently). Going further, management has zero experience forecasting numbers in this new competitive landscape. Competition will continue to grow as well.

Yes, OUTR looks attractive from a deep value perspective, but we feel like the price could get much cheaper going forward (**this could be a classic value trap**). Remember, OUTR is not facing short-term issues such as a bad management or a lawsuit. OUTR, is facing long-term erosion-the same long-term erosion that destroyed Blockbusters.

Conclusion

We are not the only ones who believe that OUTR is a great short candidate. In fact, as of November 30th, 2015, 46.71% of the shares outstanding were short. What makes OUTR a compelling short today is that we are in the midst of a tax loss selling period. With the recent decline, we believe that investors will have more of a tendency to sell OUTR to lower their tax rate. Finally, secular headwinds, mixed with insider selling and the company's history of failed ventures enhances the possibility of a price decline in the near and long-term. All in all, downside is more likely than upside.