THOMSON REUTERS STREETEVENTS

EDITED TRANSCRIPT

RCII - Q3 2014 Rent-A-Center Inc Earnings Call

EVENT DATE/TIME: OCTOBER 21, 2014 / 2:45PM GMT

OVERVIEW:

Co. reported 3Q14 total revenues of $769.5m and operating profit of $45.5m.

THOMSON REUTERS

CORPORATE PARTICIPANTS

David Carpenter *Rent-A-Center, Inc. - VP of IR*

Robert Davis *Rent-A-Center, Inc. - CEO*

Mitch Fadel *Rent-A-Center, Inc. - President and COO*

Guy Constant *Rent-A-Center, Inc. - EVP Finance, CFO and Treasurer*

CONFERENCE CALL PARTICIPANTS

Brad Thomas *KeyBanc Capital Markets - Analyst*

Budd Bugatch *Raymond James & Associates, Inc. - Analyst*

John Baugh *Stifel Nicolaus - Analyst*

Laura Champine *Canaccord Genuity - Analyst*

John Rowan *Sidoti & Company - Analyst*

Carla Casella *JPMorgan - Analyst*

Jon Braatz *Kansas City Capital - Analyst*

William Reuter *Bank of America Merrill Lynch - Analyst*

Karru Martinson *Deutsche Bank - Analyst*

PRESENTATION

Operator

Good morning, and thank you for holding. Welcome to Rent-A-Center's third-quarter 2014 earnings release conference call. (Operator Instructions). As a reminder, this conference call is being recorded Tuesday, October 21, 2014. Your speakers today are Mr. Robert Davis, Chief Executive Officer of Rent-A-Center; Mr. Mitch Fadel, President and Chief Operating Officer; Guy Constant, Executive Vice President Finance and Chief Financial Officer; and Mr. David Carpenter, Vice President of Investor Relations.

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

David Carpenter - *Rent-A-Center, Inc. - VP of IR*

Thank you, Stephanie. 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 statistical 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, a 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 forecast 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 press release issued yesterday as well as our annual report on Form 10-K for the year ended December 31, 2013, and our quarterly reports on Form 10-Q for the quarters ended March 31, 2014, and June 30, 2014. Rent-A-Center undertakes no obligation to publicly update or revise any forward-looking statements.

I'd now like to turn the conference call over to Robert. Robert?

Robert Davis - *Rent-A-Center, Inc. - CEO*

Thank you, David, and good morning, everyone. Thank you for joining us. I will be providing a brief high-level overview and update to our multi-year plan as presented in our recent February investor day. Mitch and Guy will then provide more detail on our operations and financial results for the quarter.

Overall, given where we began the year and the challenge we have continued to face from a macro perspective, I am generally pleased with how we performed this quarter. We entered the quarter coming off a disappointing Q2. But as expected, the rollout of smart phones during the third quarter had a positive influence on the core US business performance.

In fact, we posted customer gains in both August and September in the core, to close the quarter with some momentum. It has been quite some time since that has occurred during the seasonally softer third quarter. Couple that core store performance with Acceptance Now continuing to deliver consistently strong same-store sales growth, and as a result our companywide consolidated same-store sales were positive for the second quarter in a row at 1.9%, contributing to us reporting earnings that met expectations.

However, we cannot ignore the macroeconomic pressures that continue to burden our financially constrained consumers. Therefore, we must maintain our urgency to execute on the transformation we outlined in February, with a focus on operational and infrastructure initiatives such as implementing a new flexible labor model for our core US stores, developing a new supply chain, formulating a customer-focused, value-based pricing strategy, and introducing exciting new technologies to our Acceptance Now growth engine.

Now, while all of our strategic initiatives are a very important to our success, I will highlight the four key initiatives just mentioned. As many of you realize, historically our earnings results have largely been dependent on one lever alone, and that was sales. Many of our transformational initiatives, including those four just mentioned, will provide management with many more levers to pull in various times in various economic cycles that should ultimately provide more predictability in earnings and cash flows while reducing much of the volatility we have faced in our recent past.

To begin with, we believe that nothing is more critical to the success of our business than the quality of the coworkers that interact with our customers every day. We are in the midst of a multi-faceted approach to enhancing our talent management practices, one of which calls for more flexible labor in our stores. This will enable us to more closely align cost to activities and will allow us to flex our labor [colors] up or down based on seasonality, demand, local market conditions, et cetera. This is an example of a lever that can address the cost side of the equation but could also help address sales during peak periods to ensure we have enough labor to service the customers that need the attention.

Another important initiative we are focused on is a strategic imperative within our sourcing and distribution model. A supply chain initiative to perhaps broaden our supplier base and broaden our product assortment, decreased product cost, improve the lead time for restocking our stores, enable optimal pricing strategies, redistribute assortment, and improve store operations efficiencies. As you might imagine, this initiative provides multiple levers affecting both the costs as well as the demand equations. We are very excited about this transformation and are eager to better serve our customers as a result.

Our pricing work has also proven quite encouraging and insightful. As a reminder, we are focused on shifting our pricing model from a cost-plus approach to a value-based strategy that is more focused on the customer. We currently have several pricing tests in various markets that have multiple areas of focus, such as increasing demand, increasing customer retention, and encouraging loyalty type behaviors. The data-driven capability that we are building is already providing fruitful insights that we believe will provide material benefits over time. As you might imagine, having more flexible labor costs and a more dynamic supply chain will allow pricing to become a key benefactor downstream to increase demand, if and when that is important to our customer.

The bottom line here is that our core business will now have more than just one lever to pull, and we are excited about how these initiatives will continue to come together now and over the course of the next 12 to 15 months and beyond to strengthen our foundation.

In the Acceptance Now space, you'll recall that our plan this year was to launch our first technology-based virtual kiosk and grow to 50 by year-end 2014. Given the strong lift this technology is giving our current manned locations, we expanded that plan by over tenfold and just finished putting the virtual solution in 600 of our existing manned locations, in time for the high-traffic fourth quarter.

We have similarly exciting business opportunities on numerous other fronts within Acceptance Now and are applying these technological advancements to other areas of our business as rapidly as possible, including their application in low-cost, high profit, unmanned locations. Not only is the tremendous customer response exciting for the business, but it's a strong validation of the technology itself as well as our investments to date.

In summary, while our third-quarter results met our expectations, we are maintaining our focus and discipline on executing our strategy we outlined last February. Certainly our resolve has not wavered in these challenging times, and therefore I want to express my gratitude and thank all of our coworkers for their continued dedication and hard work toward reaching our goals.

And lastly, as many of you may be aware, Dave Carpenter, our VP of Investor Relations, will retire at the end of this month after 12-plus years of service at Rent-A-Center. Dave has played an instrumental role in developing positive relationships with institutional investors and analysts alike. His professionalism and his integrity have garnered the respect and admiration of his peers, and we wish Dave all the best in this newest phase of his life. Thank you, David.

I've now like to pass the call over to Mitch.

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

Thanks, Robert. I'd also like to add my gratitude and appreciation to Dave for the last 12 years and wish him nothing but the very best in retirement. Dave, it's been a great pleasure to work with you. It really has.

And good morning, everyone on the call. Overall, we are pleased with the trends we are seeing in our business segments. Our 1.9% same-store sales number was buoyed by almost 26% comps in our Acceptance Now business, while our core business same-store sales continued to improve on a sequential basis. Robert mentioned positive customer growth in the core business in August and September, something very hard to accomplish in the summer months in this business.

Let me add to that. Delivery trends have also run positive on a year-over-year basis in September and so far in October. Therefore, we continue to expect same-store sales to continue to get better on a sequential basis. We've seen this improvement in almost all of our product categories while our newest category, smart phones, has obviously helped. You'll recall we launched smart phones nationwide in July, offering some of the world's best phones along with unlimited talk, text, and data with the flexibility and convenience of no-contract service in our rent-to-own agreement.

In fact, we receive the latest and greatest phones at the same time as other national retailers. By way of example, we launched the Samsung Note 4 last week on the same date it was launched nationwide at retail.

Our collections in the core for the quarter were about where we expected them to be for our seasonality tougher summer months. Our rent-to-own skips and stolens came in for the quarter at 3.4%. Although that was 30 basis points higher than last summer, about 2/3 of the increase was due to the customary establishment of loss reserves related to the addition of smart phones.

Our inventory held for rent in the quarter is running higher than last year due to the additional smart phone inventory. Without smart phones, we ended the quarter at 27.1% of inventory held for rent, essentially flat with last year.

As Robert mentioned, we remain focused on our long-term growth initiatives. The first phase of testing our new labor model will start next month. We continue to believe there are significant labor savings in a more flexible, no-overtime model. Having said that, realization of these benefits will not happen immediately. We think it's very prudent to test this carefully and ensure no disruption to the top-line performance. In fact, we're optimistic that it could enhance our top-line performance, so, again, our first phase of testing will begin in November.

We're also well underway in implementing our new sourcing and distribution model. In the first half of 2015, will be up and running with a third-party-run distribution network dedicated solely to our business. And as Robert mentioned, this will improve our out-of-stock rates, expand the product lines available to us, and get products in our stores at a lower cost. It's a very exciting initiative, one that will begin to pay dividends for us next year.

The third major focus for us in the transformation of our core business is the ongoing development of a customer-centric pricing model. As most of you know, we have multiple levers to pull within our pricing structure. We currently have numerous pricing tests going on in our stores to see which ones drive demand the best or increase retention the most, all while protecting our bottom line. We're excited with some of the things we're seeing here, and we believe will have some demand and retention enhancing pricing initiatives to roll out throughout 2015.

Acceptance Now had another very strong quarter with their 25.7% comp, helping us grow the overall US rental market by about 1% year over year. Our customer key freight metrics remain in line with our expectations and with our historical averages. Additionally, as Robert pointed out, our new virtual technology is now in approximately 600 of our existing Acceptance Now locations, as we continue to enhance our offerings in our retail partner business. Another solid quarter in Acceptance Now, and we have some very exciting business opportunities on numerous fronts as we apply those technological advancements, especially their application in a low-cost, high profit, unmanned solution.

In Mexico, we had a 25.9% quarterly comp on almost 57% revenue growth year over year, and we cut almost $3 million out of our operating losses in that new growth initiative on a year-over-year basis. While there are some challenges operating in Mexico, we remain excited about what this growth vehicle can do for us down the road.

Overall, a good quarter. Our total and core comps have improved for three straight quarters. Business trends have strengthened the last six to eight weeks, and the four key initiatives mentioned that will help us further stabilize and grow the core while providing more growth opportunities in in our Acceptance Now segment all remain on track.

I'd like to also thank our 20,000-plus coworkers for all of their efforts in this improvement we are seeing, and for all their hard work every day.

And with that, I will turn it over to Guy.

Guy Constant - *Rent-A-Center, Inc. - EVP Finance, CFO and Treasurer*

Thank you, Mitch, and good morning, everyone. This morning I will walk you through our financial results for the third quarter, after which we will open up the call for your questions. I would also like to mention that as I refer to our third-quarter performance, either this year or versus a year ago, all numbers will be presented on a recurring basis, excluding special items.

As outlined in the press release, total revenues were $769.5 million, which represents a 2% increase, driven by revenue increases in our Acceptance Now and Mexico segments, offset by a revenue decrease in our core US retail segment, partially due to the 150-store consolidation we completed in the second quarter. Same-store sales increased 1.9% in the third quarter as compared to a year ago, driven by increases of more than 25% in both our Acceptance Now and Mexico businesses, partially offset by a 3.6% decrease in our core US retail segment.

Our total US same-store sales, when you include all of our US formats, was up for 1.4% versus a year ago, despite the challenging retail environment. We are encouraged that our third-quarter same-store sales numbers represent a sequential improvement of 130 basis points versus the year-over-year change seen in the second quarter. This improvement was assisted by our national rollout of smart phones. And on a two-year basis, same-store sales have again shown a sequential improvement versus the previous quarter, both in the core US business and for the enterprise as a whole. In fact, since the first quarter, two-year comp sales have improved over 600 basis points.

Turning to the expense side of the business, gross profit margin fell 90 basis points to 69.2%, primarily driven by a higher mix of sales in our Acceptance Now business. Salaries and other expenses increased by $8 million but were flat year over year as a percent of revenue. General and administrative expenses increased by $4.6 million to $41.6 million, an increase of 50 basis points due to investment at the field support center to support expansion in our Acceptance Now segment and to support the initiatives that Robert and Mitch outlined earlier.

Operating profit was $45.5 million, a decline of 150 basis points, driven by lower gross margin and higher G&A expenses year over year. EBITDA margin for the quarter saw similar declines.

Interest expense was $12 million, an increase of $1 million versus a year ago, driven by increased debt and a higher rate on our senior credit facility. The third-quarter tax rate was better than expected, driven by a number of activities and outcomes, including improved compliance and follow-through on our employment tax credits, the reduction of reserves related to fixed assets, and the conclusion of litigation related to our 2006 audit year. The net impact of these factors resulted in a tax rate of about 23% for the quarter. We do not expect this level of favorability to recur in the fourth quarter.

We also had a handful of special items in the quarter, which essentially netted out to have only a small impact on overall results. Above the gross profit line, we recognized a $7.1 million settlement related to the manufacture of LCD screen displays. Below gross profit, we saw one-time charges related to the impairment of internally developed software, severance costs stemming from a recent corporate reorganization, and additional costs related to the store closures that took place in the second quarter.

We will make our 18th consecutive quarterly cash dividend payout later this week on October 23, and we ended the quarter with approximately $62 million in cash on hand. And our quarter-ending leverage ratio was 3.43, well below our covenant requirement of 4.5, leaving us well positioned to execute on our initiatives.

And as we outlined in the release, our expectations of performance for the business for the balance of the year are consistent with what we outlined a quarter ago.

With that, I'll ask Stephanie to open the line for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Brad Thomas, KeyBanc Capital Markets.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

To Dave, I just wanted to thank you for helping us for so many years and wish you all the best in your retirement.

David Carpenter - *Rent-A-Center, Inc. - VP of IR*

Thank you.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

My first question was just going to be about the core segment. And perhaps if you could provide a little bit more commentary around profitability within the core, recognizing that there are a number of investments that you presumably made during the quarter, such as the rollout of smart phones, the work with Deloitte Consulting, for example. Could you maybe talk a little bit more about the puts and the takes on the profitability within the core?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

Well, I'll start out, Brad. This is Mitch. Certainly the negative same-store sales number, albeit better sequentially, still puts pressure on the margins. We don't have enough flexibility in our cost structure, which is really what drives the initiatives. That's why we're working on some of the initiatives we're working on. We're too highly dependent on the revenue side of the business and not flexible enough on the cost side. Primarily that relates to the initiative we're working on from a labor standpoint, getting overtime out of the model and getting flexibility in the model with part-time labor and so forth.

So, though it is better sequentially, we're not happy with it, with the actual margins. We've got to get flexibility in our model. That's what we're working on. You're right; there's more of a cost up front to work on that than there is a benefit. We're spending some money figuring this out and testing and using some consulting help. So, though it is better sequentially, we take some comfort in that. We've got initiatives to work on so that we're not quite as dependent on same-store sales either driving leverage up or down, like it has been throughout our history.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Okay. And then with respect to the store closures that you did in 2Q, is it possible to quantify what the benefit to earnings was in the third quarter from those closures?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

I think when we originally talked about that last quarter, we anticipated there being $9 million to $10 million in operating profit benefit for the balance of the year, and we are essentially in-line with that trajectory. So I would say it's about half of that number in the third quarter itself.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Okay, great. And then recognizing that you rolled out smart phones in July and did national advertising in September, if I'm not mistaken, could you maybe just talk a little bit more explicitly about what that run rate is on the core same-store sales as of the end of the quarter? It does sound like deliveries are up and customer gains are up. Where are comps running and where is your book of business as of the end of the quarter?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

Well, smart phones have done well for us. We've talked before about seeing it -- we thought from our testing results that it could get to 10% of our business. We're on track to do that. It's been a little more cannibalistic to our other categories than we anticipated, but overall we came in at the better end of our core guidance for the quarter on same-store sales. Our guidance was 3.5 to 4.5 -- minus 3.5 to minus 4.5, and we ended up at minus 3.6. So, overall, business has been really good, was good in the quarter. Again, on the high side, actually, of the estimates for same-store sales in the core.

Like I said, smart phones are doing great. A little more cannibalistic than we anticipated, but obviously when you add it all together, we're on the high side of our estimates. And based on the current trends, what happened in August and September -- gaining customers, which, as Robert pointed out, is rare in the summer months in this business; delivery trends over the last six, seven weeks. And as we said earlier in the year, we would expect the same-store sales to be essentially flat in the fourth quarter, and we didn't change our guidance. And based on the current trends we still would expect them to be essentially flat in the core in the fourth quarter.

Robert Davis - *Rent-A-Center, Inc. - CEO*

And just to add one comment, based on, I think -- relative to the overall comp in the quarter of down 3.6, each month throughout Q3, the comp did improve. So that gives us comfort in our assumptions leading into Q4 approaching flat in the core.

Guy Constant - *Rent-A-Center, Inc. - EVP Finance, CFO and Treasurer*

Yes, we're not going from 3.6 to flat. It was better than that when you look at the way the quarter played out.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Got you. That's very helpful. Thank you so much, guys.

Operator

Budd Bugatch, Raymond James.

Budd Bugatch - *Raymond James & Associates, Inc. - Analyst*

Couple of questions. I think you said, if I heard you right, Mitch, that the flex labor model test begins in November. Can you give us a size and duration of that test?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

Sure, Budd. Good morning. Yes, the first phase starts in November in a few stores. That will then roll into something in Q1 in an expanded test. We've got to test a few different concepts a few different ways. So it's a first phase. We think there's probably a couple of phases of testing before we have a model to roll out. The second phase should happen sometime probably late first quarter. And by that point in time, certainly in our guidance next year and by the end of the first quarter, we'll be able to talk more about exactly how we are performing in tests and what the rollout schedule would be and then what the savings would be off of that.

Budd Bugatch - *Raymond James & Associates, Inc. - Analyst*

Okay. So we will have essentially -- I guess the way we should look at that is maybe affecting the second half of next year, is where they -- where we might see the savings?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

At the earliest, yes. We won't know until we do some of this testing, but I would say that's the earliest, is the second half; third quarter, maybe even fourth quarter next year before we see the benefits of that.

Budd Bugatch - *Raymond James & Associates, Inc. - Analyst*

Okay. So the real benefit is really 2016 and beyond? As we get that and we get better usage of utilization and understanding of the implications, is that the way to read that?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

Yes, certainly from a full-year standpoint, for sure.

Budd Bugatch - *Raymond James & Associates, Inc. - Analyst*

Okay.

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

There will be some in 2015. But from a full-year standpoint, yes, 2016.

Budd Bugatch - *Raymond James & Associates, Inc. - Analyst*

Okay. Couple of questions on comp because I got confused, I think, by some of your comments to Brad. First, smart phones. Can you give us maybe -- can you put a number on what you think smart phones helped in the quarter, maybe gross and net, if you had cannibalization?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

No, we don't have it broken down that way, Budd. Again, they have done well. They have cannibalized a little more than we anticipated, but yet overall the business was strong. So, by definition, that would mean smart phones were actually a little stronger than we modeled if they were a little more cannibalistic. Yet we are at the high-end of our comp guidance, then again, by definition, that means they are even a little stronger than we modeled. So very confident we're going to end up at 10% of our business or more, but we don't have it broken down in how much it helped the comp and so forth.

Budd Bugatch - *Raymond James & Associates, Inc. - Analyst*

So where would you think comps would have been without smart phones? Would it have been midpoint of the guidance, or would it have been the lower end of that third-quarter guidance?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

Well, I would -- well, we had smart phones figured into our guidance. But certainly you'd have to say closer to the lower end, for sure.

Budd Bugatch - *Raymond James & Associates, Inc. - Analyst*

Okay. And then as I look at -- you said that you think by the fourth quarter -- in the fourth quarter, then comp store sales overall will be relatively flat or close to flat and the core will be close to flat. That begs the question as to what you think, then, the other concepts will be. Because based upon what we have, it would have said if you get close to flat in the quarter, the overall comp would have been significantly better than flat. So hopefully you (multiple speakers).

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

Sure, Budd. I may have misspoke; I don't know if I misspoke or you misheard me. But it essentially flat in the core, but overall same-store sales would be certainly positive based on the trends in the Acceptance Now. So, no, we don't see Acceptance Now or Mexico getting any slower from a same-store sales standpoint, so I may have misspoke earlier. But essentially flat in the fourth quarter on the core, and you can translate that to what we'd be overall from a positive standpoint. But it would certainly be better than plus 1.9% like the third quarter.

Budd Bugatch - *Raymond James & Associates, Inc. - Analyst*

Yes, sequentially better. If you're flat in the core and the others are relatively consistent, it's going to be a very nice number at the overall. Right? That's the way my math works, anyway.

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

Right, correct. Sorry if I confused you, Budd.

Budd Bugatch - *Raymond James & Associates, Inc. - Analyst*

Well, that's all right. I'm easily confused, as people who know me well have figured out a long time ago.

And lastly for me, the gross margin in Acceptance Now was, I think, the lowest in the third quarter. And I know we have seasonality and variability in that segment. But was there something going on that caused the cost of sales to be higher in Acceptance Now? And how does that portend for the future?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

Well, the gross profit was down compared to last year. It was down to roughly our 58%, which is our model on our website for that business. So the gross profit was down year over year, but only down to where we had modeled it at 58%. Part of that is our pricing structure, whether we have 90 days same as cash in the stores and so forth. And when we do 90 days same as cash, it can hurt the profit percentage, but certainly drives more gross profit dollars because it drives volume. So we're looking more at growing the dollars than the percentage.

Obviously you'd like to do both, but like I said, we're more focused on growing the overall gross profit dollars than we are the percentage. And again, it only dropped to where our model is. Last year was almost 200 basis points higher than our model in the third quarter. So if we can drive more revenue and still hit our model, we don't consider that a bad thing. The overall operating margin improved sequentially by about 240 basis points, and we expect an even better margin in the fourth quarter, and our overall operating margin to be up year over year in the fourth quarter.

So sequentially it's getting better in Acceptance Now, and the business just continues to do great from a revenue and gross profit standpoint. We're not 100% happy with the flow-through either, and we're working on some things there. And like I said, we will have a higher operating margin in the fourth quarter than what we had in the fourth quarter of last year.

Budd Bugatch - *Raymond James & Associates, Inc. - Analyst*

Great. The only thing I would note on that is first quarter is usually the lowest gross margin quarter because of EPO or early purchase. So I understand where the annual number is for the model, but the quarters do show a great deal of variation. So that was why -- that was the genesis of that question. But thank you for the answer. And David, again, good luck to you, and congratulations on a great career.

David Carpenter - *Rent-A-Center, Inc. - VP of IR*

Thank you.

Operator

John Baugh, Stifel.

John Baugh - *Stifel Nicolaus - Analyst*

Dave, congrats. I've enjoyed working with you. Good luck. Just quickly a couple things. First of all, love some commentary about Mexico, what the plan is there and whether there's any loss or breakeven projections out into next year.

Robert Davis - *Rent-A-Center, Inc. - CEO*

Sure. This is Robert, John. As you know, we've stopped opening stores as we got our 30-plus stores open in the first half of this year. The focus and intent is to take the next 12 months, starting July 1, if you will, so July 1 through June 30 of next year, to stabilize the operation and minimize the losses going forward. We will most likely not make any determination on future new-store growth until at least the end of Q2 next year as we look to get that operation profitable.

We do have forecasts for this quarter for Mexico to approach breakeven in December, and right now we are essentially in line with that forecast. As you know, the demand has been there for quite some time. We want to make sure that our bench is starting to deepen and strengthen. As we open new stores, we want to do it with tenured coworkers as opposed to new coworkers, so that's the focus over the course of the next couple of quarters through Q2 of next year.

John Baugh - *Stifel Nicolaus - Analyst*

Was that the month of December or the quarter of December, breaking even?

Robert Davis - *Rent-A-Center, Inc. - CEO*

Month.

John Baugh - *Stifel Nicolaus - Analyst*

Months? Okay. And then, if you could, the 2014 guidance you say in the release is consistent with the Q2 press release. And looking at the Q2 press release, I think there were eight different metrics you commented on, everything from comps to EBITDA, tax rates, earnings per share, et cetera. Are we to take that all of those are the same? Certainly the tax rate would be. Just curious to what numbers might have changed in there.

Guy Constant - *Rent-A-Center, Inc. - EVP Finance, CFO and Treasurer*

John, as you know, we gave some ranges around some of those numbers, and I think from our perspective we feel very comfortable that what we think will happen for the balance of the year is consistent with all of those ranges. You made the point on tax rate, and I think it's reasonable to assume the tax rate will probably be a little lower than what we assumed in terms of an annual rate now, given what happened in the third quarter. But as for the balance of the guidance, we feel very comfortable with the ranges we established back in Q2 as holding for the balance of the year.

John Baugh - *Stifel Nicolaus - Analyst*

Great. And then if I could, maybe just on the distribution initiative, how you think about that. It seems like from a cost perspective and a capital perspective, having a vendor ship directly to your store is an inexpensive way to go. But clearly you're suffering some out of stock and maybe some service issues. I'm just curious as the puts and takes on that particular initiative, particularly as it relates to the capital and expense.

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

It's a good question, John. We do believe that by using a third-party logistics distribution network that we'll get product to the store cheaper than it's getting there now at a lower cost that it's getting there now, based on buying full containers and truckloads from the vendor and then having it distributed through this third-party organization. Overall, our costs will come down. The stocks will go down. There will be an initial inventory cost -- not like an inventory cost where if we had our own DCs so we had to fill our own DCs. And we're still working on what the number will be, but there will be some initial cost to start the flow of goods that way.

We should be able to, by getting faster delivery to our stores, be able to make up for that in the inventory at the store by having lower minimums going to the store, not having to have five or six pieces at one time of one particular product come to the store, like it does now, from a vendor. So there will be some offsets. When we give our guidance at the beginning of the next year, we'll have that in our capital and in our cash flow guidance. So there will be some initial inventory next year in these warehouses. We believe we'll be able to offset it with the inventory at the store level.

But overall, even if that's a net positive where it is a little more cash sitting in inventory, at the end of the day we're going to have lower costs on a product-by-product basis in our stores, which will help us from a pricing standpoint, a growth standpoint, demand, retention, and all those things. So, our modeling of that initiative is very positive overall.

Robert Davis - *Rent-A-Center, Inc. - CEO*

And given we are leveraging a third party, there is no CapEx. We're not building anything, so most of the capital is working capital.

John Baugh - *Stifel Nicolaus - Analyst*

Got it. And my last question is on the held-for-rent, you mentioned without smart phones it would've been in line. Is that a number that's going to come back in line? Did you have to buy all of these smart phones at once in some package deal to save money, or how do I think about that going forward?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

Yes, that's a great question. Yes, they will come back in line when it gets to -- when inventory on smart phones becomes 25% of -- roughly 25% of what's on rent. But right now there's as much idle as there is on rent because, yes, we've had to secure the inventory. Things like the Note 4 rolling out last week, you get them when you can. So, yes. And actually that happens, John, with any new product we buy. If we were -- even buying a new type of TV like the ultra high-definition TVs, the 4K TVs. We've just started carrying those. And we probably have more idle than we have on rent today, so it effects it negatively and still you get enough of them on rent.

The smart phones we're calling out just because it's become a big category for us; we have rented a lot of them. But it happens every time we start a new product. This is just bigger and needs to be called out, otherwise our inventory would be 2 or 3 points higher. And we get a lot of questions on why. That's why we called out the difference.

John Baugh - *Stifel Nicolaus - Analyst*

Right. Thank you for that color, and good luck.

Operator

Laura Champine, Canaccord.

Laura Champine - *Canaccord Genuity - Analyst*

You mentioned the disappointing profitability in the Acceptance Now business in the quarter. How much did it cost that ran through the P&L to roll out the new kiosk technology? And then could you talk about some other things you're doing to improve the overall profitability of the Acceptance Now segment?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

The costs -- I don't know if you have that, Guy, as far as how much that was as far as the cost. Most of that would've been capitalized costs, developing that technology, so it probably wasn't a big part, Laura. We're working on to improve the margins. Losses is the biggest category, and though we were sequentially lower in the third quarter than the second quarter, we're higher than last year. But, again, sequentially better, and we expect that to continue in the fourth quarter. So that's part of it. A focus there that's working so far, again, and being sequentially lower third quarter over the second quarter.

And also some of the infrastructure for growth that went in the business has been on the business on the front end of the year and is done now for the year. So revenue catches up to that as we get into the fourth quarter, would be the other one. Those were the two big ones. In fact, the investment fee has already been made, and the fact that losses are sequentially coming down. And when you combine those two with the revenue growth, we'll have our best operating margin in the fourth quarter that we've had in probably two years.

Laura Champine - *Canaccord Genuity - Analyst*

You mentioned that in the core business, I think that 3.4% charge-off for skips and stolens just applies to the core business. What is that same metric for the Acceptance Now business?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

I don't have that in front of me. It will be in the Q, Laura. I don't know if these guys have it or not. Like I said, it was in my notes here, I know it was 60 basis points lower than the second quarter. It 160 basis points higher than last year, but, again, sequentially better. And Dave Carpenter is getting me the numbers right now. So like I said, these will be in the Q, but it looks like they're at 6.7%, which would have made last year 5.1%, that 160 basis points.

So, again, remember, those are always going to be higher numbers than are in the core because we pay more for the product.

David Carpenter - *Rent-A-Center, Inc. - VP of IR*

Down from Q2, the 7.7%.

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

Yes. Q2 was 7.7%, Q3 6.7%. Last year, though, in Q3 was the 5.1%, so sequentially quite a bit better but still higher than last year. And, again, they will always be higher in the core because we're paying retail for the product, and that's in our model.

Laura Champine - *Canaccord Genuity - Analyst*

Got it. And then lastly, what can you do to -- what are the initiatives that you are taking to improve that rate?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

Good question. It's all operational execution in making our calls when we need to, executing properly on when we need to be at somebody's front door, knocking on their door when they are certain number of days past due. So it's executing the plan, which they did improve in the operating team over there. Mark Denman and his team improved quite a bit in the third quarter, and we're seeing that continued improvement as we get into the fourth quarter.

Laura, I could give you a real complicated answer, but it's really just executing our program and when we're supposed be calling and when we're supposed to be running the customers that are past due.

Laura Champine - *Canaccord Genuity - Analyst*

Got it. Thank you very much.

Operator

John Rowan, Sidoti & Company.

John Rowan - *Sidoti & Company - Analyst*

Congratulations, David.

David Carpenter - *Rent-A-Center, Inc. - VP of IR*

Thank you.

John Rowan - *Sidoti & Company - Analyst*

Over the past year have you seen any discernible shift in the return rates out of Acceptance Now (multiple speakers)?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

We have not. As I mentioned, John, the metrics are staying in line with our expectation and historically as far as the returns. So no, not seeing any shift there.

John Rowan - *Sidoti & Company - Analyst*

Okay. And Mitch, I think you said about 10% of the business would be cell phones. I am assuming 10% means 10% of revenue.

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

Yes. We can get ourselves to 10% of revenue. We're on track to get there in the core; 10% of the core revenue.

John Rowan - *Sidoti & Company - Analyst*

And what other product categories are cell phones actually consuming or cannibalizing?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

The biggest one, probably won't surprise you, is the tablet business. But computers in general, primarily the tablet business. A little bit from a laptop standpoint, but primarily the tablet business.

John Rowan - *Sidoti & Company - Analyst*

Okay. And then just last question, with gas prices coming down, can you give us some historical perspective as to how that's affected your business? And if we do see lower pump prices for the remainder of the year, how does that affect you guys going forward?

Robert Davis - *Rent-A-Center, Inc. - CEO*

Well, John, I think you have heard us in the past talk about gas prices going the other direction. I think this is at least some silver lining in the current macro environment that gas prices are actually coming down. I think historically what we have talked about as gas prices increase is just two things. One, it impacts demand pretty immediately in terms of our consumers having less disposable income. But it also impacts our costs with our fleet of vehicles out there making deliveries and running accounts and doing pickups every day as well.

We certainly view the current trend in gas prices as a potential tailwind. I wouldn't suggest to you that we are overly bullish in our forecasts going forward as a result of the gas prices, primarily just given the broader macro environment that continues to be a challenge for consumers. Such as the unemployment extensions that stopped at the end of last year. Wages are not increasing for our customers throughout the course of 2014. I think everyone knows SNAP benefits decreased in November of last year.

Subprime credit is actually expanding for our consumer base, particularly on the higher end. And I'm not sure many folks are aware of this, but credit scoring now excludes medical debt and collections. And that helps increase credit stores by about 25 points, and that perhaps gives additional consumers more credit.

So, while gas prices could perhaps be a tailwind, there are still other factors that are applying a little bit of pressure on us on the other side. So we like what we're seeing in gas prices. I think it will help us more on our own cost side than it will on demand, at least in the near term, but it's a potential tailwind with some upside. But we're not forecasting bullish increases in demand as a result.

John Rowan - *Sidoti & Company - Analyst*

Perfect. Thank you very much.

Operator

Carla Casella, JPMorgan.

Carla Casella - *JPMorgan - Analyst*

One housekeeping item. If you could give us what your AVL or your revolver drawn was and the availability on it.

Guy Constant - *Rent-A-Center, Inc. - EVP Finance, CFO and Treasurer*

Yes, our revolver draw is a little under $200 million at this point, which would leave us with about $600 million of availability. So, a little less than $200 million drawn on our revolver.

Robert Davis - *Rent-A-Center, Inc. - CEO*

$600 million total (multiple speakers). $200 million drawn, is about $375 million to $380 million that's available. (Multiple speakers).

Carla Casella - *JPMorgan - Analyst*

Okay, great. And then on the pricing, now that you've done some pricing -- more studies, can you just tell us where you think in general you're too high on pricing and where you've been too low. Is there any key categories that jump out?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

Well, it's a little more complex than that, Carla, as far as what part of the pricing impacted us when we have so many different levers, in that there is a rate, there's a term to acquire ownership, there's the 90 days same as cash price percentage of overall rent-to-own amount driving the 90-days-same-as-cash prize. There's an early-purchase discount percentage that we can raise or lower. So we're playing with a lot of those things. But in general, it's about where you'd expect it to be based on what you see in retail. The most pressure is on electronics, computers and televisions, and there's a lot less pressure on appliances and furniture. Just like what you see traditional markup in retailers.

Electronics continue to deflate, and those stay under a lot of pressure. So as we think of these levers, the electronics categories are certainly more sensitive than the furniture categories.

Carla Casella - *JPMorgan - Analyst*

Okay. And then in smart phones, do you have a sense for who you are taking share from, given that you are a new entrant into that market?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

I don't. I can't tell you with any certainty. There's certainly a lot of places to get smart phones, and probably drawing a little bit from everywhere. Keep in mind that that customer -- and we may just be expanding the market, too, giving the opportunity to put a $600 retail phone in the hands of someone who may not qualify for credit for it. Could just be expanding the market. Not that those people didn't have -- don't have phones when they walk in our store now, but they might not have the smart phone they want. So, probably as much, Carla, as we're expanding the market as anything else as far as -- and then as far as the other part where we'd be taking share from people, it's probably spread out across the spectrum.

Carla Casella - *JPMorgan - Analyst*

Okay. And then just one last question on the Acceptance Now business, I know Conn's has been a big customer of yours, and I'm wondering if you're fully rolled out in Conn's and if you're seeing anything specific in that business. They've had some weaker numbers.

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

We are fully rolled out in Conn's. And I think if we're not in every store, we're in almost every store. The business with Conn's has been very good for us and continues to be very good, so we're not seeing any drop-off. If anything, it's better than it's been in the past. So overall we're very happy with that relationship and things are going very strong there.

Carla Casella - *JPMorgan - Analyst*

Okay. Thank you.

Operator

Jon Braatz, Kansas City Capital.

Jon Braatz - *Kansas City Capital - Analyst*

Mitch, a couple questions. Looking at cell phones in isolation, are cell phones more profitable, less profitable than the other product lines? And then, secondly, you mentioned you are rolling out virtual kiosks in 600 Acceptance Now. How might that change -- how is that changing the dynamics of those individual stores? And can that rollout incrementally and by itself improve the overall margins at Acceptance Now?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

Sure, Jon. The first one, phones are approximately the same. They may be 1% lower or something, but generally speaking they are about the same as our other product categories. Again, maybe slightly lower. We're forecasting slightly higher losses in that category than other products. There will be a little more damage and so forth, so when you put everything together, slightly lower but not significant.

On Acceptance Now, the virtual technology improves productivity. It's just so much faster -- in our manned locations, so much faster for the transaction now. That's helping drive more business, especially when the stores are at peak periods, like a Friday afternoon or a Saturday. We're more productive, it's faster, it's a better customer experience, so it increases the amount of deliveries they can do in a day and is increasing business.

From a margin standpoint, it eventually could help margins in that we may find we can run the stores with less labor. We're looking at that. We're just so new into it we don't know for sure yet whether we can. But I can envision a day where, if it's a more productive transaction -- a transaction only takes a few minutes rather than 45 minutes, so you should be able to lower your labor costs. And of course, as we apply it next year into what we call unmanned locations it will increase the margins quite a bit because we'll have no labor at all in the store. So today it's not helping the margins; I can see a time next year where it starts to help the actual margins.

Today, we're getting benefit from a revenue standpoint in that it helps the business. I can see down the road into next year where it can help the margin side as well.

Jon Braatz - *Kansas City Capital - Analyst*

Okay. All right. Thank you very much.

Operator

William Reuter, Bank of America Merrill Lynch.

William Reuter - *Bank of America Merrill Lynch - Analyst*

On the Acceptance Now, I was wondering whether you had had any of your partners that are exiting their relationship of any scale recently. And then what you guys see in terms of potential to expand into additional partners over the next 12 months or so.

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

Sure, William. We have not seen anyone of any scale exit the relationship. And as far as opportunities, there is lots of them. The demand is still heavy. Almost all furniture players want it in their stores as fast as we can get it there. There's certainly -- we know that other companies like Sears and Kmart have it in their store with one of our competitors, so that's certainly -- we see that as an opportunity down the road for us to try to get that business. And then there's other businesses that don't have it in their store yet that present an opportunity for us. So, suffice it to say, William, the demand is strong, and that business will continue to grow for a number, a number of years.

William Reuter - *Bank of America Merrill Lynch - Analyst*

Have you guys -- given the fact that you guys have moved into cell phones in your core, have you guys had any conversations with the wireless providers themselves?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

You know, we haven't yet. We want to make sure we can figure it out for ourselves first, because we want to make sure we can get returns, perfect getting a return, and perfect the execution of getting a return and being able to refurbish it into a like-new condition and re-box it and those kind of things. Because once we do it in Acceptance Now, we'll get returns from that business, albeit not many at a 75% keep rate, but we will get some. So, we're figuring it out for ourselves, but certainly we see that as an opportunity down the road that Acceptance Now getting in the smart phone vendors.

William Reuter - *Bank of America Merrill Lynch - Analyst*

Okay. And then just my last question, kind of on the same topic. You guys noted that you expect to have higher losses on the cell phone business. I'm wondering at what point you guys will have enough data where you can see whether your estimates around the profitability of this segment are indeed pretty similar to very slightly below some of your other categories, based upon what you guys are receiving back. So what's the timeline when you'll have enough data there?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

I would say another couple of quarters.

Robert Davis - *Rent-A-Center, Inc. - CEO*

We've got to get through Q1 with payouts anyways, to see how behaviors change during payout season, too.

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

Yes, when the income tax refunds come in. So I'd say by the end of Q1, we'd have pretty good data on whether our forecast was right. Remember, our forecast isn't based on just what we think will happen; it was based on six to nine months worth of testing in three different markets.

William Reuter - *Bank of America Merrill Lynch - Analyst*

Right. Okay, that's all for me. Thanks a lot.

Operator

Karru Martinson, Deutsche Bank.

Karru Martinson - *Deutsche Bank - Analyst*

I was just wondering, when we look at the year-ago fourth quarter, could you remind us of the weather impact in December?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

I don't recall it being a major impact for us. I don't -- fourth quarter was a little rough last year. December especially was rough for us, but I don't recall it being a weather-related issue.

Karru Martinson - *Deutsche Bank - Analyst*

Okay. So when we look at the flat comp in the core, it's really coming from those customer gains that you've seen and the momentum that you've seen coming from on a month-to-month basis?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

Absolutely, yes.

Karru Martinson - *Deutsche Bank - Analyst*

All right. When you look at the core store shopper, certainly a stressed consumer, but where is that shopper going today? Is it the Sears? Is it the Buddy's, the Aaron's, or is that shopper just not shopping right now?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

Well, our -- they are shopping with us over the last couple of months. So our trends have gotten a lot better in the customer growth. Robert mentioned gaining customers in August and September, which is hard to do in this business. We're up customers in October, so I guess they're coming back to us over the last few months. Certainly there's competitors out there they could be going to. There is lower-priced and more the discount shops. You mentioned a couple of them from a retail standpoint, and certainly there's rent-to-own competition as well.

Karru Martinson - *Deutsche Bank - Analyst*

Okay. I think on the second-quarter call, you talked about the 600 kiosks updated for technology. We've reached that goal heading here into the fourth quarter. Is there still expansion opportunity this year on the virtual technology, or is that all going to flow through next year?

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

The rest of it will be all next year. We don't want to do much in the fourth quarter; it's such a busy time of year in our retail partner stores as well as our core stores. So it would be all next year, Karru.

Karru Martinson - *Deutsche Bank - Analyst*

Okay. And just -- sorry to harp on the implied guidance for the fourth quarter, but were there any one-time charges last year that we should be mindful of? If I remember, there were a lot of moving parts last year.

Mitch Fadel - *Rent-A-Center, Inc. - President and COO*

There was some in there. Guy?

Guy Constant - *Rent-A-Center, Inc. - EVP Finance, CFO and Treasurer*

Yes, we did have -- in the fourth quarter, we had a number of issues that put some pressure on margins in the business. So certainly if you look at our quarterly results last year, the fourth quarter featured our lowest margins of the quarter. So, when Mitch commented earlier, we certainly feel strongly about margins getting better through the balance of the year. But when you look at the acceleration versus what we delivered last year, it accelerates further in part because last year felt some pressure on the margin side.

Karru Martinson - *Deutsche Bank - Analyst*

Thank you very much, guys. Appreciate it.

Operator

I'm showing that there are no further questions at this time, so I turn the call back over to Mr. Davis for closing summary.

Robert Davis - *Rent-A-Center, Inc. - CEO*

Thank you, Stephanie, and thank you all for your interest in the Company and for joining us this morning. As mentioned earlier, we are generally pleased with the quarter, but know we still have our work cut out for us, and that's why our sense of urgency remains high to execute on our initiatives and help deliver more leverage to the business to achieve more stable earnings and cash flows over time. So, thank you for joining us. We look forward to reporting back to you next quarter.

Operator

This concludes today's conference call. You may now disconnect.
