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RCII - Q3 2013 Rent-A-Center Earnings Conference Call

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OVERVIEW:

RCII reported 3Q13 total revenues of $754.8m, net earnings of $27.6m and diluted EPS of $0.51. Expects 2013 total revenues to increase approx. 1% and diluted EPS to be $2.80-2.85.

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CORPORATE PARTICIPANTS

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Mark Speese *Rent-A-Center - CEO & Chairman*

Mitch Fadel *Rent-A-Center - President & COO*

Robert Davis *Rent-A-Center - EVP, Finance, CFO & Treasurer*

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Brad Thomas *KeyBanc Capital Markets - Analyst*

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Laura Champine *Canaccord Genuity - Analyst*

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PRESENTATION

Operator

Good morning and thank you for holding. Welcome to Rent-A-Center's third-quarter 2013 earnings release conference call. At this time, all participants are in listen-only mode. Following today's presentation, we will conduct a question and answer session. (Operator Instructions)

As a reminder, this conference is being recorded Tuesday, October 23, 2013. Your speakers today are Mr. Mark Speese, Chairman and Chief Executive Officer of Rent-A-Center; Mr. Mitch Fadel, President and Chief Operating Officer; Mr. Robert Davis, Chief Financial Officer; and Mr. Davis Carpenter, Vice President of Investor Relations.

I would now like to turn the conference over to Mr. Carpenter. Please go ahead, sir.

David Carpenter *- Rent-A-Center - VP, IR*

Thank you, Mo. Good morning, everyone, and thank you for joining us. You should have received a copy of the earnings release distributed after the market closed yesterday that outlines our operational and financial results that were made in the third quarter. If for some reason, you did not receive a copy of the release, you can download it from our website at investor.rentacenter.com.

In addition, certain financial and fiscal information that will be discussed during the conference call will also be provided on the same website. Also, in accordance with SEC rules concerning non-GAAP financial measures, the reconciliation of EBITDA is provided in our earnings press release under the statement of earnings highlights.

Finally, I must remind you that some of the statements made in this call such as forecasted growth in revenues, earnings, operating margins, cash flow and profitability and other business or trend information are forward-looking statements.

These matters are, of course, subject to many factors that could cause actual results to differ materially from our expectations reflected in the forward-looking statements. These factors are described in the earnings release issued today, as well as our annual report on Form 10-K for the year ended December 31, 2012 and our quarterly reports on Form 10-Q for the quarters ended March 31, 2013 and June 30, 2013. Rent-A-Center undertakes no obligation to publicly update or revise any forward-looking statements.

I would now like to turn the call over to Mark. Mark?

Mark Speese - *Rent-A-Center - CEO & Chairman*

Thank you, David. Good morning, everyone, and thank you for joining us this morning.

Suffice it to say, we are disappointed with our overall results, yet I remain enthused and optimistic about many of the trends that we are seeing, specifically in the core US business.

As for our results in the quarter, total revenue increased 2.1% year over year with our RAC Acceptance and Mexico business units more than offsetting the decline in the core business. Net earnings were down approximately $12 million year over year, again primarily due to the operating profit decrease in the core US segment.

That said, we continue to see positive strong demand trends in the core. Deliveries, the leading indicator for demand, were up again this quarter, increasing over 7% year over year, then following the 6.6% increase in the second quarter. And, in fact, as we predicted, our portfolio of agreements in the core, meaning the number of active agreements that we have, has now surpassed the prior year levels. However, the monthly average revenue per agreement or ticket is down, and as such, the value of the portfolio remains below the prior periods.

That drop in the ticket, which is greater than we expected, has been caused by additional promotional activities to attract customers who remain under pressure, lower consumer spending and continued product deflation in electronics. While the overall retail environment remains challenging, we've been successfully driving more traffic and customers to our stores, leading to the increase in deliveries and the larger portfolio size. That trend and the recent stabilization in the average ticket pricing gives us confidence in our long-term strategy of improving the results in the core.

Regarding the growth initiatives, they continue to perform well. Our RAC Acceptance business added over 100 new kiosk locations during the quarter. Revenues were up approximately 48% to $124 million in the quarter, contributing over 16% of our total revenue and over 33% of our operating profit. We are very pleased with our results here.

In Mexico we achieved our new store opening goal for the year and in the quarter with 150 locations. Their revenues grew over 91% in the quarter, and as previously stated, we remain on track to achieve the 4-wall breakeven by the end of 2013.

We remain very excited about the long-term opportunities that we have in Mexico.

Also as mentioned in the press release, we've embarked on another initiative. Our wholly-owned subsidiary, ColorTyme, a franchiser of rent-to-own stores operating under the trade name of ColorTyme, has changed his name to Rent-A-Center franchising international in connection with an offer to the current franchisees of the opportunity to convert their ColorTyme store to the Rent-A-Center brand. Now we are currently in the midst of discussions with our ColorTyme franchisees regarding this offer.

During the fourth quarter, we expect to complete a variety of buy/sell transactions with certain franchisees to facilitate their conversion to the Rent-A-Center brand. In addition, we will pay certain signage and related reimaging costs for those franchisees electing to rebrand. As such, we expect to report a charge in the fourth quarter related to the rebranding initiative in the range of $1 million to $3 million. Now while I am unable to provide a number today, it is our expectation that the majority will rebrand to the Rent-A-Center name. We believe that a unified network of both Company-owned and franchise stores operating under the Rent-A-Center name creates a stronger service offering for our customers and leverages our growth efforts to reach more customers. We expect to be able to provide more specifics surrounding the conversion counts, geographies and so forth during our next quarterly call.

In terms of guidance, for the remainder of 2013, Robert will provide more specifics, but again, as was noted in the early earnings release last night, given our third-quarter results and the impact of pricing on the core portfolio, our expectations for EPS is now a range of $2.80 to $2.85. While disappointed in the quarter, the current trends remain positive. Our growth initiatives continue to perform well, and financially we remain solid.

As always, I want to thank all of our coworkers for their continued hard work and contributions, and of course, we appreciate your support as well.

With that, let me ask Mitch to provide a more in-depth detail on the operating results of the various segments.

Mitch Fadel - *Rent-A-Center - President & COO*

Thanks, Mark, and good morning, everyone.

As Mark mentioned, we are pleased with our results in building our portfolio of agreements in our core business as we surpass prior year levels of agreements in the quarter.

Overall our same-store sales declined 0.8%. This was an improvement of 0.8% from our second-quarter results. This improvement was primarily the result of the core segment, which was down 5.1% versus being down 5.9% last quarter. Same-store sales in the core segment has improved each quarter this year, albeit not as fast as we would like. The 7.3% improvement over in year-over-year delivery shows continued strength in the model and in our ability to gain market share. However, the average revenue per agreement are the ticket component remains under pressure and has us still in a negative revenue position for now.

But we now have more agreements on rent than a year ago. There are two primary reasons for negative comps in the core. One is the ticket that we've already talked about. More specifically, this is being caused by electronics deflation and aggressive promoting to gain market share.

The other one is our early purchase option -- our sales income is running significantly lower than last year. This is primarily due to changes we made at the beginning of the year to our early buyout programs. While seeing lower margin early purchase options is not necessarily a bad thing, it does affect year-over-year revenue accounts. In fact, although the fourth-quarter overall core revenue count will be negative again, we estimate our rental and fee counts in the quarter be about flat.

And this positive trend also shows up in the course gross profit margin, improving by 30 basis points year over year. So very good news on deliveries and overall portfolio of agreement results. The headwinds are ticket and fewer revenues from early purchase options but, again, Q4 looks like rental and fee revenue year over year in the core should be about flat, which is a very good trend and we believe a very positive sign of things to come.

On the collection side, our losses ran a little high at 3.2%. The summer quarter is usually our worst loss quarter of the year, and the 3.2% is at the higher end of our historic summer range. Our operations team will continue his focus here, and we expect this to not be an issue going forward.

On the inventory front, we're in good shape. You can see the positive delivery and portfolio of agreement performance just by looking at our inventory numbers. The health of our inventory dollars in the core are flat year over year, yet the online inventory in that core segment is up about $40 million. This gives us a health per earned percentage of 26.4%, a 120 basis point improvement from last summer.

Regarding RAC Acceptance, we remain very pleased as Mark said with things in that segment. For the quarter, revenues of about $124 million, profit of about $19 million and a positive comp over 29%. We've opened 320 through the first three quarters, 100 more than last year. All of our operating metrics in this segment are staying consistent and in line with expectations. RAC Acceptance results are tracking to their new store economic model, and demand remains strong. Overall RAC Acceptance is a very successful growth vehicle for us, and it's helping us grow the overall US market, which for most retailers is not an easy thing to do right now.

In fact, when you think about our core and RAC Acceptance segments together as one US business model, our revenues in the US are up about 2%, another sign and another area that points to the fact we are growing our United States market share. In Mexico we opened 22 in the quarter, and we have now met our new store goal there for the year. We wanted to get them all opened before the fourth quarter, and we did just that. Mexico's revenues, as Mark mentioned, grew over 91% in the third quarter with a positive count of over 36%. We remain excited about this additional growth vehicle as we remain on track to achieve 4-wall breakeven in Mexico for the first time in December.

Overall the core is improving from a market share in standpoint with rental and fee revenue getting back to about flat in the fourth quarter, while RAC Acceptance provides a very strong near-term and long-term growth strategy and Mexico continues to grow towards a meaningful growth strategy for us for many years to come.

I'd like to thank our 20,000 plus coworkers for all their efforts as we continue to improve the quality of life for our customers. Robert?

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

Thank you, Mitch. I'm going to spend a few moments updating you on our financial results during the quarter and then review our 2013 revised annual guidance, and then we will open the call for questions.

As outlined in the press release, our total revenues were $754.8 million during the third quarter of 2013, an increase of $15.5 million or 2.1% as compared to the third quarter of last year. Our net earnings in the quarter were $27.6 million, while diluted earnings per share equated to $0.51, a decrease of approximately 24% quarter over quarter. These results include about a $0.09 drag on earnings in the third quarter due to the continued investment and ramp-up of our international growth initiatives.

Operating margins in the quarter declined 170 basis points, primarily due to the negative same-store sales results in the core RTO segment.

Similarly, our third-quarter EBIT margin declined 190 basis points to 10.1%. Going into our seasonally strongest quarter of the year, from a growth perspective, we do expect that both operating profit and EBITDA margins will increase approximately 200 basis points sequentially from the third quarter. We generated positive operating cash flow of $57.4 million during third quarter, and year to date we have generated approximately $173 million in operating cash flow.

During the quarter, the Company reduced indebtedness by over $39 million while continuing to invest in new stores, new channels, and new markets. In fact, our overall location count has increased approximately 10% from the prior year and 2.6% since June 30. Since quarter end, we have reduced indebtedness a further $19 million, while our $200 million accelerated share buyback continues to be executed in the market.

Dividends continue to play a vital role in our total shareholder return, and we did make an $11 million dividend payment in the quarter and anticipate making our 14th consecutive quarterly cash dividend payment later this week. We believe we have taken a fair and balanced approach to total shareholder return.

We ended the quarter with roughly $53 million in cash on hand, and our leverage ratio at the end of the third quarter remained essentially flat at 2.17 times, well below the floor on our covenant requirement of 3.25 turns. We continue to believe our balance sheet remains strong, and as such, we believe we remain well-positioned to continue to execute on our growth initiatives.

Now, in terms of guidance. With just one quarter remaining, we have revised our annual 2013 guidance as follows. We are now expecting diluted EPS to range between $2.80 and $2.85. This includes an approximate net $0.30 drag on EPS relating to our international growth initiatives. We previously expected a $0.25 drag from international, but are updating this to reflect two recent developments.

The first is a new lower share count due to the ASR impacting the dilution, and the other being that given our continued confidence in Mexico, we have decided to increase our investment there and preparations for entering Mexico City in the first quarter of 2014.

In terms of revenues, we now expect total revenues to increase approximately 1% with same-store sales declining approximately 1.5%. In terms of EBITDA and free cash flow, the Company now estimates EBITDA will approximate $370 million with free cash flow expected to be roughly $90 million. For 2013 we expect both our consolidated, operating, and EBITDA margins to decline approximately 100 basis points due to the continued investment in our growth initiatives, as well as the impact of the negative same-store sales in the Core US segment. However, given the agreement count in our Core US segment has now surpassed prior-year levels, we do believe 2013 will be a valley in regards to our profit results and margins, and we look forward to reporting back next quarter with our fourth-quarter results and the initiation of our 2014 annual guidance.

Now this 2013 guidance does not include the potential impact of any repurchases of common stock the Company may make, changes to future dividends, material changes to indebtedness or the potential impact of acquisitions, dispositions or store closures that may be completed or occur after the date of this press release.

That concludes our prepared comments. Mo, would you now open the call for questions?

QUESTIONS AND ANSWERS

TRANSCRIPT

Operator

(Operator Instructions) Brad Thomas, KeyBanc Capital Markets.

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

Good morning, Brad. Mo, let's move onto the next one.

Operator

Budd Bugatch, Raymond James.

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

He must be on mute or something, Mo.

Operator

Mr. Brad Thomas, are you there?

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Can you hear me?

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

Hi, Brad.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Okay. Sorry about that. Something was not working technically. I wanted to just first ask about what you guys are seeing from a competitive standpoint; we get asked about that a lot. You know, obviously when we look at your results here and see the traffic increase and the account growth, it would see that you are picking up customers and gaining market share, but do you think it's perhaps competition that is maybe nipping away a little bit at the ticket?

Mitch Fadel - *Rent-A-Center - President & COO*

Brad, This is Mitch. You know, you put it in whatever order you want, really. If you get more aggressive to gain market share, it shows up negatively in the ticket, but we are gaining the market share.

You know, we talk in this press release and in our prepared comments also about the electronics deflation continuing. In a lot of ways, our promotional activity just reflects the deflation in electronics.

Our whole ticket problem is in electronics. Whether you consider promotional activity or everyday pricing, you know, the 5% we are down -- we've crossed the line on agreements. So the agreements are down year over year. So if we are down 5% in the comp, it's all in ticket, and we can tell you it's all in electronics, and that's about half our business. So you can calculate that, that the electronics is down probably closer to 10% year over year. But that's what you're seeing out there. If you go back 15 months on electronics, they are down. We've always talked about -- and by the way, it continues, the product deflation, with the next TV technology coming out in the future, they continue to deflate the current ones. We've always talked about how we have a lot of different levers we can pull, Brad, we can lower rate or we could lower term, and obviously in the last -- so far this year, we've done a lot more rate than term to be more competitive, and it's showing up in the traffic and in our delivery count but it's coming at the expense of ticket. Had we just lowered term to make up for the deflation, it would keep our margins in line and give the customer about the same overall margin, but it wouldn't be as competitive as if we just did it off of term. So you're always trying to balance those levers.

So the short answer is competition is always probably what we look at for pricing. We feel like we're doing pretty well against our competition based on the way we are growing the market share and growing deliveries, and the agreements are now higher than they were last year, even though, remember, we started the year with a major deficit in our agreement count. We've made that up and now crossed the line. It's showing up unfortunately on the ticket side, and it will be another couple of quarters before we have enough agreements to make up for the ticket and then have a positive same-store sales sometime in 2014.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

That's helpful. And if I could just ask a follow-up on RAC Acceptance, which continues to really be a bright spot for you all. If we could just get an update on how that keep rate is trending and then perhaps how you feel about the pipeline for additional stores as we look ahead to 2014.

Mitch Fadel - *Rent-A-Center - President & COO*

I say the metrics remain consistent, both in collections and in keep rate, and we feel real good about the pipeline. We will give guidance -- I'll remind everyone we will give guidance in January for 2014 when we do our January earnings call, but the pipeline is strong. The pipeline is strong.

Like I said, we've opened 100 more through three quarters than we did last year through three quarters, and the pipeline remains strong. So, very excited about RAC Acceptance.

Overall, as I pointed out in my prepared comments, if you add the two together, we are growing the US market share. Now we are not happy with with the core is -- don't misunderstand that comment. But we are growing the US market share when you add the two together, and they are in the US, and it is a pretty similar customer base. So in some ways, you have to add them together to see what's happening to our business. It doesn't mean we're not working our butts off to get the core back into positive territory on its own, though.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Of course. Thank you very much.

Mitch Fadel - *Rent-A-Center - President & COO*

Thanks, Brad.

Operator

Your next question comes from the line of Budd Bugatch with Raymond James.

Budd Bugatch - *Raymond James & Associates - Analyst*

Can you hear me?

Mitch Fadel - *Rent-A-Center - President & COO*

Good morning, Budd.

Budd Bugatch - *Raymond James & Associates - Analyst*

Good morning, Mark. Good morning, Mitch. Good morning, David. Good morning, Robert. You've answered, I guess, my first question, which is electronics deflation. Because it is not new, and what is new is the fact that you are changing more price than term; is that what I understand?

Mark Speese - *Rent-A-Center - CEO & Chairman*

That's right, Budd. We go back to the beginning maybe late spring, and you're exactly right. Product deflation is not new, but to be more competitive and drive market share, we are doing more on the rate than term and you've got it.

Budd Bugatch - *Raymond James & Associates - Analyst*

Okay. And the operating expense in the core also went up by $7 million or so. Is that more promotional expense, or what caused that?

David Carpenter - *Rent-A-Center - VP, IR*

Budd, Some of that is the byproduct -- in Mitch's prepared comments, losses as a percentage of revenue came in higher than our historical ranges. So a few million of that increase was related to losses, and the rest is primarily utilities in the summer with air-conditioning, and the overtime hours were a little higher in the third quarter than the prior quarter just given vacations and time off.

Mitch Fadel - *Rent-A-Center - President & COO*

And then the loss number, Budd, is a couple million higher than last year, and that is part of that $7 million. We have been at 3.2% before in the third quarter. We weren't last year. Last year was on the historically low side. When we look at a range of where the third quarter runs, it will run between 2.7% and 3.2% of revenue. This is on the high side, the 3.2% I mentioned. We've been 3.2% before, though. So I don't want anyone to panic about being a 3.2% before. We have been there before. We just weren't there last year, and that's a few million of the $7 million that Robert was talking about.

Budd Bugatch - *Raymond James & Associates - Analyst*

Okay. Just two other quicker questions, I hope. One, on the change in the franchise agreement, what's the economics change, and how will we see it in reported results? Will there be a change in franchise fees, or how will that work?

Mark Speese - *Rent-A-Center - CEO & Chairman*

Yes, we'll give a lot more color on this when we have more numbers come January in that call. But yes, the franchise Rent-A-Center will cost franchisees more than ColorTyme, so there will be increases in fee revenue with the franchisees. The product markup stays about the same, so that won't change much on that side. But the royalties and fees to open stores do go up using the Rent-A-Center name versus the ColorTyme name. We'll know and give some color in January on how many stores convert over how many still have ColorTyme. There will be some left ColorTyme, although as Mark said, the majority, we believe, will end up Rent-A-Center.

Budd Bugatch - *Raymond James & Associates - Analyst*

Do you want to give us any feeling of what your thought is and how much it goes up or a quantification of that?

Mitch Fadel - *Rent-A-Center - President & COO*

Not at this time.

Budd Bugatch - *Raymond James & Associates - Analyst*

Okay. And my last question is regarding Mexico, you said I think you're on track to do a 4-wall profit breakeven by the end of the year. What about overall segment breakeven, when do we look for that to occur?

Mitch Fadel - *Rent-A-Center - President & COO*

Let me go back to your last question, though, because I might've misunderstood it. We're not giving any color we don't know where the store count is going to end up. But if you're looking for how much the fees go up, that I can tell you because that's public information already. The ColorTyme royalty rate is between 2% and 4% depending on their volume. The Rent-A-Center royalty rate will be between 4% and 6%, so basically it goes up 2 points.

Budd Bugatch - *Raymond James & Associates - Analyst*

That was what I was looking for on that. And then on international, I'm looking for when we might get to a breakeven for the segment in Mexico.

Mitch Fadel - *Rent-A-Center - President & COO*

Yes, the 4-wall breakeven at the store level does not include overhead, and then given our ramp-up in new stores that we expect to continue throughout next year and beyond, it will be sometime out before there is segment breakeven. If we stopped opening stores, that segment breakeven would accelerate must sooner. But just given the outlook and the positive framework in that country, we intend to continue to open stores. As you know, the new store economics there is a drag in earnings when you open new stores.

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

And we would expect it to be accretive every year relative to --

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Mitch Fadel - *Rent-A-Center - President & COO*

Yes, there will be less deletion each year going forward, but just overall profit is a few years.

Budd Bugatch - *Raymond James & Associates - Analyst*

And the positive sign will occur in 2015 at 2016, or was it longer than that?

Mark Speese - *Rent-A-Center - CEO & Chairman*

We haven't given that specific direction because it depends on store count, and we will continue to evaluate the new store opportunity each year. We do expect it to increase from 60 this year to a larger number next year, but we will provide more guidance for that in the first quarter in January.

Budd Bugatch - *Raymond James & Associates - Analyst*

I'll keep trying. Thank you very much and good luck.

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

Hey, Budd. Just, you may know that we are planning an Investor Day in February that will be another 5-year look, and I suspect at that point there will obviously be some assumptions in terms of the number of openings and so forth. But we will create a waterfall that will answer the question you are asking. But we're going to wait and do that in the Investor Day presentation in February when we provide a full 5-year look on all the various businesses.

Budd Bugatch - *Raymond James & Associates - Analyst*

That will be great, Mark. We look forward to that. Thank you very much.

Mark Speese - *Rent-A-Center - CEO & Chairman*

Thanks, Budd.

Operator

Laura Champine, Canaccord.

Laura Champine - *Canaccord Genuity - Analyst*

The deliveries are moving up faster than dollar sales. We are seeing that some pressure on the salary and other expense line is going to extend into 2014. Can you comment on how long it will take before you start see leverage on that line again and what kind of a comp you would need to do that?

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

Laura, we didn't hear the very beginning of your question. You came on late. Would you mind repeating it, please? We're sorry about that.

Laura Champine - *Canaccord Genuity - Analyst*

Sure. Because deliveries are growing faster than sales and the charge-off rate is higher too, we are just assuming that there will be continued pressure on margins next year on the salary and other line as you collect from those contracts. Can you comment on what kind of a comp you would need to see to see margins flat, and do you also think that you will see pressure on that expense line in 2014?

Mark Speese - *Rent-A-Center - CEO & Chairman*

We don't expect pressure on that line by increased deliveries. Obviously there's additional costs associated with more deliveries, so to speak, but not materially in regards to leverage, if you will. We've always talked about needing a 1% or 2% comp in regards to needing to leverage our fixed cost business model, if you will. So we're not anticipating increase pressure on that line going into the next year.

Mitch Fadel - *Rent-A-Center - President & COO*

And sequentially, as you pointed out, Robert, the EBITDA margins you would expect it sequentially in the fourth quarter to be up 200 basis points.

Mark Speese - *Rent-A-Center - CEO & Chairman*

Right. Right.

Laura Champine - *Canaccord Genuity - Analyst*

Okay. Thank you.

Mark Speese - *Rent-A-Center - CEO & Chairman*

Thanks, Laura.

Operator

Bruce Zessar, Advisory Research.

Bruce Zessar - *Advisory Research - Analyst*

I had a question regarding RAC Acceptance versus the core business. You've said in the past that you haven't seen much in the way of cannibalization as RAC Acceptance has grown relative to the core unit. But with the results in the third quarter, is there any evidence that may be undercutting that thesis? In fact, as RAC Acceptance is growing more, that that is cutting into the core business?

Mitch Fadel - *Rent-A-Center - President & COO*

This is Mitch. There's a couple of reasons why we don't think it is -- certainly not materially.

One, our deliveries are higher, and we've got more agreements on rent, and we don't see a way that it would actually be affecting the promotional activity, which is generally being costs in a lot of ways by product deflation and electronics. so that's really not the reason why the ticket is down and we are up in customers.

The other thing we do, Bruce, is we've get names of all of our customers. So we can book at overlap, whether the customer ever was with us before, and if they are with RAC Acceptance now, have they ever done business with Rent-A-Center and vice versa? And it's very, very de minimis, the overlap there.

Now what we can't track is opportunity; right? When somebody leaves the national furniture store, have they gotten turned down for a credit, and RAC Acceptance wasn't in there, would they have gone to Rent-A-Center? It's hard to track the opportunity costs -- or opportunity potential there. But by name, there is very little overlap, and again, just based on the way we are doing more deliveries, when it's a ticket problem, we wouldn't relate that to RAC Acceptance.

Bruce Zessar - *Advisory Research - Analyst*

Okay. Thank you.

Mark Speese - *Rent-A-Center - CEO & Chairman*

Thanks, Bruce.

Operator

Arvind Bhatia, Stern Agee.

Brett Strauser - *Sterne, Agee & Leach, Inc. - Analyst*

Hey, guys. This is Brett Strauser in for Arvind.

Mark Speese - *Rent-A-Center - CEO & Chairman*

Hi, Brett.

Brett Strauser - *Sterne, Agee & Leach, Inc. - Analyst*

A couple of questions here. I'm wondering if you could talk about how much the gross margin in your core business benefited from the lower level of EPOs?

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

About 30 basis points year over year we are up.

Mark Speese - *Rent-A-Center - CEO & Chairman*

And it is reflective of the mix and the sales mix change. Because merchandise sales are less of the overall revenues than they were before. So, as you know, those are lower margin revenues, and so yes, there is some pickup in the overall gross margin due to less sales.

Brett Strauser - *Sterne, Agee & Leach, Inc. - Analyst*

All right. As you rebrand these franchisees, does this mean that -- will there be any opportunity for them to participate in RAC Acceptance in terms of handling any product returns?

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

That's not the plan right now. We haven't gotten that far. As far as how RAC Acceptance might relate to franchisees in the future, this is not something we've addressed at this point. So right now the answer is no. Obviously it could in the future end up tying into our franchise business, but right now we don't have it tying into the franchise business.

Brett Strauser - *Sterne, Agee & Leach, Inc. - Analyst*

Okay. And one last one for me. Last quarter you talked about a virtual kiosk or an online business model that may be in the works, and I'm wondering if you could provide any update there?

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

We are working on that. We continue to work on it. We don't have any specific updates. I think by the January call or certainly in the Investor Day that Mark was referring to earlier, we will have an update on that business model for the next 5 years and how a virtual model will play into that model. For right now, we would just tell you we are continuing to work on it and seriously work on it, and we will have more of an update in January and February.

Brett Strauser - *Sterne, Agee & Leach, Inc. - Analyst*

Okay. Thanks, guys.

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

Thanks, Brett.

Operator

Jon Braatz, Kansas City Capital.

Jon Braatz - *Kansas City Capital Associates - Analyst*

One question. Given the weakness in the core operations and maybe an uncertainty about when your customers are going to return again, are there more stores maybe failing to meet the hurdle rate, and could we see some additional store closings beyond maybe what we've seen before -- closings or mergers with other stores? Did we see that pick up a bit going forward?

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

We are not anticipating that going forward it right now, John. And your point is a good one.

Having said that, actually the individual stores are handling more traffic and more customers, which actually goes the other way; right? Albeit pricing is down, so we are not leveraging the fixed costs as much as we would have otherwise. The fact is we are actually handling more transactions and serving more customers today in the stores that we have.

So, as we sit here today, the answer is no. And, again, we think there is an opportunity to grow further into this given the traffic that we've been seeing and the stabilization in pricing and so forth. I think that goes maybe to the question that Laura was asking a while ago about leveraging the fixed costs. I think we, as Robert said, going into our seasonally strongest fourth quarter, as I sit here today, I would tell you the quarter we've just come out would be the low watermark, if you will. We expect it to improve from here.

Mark Speese - *Rent-A-Center - CEO & Chairman*

In my prepared comments, we expect 2013 to be the valley in terms of margins and profit.

Jon Braatz - *Kansas City Capital Associates - Analyst*

Thank you, gentlemen.

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

We continue to evaluate individual stores and their performance, and as you've seen, we've done handholds, if you will, each quarter. I don't expect that to change, but I would not suggest that you think about a larger consolidation plan of some type. No.

Jon Braatz - *Kansas City Capital Associates - Analyst*

Okay. Thank you.

Operator

Carla Casella, JPMorgan.

Carla Casella - *JPMorgan - Analyst*

The question has been answered, but did you say how long you expect the ColorTyme transition to take, the buy/sell transactions?

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

I don't think we did, Carla. It should be done by the end of the year, or there may be a few roll over into early next year. So by the January call, we will have a real good handle on the exact numbers of how many converted and so forth. So by the January call, it will be if not 100% done, then in the 90% range being done.

Carla Casella - *JPMorgan - Analyst*

Okay. And then the cost to convert on a per store basis?

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

We are picking up a lot of that rebranding, and that's why we see the potential for a $1 million to $3 million restructuring charge in the fourth quarter.

Carla Casella - *JPMorgan - Analyst*

Okay. So it sounds like that would run through SG&A then instead of just CapEx. Is there any capital expenditures needed?

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

Yes, there will be some additional capital as well, you know, in a similar range; $1 million maybe.

Carla Casella - *JPMorgan - Analyst*

Okay. Okay. Great. That's all I had. Thanks.

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

Thanks, Carla.

Operator

Chuck Ross, Inside Investments.

Chuck Ross - *Inside Investments - Analyst*

In Mexico revenues are obviously up a whole lot. Operating profit or operating loss did not improve a whole lot. It is strictly because of the large number of openings this year, or is there anything else going on there?

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

It is because of the large number of openings. Our stores, as they are maturing, are running, generally speaking, anyhow on the model. They are improving, and stores get profitable as they age. So yes, it's because of the openings.

And as I mentioned earlier, we frontloaded them more so than last year by getting all 60 opened this year before the fourth quarter, so they were open by the best time of year. So that's what you are seeing there is the opening schedule being pretty heavy.

Chuck Ross - *Inside Investments - Analyst*

Okay. If we can just step back a little bit and take a little longer view, I look back to 2010 when the economy was also very, very weak, and yet the core business had much higher operating profit than this year. Are there some reasons beyond what you've already talked about going on this year? Are there any systemic issues that you are aware of?

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

No, I think the product deflation is the biggest one. We did lose -- go back to the beginning of this year when we talked about starting out the year, quite a bit behind in our agreement portfolio quite a bit. So this started really last year as far as we just lost ground last year, and because of the recurring revenue nature of our business, it rolled into this year.

Now we've crossed that line as far as now we have more agreements on it than last year and though we've had to do it with lower pricing by lowering rate rather than just lowering terms with this deflation.

So I think it really started last year, Chuck, in that we lost agreements last year, started this year behind the eight ball. We've made up the agreements, but we haven't made up the revenue just yet and that will come. And obviously we need even more agreements to make up for the lower tickets.

Chuck Ross - *Inside Investments - Analyst*

Right.

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

Also, a little bit of the way our business model works, 2009 actually was a pretty good year for us. The results of 2009 showed up in 2010 because you have to build that portfolio of accounts and so forth. We had a pretty rough 2008. We actually had a quite good 2009 from a portfolio standpoint, and then it showed itself in 2010's results. Just because of how our business works, building an annuity, if you will, with recurring revenue off the portfolio.

Chuck Ross - *Inside Investments - Analyst*

Okay. Lastly, you have mentioned twice that you expect this year to be the valley in earnings and margin. But to be honest with you, I'm not real clear on why next year is going to be better. So I'm afraid I'm going to ask you to quickly run through that one more time.

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

We will obviously provide more color in January. But given the fact that our agreement count has now passed last year and the price has stabilized more recently from a trend perspective, going into the fourth quarter, our seasonally best quarter, we will grow our overall portfolio, and that will allow us to have a shot in the arm, so to speak, in the core business going into 2014. Coupled with the RAC Acceptance business maturing, continuing to mature and the flow through on the incremental revenue from RAC Acceptance are two of the big primary reasons that 2014 will be an improvement over 2013. But, again, we will provide additional color more specifically in January.

David Carpenter - *Rent-A-Center - VP, IR*

Remember, Chuck, we talked earlier about the sales numbers being down because the early purchase options are running behind. The fourth quarter, we are going to be right around flat with rental and fee revenue in the quarter. So if you get back to flat and you seasonally add all the customers in the agreements that Robert was referring to in our best quarter, the fourth quarter, it gives you momentum going into next year. We are going to be back to about flat anyhow, and with those extra agreements, you can see how next year would be positive sales numbers. Without any changes -- any material changes to the expense base, that's why this year is going to be a valley.

Chuck Ross - *Inside Investments - Analyst*

Okay. And Mexico is expected to lose less money next year (multiple speakers)

David Carpenter - *Rent-A-Center - VP, IR*

(multiple speakers) That's correct.

Chuck Ross - *Inside Investments - Analyst*

All right. Thank you.

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

Thanks, Chuck.

Operator

Barry Haimes, Sage Asset Management.

Barry Haimes - *Sage Asset Management - Analyst*

Thanks very much. I had two questions, I guess.

One with the pressure on term and rate that you talked about in terms of promotions, that could be two issues. One, more supply. So greater square footage growth in the industry could be putting the pressure on, and then the second, of course, is pressure on the core customer. So I wonder if you could talk a little bit about where you think that pressure is coming from.

And then my second question was just to get a feel for the age of inventory in the stores, is it skewing a little older as people give back more goods, or is it sort of in the range of normal? Thanks.

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

Sure, Barry. I think the answer to the first part of your question is primarily the pressures on our core customer. The square footage in the industry hasn't changed materially over the last couple of years. There's a few new stores. We bought stores too and merged the accounts into ours.

So overall it is not so much the supply or a lot more places to go shop or rent to own store. It's mostly the pressure on the core customer. And on the inventory, it's about the same. We're not -- you can see the overall inventory numbers are a whole lot better than they were a year ago with the idle inventory, the held for rent inventory staying the same as last year, yet $40 million more on rent in the core, which certainly speaks to that portfolio being up, right? But from an age standpoint, there's nothing -- no material changes in the age of the inventory either.

David Carpenter - *Rent-A-Center - VP, IR*

I was just going to add going back a couple of years anyways, we talked earlier about deflation being managed through rate and term, and historically we have been primarily focus on term. Our average age of inventory in the system today is less than it was a few years ago as we were reducing term primarily.

So the overall fleet of inventory, if you will, is cycling through the stores faster, which speaks to, I guess, the inverse of your assumption there about age of inventory being old.

Barry Haimes - *Sage Asset Management - Analyst*

Terrific. Thanks very much. Appreciate it.

Operator

Seth Rosen, Eminence Capital.

Seth Rosen - *Eminence Capital - Analyst*

Just in reference to the comment that the impact on discounting has been more on rate rather than term. Can you just explain how that manifests itself through the P&L?

So, what I mean by that is, if we've only been more promotional for 3 months or so, does it take a full 18 months or the average duration of the contract to cycle through the impact? Or is the nature of the promotions more of the kind where you give the first month free so it is all impacted in the current quarter.

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

In the pricing -- I mean, product deflation has been around longer than just this quarter. So it goes back a ways before this quarter.

Where we started lowering rate more than lowering term goes back to about April 1. With our average life of an agreement running in the 4.5 month range in our system, that's why we're seeing a leveling off of that ticket now that Robert mentioned earlier. So we've probably been lowering more rate -- on electronics lowering rate more than term now for about 6 months, and we've cycled through that, which is why we're seeing the leveling off that Robert referred to.

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

And the way it sort of manifests itself through the P&L is strictly through revenue and to some extent margin. And if we were more focused on term, that might impact working capital and cash flow a little differently. But given the fact that the inventory has really been managed through the rate and not terms is primarily through the revenue line as opposed to working capital in the balance sheet.

David Carpenter - *Rent-A-Center - VP, IR*

And the fact that you can still make your normal percentage margin on product, but when they are deflating, the dollars are lower. And when we take them off the monthly rate, that's where the revenue per month is down about 5% on the ticket.

Seth Rosen - *Eminence Capital - Analyst*

Okay. And then your guidance for the fourth quarter that the margins would be up 200 bps, EBITDA margins in the core, so that's down 200 bps year over year, up 200 bps sequentially. Should we expect a similar profile to this third quarter that gross margins are up and that the EBITDA margins are down, or will the makeup be different?

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

Well, the prepared comments of the 200 basis points up sequentially was consolidated, not focused on the core, but we would expect the core margins to expand in the fourth quarter over the third as well.

Seth Rosen - *Eminence Capital - Analyst*

Okay. And the same dynamic with gross margins being up delevering on the SG&A?

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

Yes.

Seth Rosen - *Eminence Capital - Analyst*

Okay. Thanks.

Operator

John Baugh, Stifel.

John Baugh - *Stifel Nicolaus - Analyst*

Thank you for taking my question. So I just wanted to hone in on the core again and discuss the margin and your confidence that 2014 will be up. So it sounds like because the portfolio is being rebuilt to some degree, you are going to back off of the discounting on the rate like soon or in the fourth quarter. That's the first question.

And then secondly, do you not as RAC continues to grow absorb on the returns that you're seeing from RAC with increased seeing losses to some degree to get funneled through the core business on that return merchandise? Thank you.

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

First, John, on the pricing, as we said, it's leveled off already from when we started lowering rate rather than only lowering term on these electronics -- on this electronics deflation issue. So we've already seen that level off, and that's what gives us confidence going forward as well. As we've rebuilt the portfolio and now that we've leveled off, for a number of weeks, it has stayed about the same.

And RAC Acceptance, as they grow, we get more products. Fortunately their metrics have stayed very similar in that the returns are very low, and we haven't had a problem putting the product in our stores, rerunning it. It's still in the 30 to 40 basis point range as far as the impact it has on the core business depreciation when we look at that with it all coming back in. If it does, we can rent it. It goes out at a higher margin because we paid more for it, as you know. You know, in that 30 to 40 basis point range is all the overall effect is on the core business.

So not much of an effect there, obviously not when you calculate the overall profit. If you take, you know, that range of 30 to 40 basis points on the core business and then figure out what RAC Acceptance is making, it is still a great model for getting rid of the product. And only when we calculate the profit of RAC Acceptance, what it does to the margin in the core, that 30, 40 basis points, it obviously is in. The 30 or 40 basis points doesn't calculate very much against all the profit the RAC Acceptance makes in the first place.

Mark Speese - *Rent-A-Center - CEO & Chairman*

And, in fact, Mitch and John, the gross profit margin in the core has actually increased each quarter this year. So even with that impact from the RAC merchandise, gross profit margins are improving at the core.

John Baugh - *Stifel Nicolaus - Analyst*

Great. And then just secondly, anything going on on the regulatory front either within Rent-A-Center dealing with the various entities or industrywide?

Robert Davis - *Rent-A-Center - EVP, Finance, CFO & Treasurer*

No, there's not. From a legislative standpoint, nothing unusual, abnormal or significant for them that are going on as we speak. So, no things are pretty quiet in pretty good shape.

John Baugh - *Stifel Nicolaus - Analyst*

Great. Thank you, Mark. Good luck.

Operator

And at this time, there are no further questions. I would like the hand the call to Mr. Mark Speese for his summary comments.

Mark Speese - *Rent-A-Center - CEO & Chairman*

Thank you, Mo. Well, ladies and gentlemen, thank you again for joining us this morning. As I started my comments, we disappointed with our results in the third quarter and yet, at the same time, we are introduced, we are excited about what we're seeing. We are successfully driving traffic into our stores. The portfolio is larger than has been previously. Pricing has been the issue, and we've seen a fair amount of stabilization there. We recognize we have got work to do in the core, but we think we're in a good position to continue driving traffic.

And the next line that we have the cross, if you will, is the value of that portfolio. So the size is now bigger, and when we make the value of it bigger, that's when it is going to show up in a very positive way, and we believe we are on a path of doing that. It is going to take another quarter or two to do so.

The emerging businesses, a lot of enthusiasm, a lot of excitement and a lot of good things going on there. You heard Mitch say clearly RAC Acceptance performing well. The demand pipeline remains strong. So we are optimistic about what we can continue to do there.

In Mexico, again, a different story, but an exciting one also. It's performing generally in line with our expectations. We are getting ready to go into Mexico City in the first of the year, and we will be breaking even at the 4 walls later this year. So, again, we feel excited about the long-term prospects there.

So, as always, we appreciate your interest. We appreciate your support, and we look forward to reporting back to you at the end of the year with our fiscal results and hopefully an opportunity to see all of your February at our Investor Day that will have more information coming on that.

So thanks again, and we will talk to you next quarter.

Operator

And ladies and gentlemen, with this, we conclude today's presentation. We thank you for joining. You may now disconnect.
