As Jackson Hewitt Contemplates Bankruptcy, Analysts Fear for Long-Term Health of Company, Franchisees

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Return preparation giant Jackson Hewitt Inc.'s battle with lenders over debt signals financial problems for the coming year that could filter down to its franchisees, industry observers say.

The nation's second-largest retail tax return preparation company canceled a third-quarter earnings call with investors March 10 in light of its struggles to restructure its balance sheet and come to a financing agreement with lenders. A corporate filing indicated that such an agreement may include a "prepackaged bankruptcy" for the overstretched company.

Business analysts and observers say that though franchisees could operate during bankruptcy proceedings, they could feel the pinch from their parent company's financial troubles.

"There may be a prepackaged bankruptcy where they restructure their balance sheet and they take out all the equity for shareholders, but my guess is it continues to operate next year. It will just be a different company with a different capital structure," said David Burtzlaff, an analyst with financial services firm Stephens Inc.

Shares of the company dropped more than 40 percent after the call was canceled and the company announced lower than expected earnings.

According to Jackson Hewitt's March 10 quarterly financial filing with the Securities and Exchange Commission, the company had approximately $4.8 million dollars in cash but must make a long-expected $30 million mandatory payment to lenders by April 30, 2011. If Jackson Hewitt cannot produce documentation of a restructuring plan by April 29, the lender can consider Jackson Hewitt in default and cancel all funding, the filing said.

The key lender is Wells Fargo, which has Jackson Hewitt on some "pretty unkind loan terms," said Adam Rust, research director for the Community Reinvestment Association of North Carolina.

"Wells Fargo is taking cash out now because they don't expect that there will be any value in Jackson Hewitt after bankruptcy. The company has been run into the ground -- its largest asset is goodwill and it only has a few million in cash against more than $300 million in debt," he said. Financial filings show the company also has $73 million in accounts receivable, which includes $8.4 million in past due franchise fees.

"The only way lenders have a chance to make their money back is to try to let them earn their way out of it," said Burtzlaff, but Rust was dubious Wells Fargo would want to take over a return preparation business.

The company has been unable to right the ship for the last few years as management errors have made it difficult to overcome volume declines, Burtzlaff said. "They have a huge amount of debt and the interest they're paying has been eating them alive. Their business has been in decline for the last several years, with return volumes down 7 percent in 2008, 13 percent in 2009, and 14.4 percent last year. They may be up this year, but over that time period you would have lost over a million returns," he said.

The company is also heavily franchised, with few assets to liquidate to make its mandatory payments, Burtzlaff said. Further, Rust said the assets Jackson Hewitt does have are difficult to monetize. The name recognition from the Jackson Hewitt brand is closely tied to franchisee's physical location, and customers may not follow if the franchisee changes locations, Rust said. The proprietary tax software the firm uses internally will be out of date at the end of this filing season, and its most profitable refund settlement products, refund anticipation loans, are under fire from regulators, he said.

A Boon for Competitors

Jackson Hewitt's financial difficulties will change the industry landscape and may create an opportunity for competitors to increase their market share, analysts say.

Even without its financial uncertainty, Jackson Hewitt is set to lose its biggest competitive advantage if regulators succeed in suffocating its RAL funding, Rust said.

On February 10, the FDIC ordered Jackson Hewitt's RAL lender, Republic Bank & Trust Co., to stop offering the loans, which are borrowed against a taxpayer's expected future tax refund. Republic has filed a suit against the FDIC, challenging its rulemaking process, and has vowed to fight the order, though the timing of the order means it is unlikely to curtail lending in this tax season. Given that Republic was the last active RAL lender, analysts say it seems unlikely RAL funding will be available for future tax seasons. (For prior coverage, see *Doc 2011-4550* or *2011 TNT 43-8*.)

Meanwhile, H&R Block, the country's largest commercial tax return preparer, is in position to "squeeze competition," said Burtzlaff. H&R Block lost out on its RAL funding before the 2011 tax season, but on a level playing field, it has the size to pull returns away from its competitors, he said. (For prior coverage on H&R Block, see *Doc 2010-27413* or *2010 TNT 248-1*.)

Alan Bennett, H&R Block's president and chief executive officer, acknowledged some loss of business from Block's inability to offer RALs, but on a March 9 investor call he said the company compensated with an aggressive marketing campaign and a new client enticement program that offered free digital preparation of Form 1040EZ on its website.

If no one has RALs, H&R Block's other refund settlement products have a few advantages, Burtzlaff said. It owns a bank through which it can independently offer the assisted refund or the refund anticipation check, he said.

A financially unstable parent company can also put franchisees at a disadvantage, John Hewitt, president of Liberty Tax Service and founder of Jackson Hewitt, told Tax Analysts.

Financial troubles may mean Jackson Hewitt's more than 5,400 franchisees can no longer count on the parent company for tangibles such as software and computer support, operations or management systems, certification processes, and, in some cases, financial support for marketing or employee training, he said.

However, the biggest strike against Jackson Hewitt franchisees is the loss of RALs, Rust said. Burtzlaff agreed, saying that without refund settlement products, small preparers may be at a significant competitive disadvantage, especially since H&R Block and Jackson Hewitt compete heavily for the same early season filers with relatively simple or refund-due returns.

At the taxpayer level though, Hewitt said, franchisees are likely to be shielded from the troubles that financial distress casts on a parent company. Some people may take notice of the parent company's problems and switch preparers, but "most will be oblivious," he said.