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RCII - Q4 2014 Rent-A-Center Inc Earnings Call

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OVERVIEW:

Co. reported 4Q14 total revenues of $797m. Expects 2015 consolidated total revenues to be $3.25-3.35b and diluted EPS to be $2.05-2.30.

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CORPORATE PARTICIPANTS

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PRESENTATION

Operator

Welcome to Rent-A-Center's fourth-quarter and year-end 2014 earnings release conference call. At this time, all participants are in a 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, February 3, 2015.

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 Ms. Maureen Short, Senior Vice President Finance, Investor Relations, and Treasury.

I would now like to turn the conference over to Ms. Short. Please go ahead, ma'am.

Maureen Short - *Rent-A-Center, Inc. - SVP Finance, IR, and Treasury*

Thank you, Mike. 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. [The outlines] are operational and financial results that were made in the fourth 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, 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 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 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 quarter ended March 31, 2014, June 30, 2014, and September 30, 2014. Rent-A-Center undertakes no obligation to publicly update or revise any forward-looking statements.

I would now like to turn the conference call over to Robert.

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

Thank you, Maureen, and good morning, everyone, and thank you for joining us. As you know, we are a year into an ambitious multiyear plan to improve the performance of our domestic RTO business. I will be providing a high level overview of our performance and Mitch and Guy will then provide more detail on our operations and financial results.

As I reflect back on my first year as CEO, I am proud of the progress we have made in many areas, but I know there is still a lot of work to do to transform our business and set the foundation for profitable long-term growth.

During the fourth quarter, we met our revenue expectations, excluding accounting adjustments; core US same-store sales were close to flat; and Acceptance Now continued to deliver strong, consistent same-store sales growth. This resulted in total Company same-store sales of approximately 5% for the quarter.

In addition, core US operating profit increased year over year for the first time in many quarters. However, our EPS fell short of our expectations because our margins were not as strong as projected and our skip/stolen losses were too high. In short, we did not achieve the desired balance between sales growth and margin improvement that we are ideally seeking through our strategies.

As a result, our resolve is strengthened in the pursuit of that balance and the urgency remains high in delivering on the initiatives and results that we have promised. To that end, our focus is on improving operational execution by implementing a new labor model for our core US stores, developing a new supply chain model and implementing a customer-focused, value-based pricing strategy.

And in our Acceptance Now business, we are already seeing some progress on getting skip/stolen losses back into line. And we remain excited about the growth prospects for this business, including the much anticipated rollout of virtual Acceptance Now locations.

In the fourth quarter, we made significant progress on these key initiatives. Starting with the labor model, as we have mentioned, we believe there is $20 million to $25 million of annual overtime labor savings from employing a more efficient labor model in our brick-and-mortar stores.

And in November, we launched our initial flexible labor model pilot in a handful of stores in the Dallas area. We recently concluded that pilot and have already taken those learnings to an expanded number of stores. We believe more strongly than ever that we can realize significant cost savings and provide greater staffing flexibility by introducing part time and specialized talent into the core business model.

We also believe that these changes will allow us to drive more sales by being appropriately staffed during seasonal, day of week, and daypart peaks. Although the systemwide realization of the first phase benefits, those related to the overtime premium, will not be at full run rate until the second half of 2015, we do expect to capture meaningful labor savings even in the first half of 2015 as our operators begin to implement aspects of the program.

And looking further ahead, we will utilize a more data-driven approach to determine the optimal amount of store labor hours. And we believe there is potential to unlock additional meaningful savings beyond the overtime premium through this more flexible staffing model in the future.

As for sourcing and distribution, our supply chain and logistics work continues and is on track for a second half of 2015 rollout. However, our work has already begun to pay benefits. We did recognize $10 million in cash savings in 2014, largely via optimized promotional buys and leveraging our product service centers.

During the fourth quarter, we did host our first ever Supplier Summit, with over 60 manufacturers and distributors. And we now have a contract in place with NFI, our third-party logistics provider. They will provide distribution and logistics services from a network of five DCs.

And furthermore, we are in the first of several waves of sourcing events that will optimize and rationalize our products and supplier partners and our plan is to begin moving product through the new process in the second half of this year.

This supply chain transformation will also equip us to quickly react to changes in business trends and better serve our stores and our customers. And perhaps even offer broader product lines. All of which should help drive sales as well.

Now we do expect to see an uptick in working capital in 2015 of approximately $25 million as we stand up the new model. And we will see cash savings as we complete the various sourcing events over the coming months.

However, since the cost of sales benefit will be realized as the new products go on rent, the more meaningful P&L impacts will not come until late in 2015, followed by significant run rate savings in 2016. As we go forward in 2015, we will be able to share more detail on the projected P&L impact.

As you know, we have been in the development of a massive technology project, inclusive of our core business POS system, which is critical to supporting our growth. I am excited to say the new POS system is now fully operational in its first site. This follows the successful and limitation of the back-office portion of the project last fall.

And in the coming days, the new POS system will be further deployed to its first district, with systemwide deployment to follow thereafter.

In summary, while our core strategy might look a little different now as a mature business than it might have in the past as a growth business, we are convinced that there is significant earnings growth opportunity in the quarter. In fact, both the first phase of our labor model changes and our supply chain changes provide meaningful eight-figure savings opportunities that will sharply improve core performance.

We know that there is a wrong way to cut cost in a business, one that improves short-term profits at the expense of the customer experience. We are not taking that approach.

Each of our initiatives provides the balance we seek between margin improvement and sales growth through a better customer experience. And our operators are on the front line in making that happen.

So before I turn the call over to Mitch to provide a more detail on the quarter and to talk about the exciting initiatives we have to drive revenues in the core and Acceptance Now, I would like to sincerely thank all of our hard-working coworkers for their continual dedication and commitment toward reaching our goals and for their upcoming efforts in delivering on our initiatives. I am excited to see what you can achieve in 2015. Mitch?

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

Thank you, Robert, and good morning, everyone. I will start with the core overview. Overall, Q4 was a quarter where we made some significant progress on revenues in the core business, bolstered by the strong demand we saw during the holiday season.

Smartphones grew to approximately 7% of our core US store revenue in the quarter and continued to drive new customers. We have seen some cannibalization, primarily within computers and tablets.

And although cannibalization is notoriously difficult to calculate, we estimate it to be in the range of 25% to 50%. So overall, the new product category has helped improve same-store sales in the quarter.

Our same-store sales in the quarter were essentially flat, at down 0.6%, our best number there in a couple of years. Our smartphone offering, including some of the world's best smartphones along with unlimited talk, text, and data, with the flexibility and convenience of no contract service in our rent-to-own agreement, continues to be highly sought after by customers. And we continue to believe smartphones will be about 10% of our core US revenue at maturity.

Now from a collection standpoint, our core US rent-to-own skip and stolen losses came in at 3.5% in the quarter, 80 basis points higher than the same period last year, almost completely driven by smartphones. To that end, we have taken some steps to mitigate those losses, including the registration of the unique IMEI number of each phone with a central registry to prevent the theft and monetization of phones in the secondary market. This has been effective in helping mitigate those losses.

We also will be taking future steps, including locking down phones in certain circumstances. So managing losses in the smartphone business will remain a key priority for the core business.

The bottom line on phones is they are at a lower gross margin percentage than our other products and they do have a higher loss rate. But they add incremental margin dollars into a mature business, helping us grow our overall profit dollars and our overall profit percentage.

And as we noted in the press release and as Robert mentioned, our core operating profit increased year over year for the first time in many quarters. And smartphones were a big part of that. So they might be a lower margin themselves than the other products, but when you add them onto the other product, even with a little bit of cannibalization, you end up with a higher bottom line, profit dollars, and percentage. Again, for the first time in many quarters.

Inventory held for rent is running higher than last year due to the addition of smartphone inventory and it will until we comp over the rollout time frame. Excluding smartphones, our held for rent inventory in the core was 26.8%, 30 basis points lower than last quarter.

Now as Robert mentioned, in addition to smartphones, we have some exciting initiatives to continue the top-line momentum we saw throughout 2014. From a pricing standpoint, utilizing insights from our pricing strategy work in the fourth quarter, we implemented some initial price changes in certain product categories.

And we continue to monitor the numerous pricing tests and expect increased demand, improved retention, and become more targeted in our offerings, using data and consumer insights in ways that we have not done before and to offer a customer value proposition that is better than it has been before. Some very exciting learnings that will benefit the customer for some time to come.

In the first two quarters of 2015, we will be rolling out some additional changes to our pricing strategies. Pricing within product categories is becoming more differentiated based on customer preference and the lifecycle of products.

We have many levers to pull, whether it is a rate, the number of months to acquire ownership, the 90 day same as cash pricing, early purchase option discount percentages, et cetera. No longer are these the same for every product category. We may choose to drive traffic with one, margin with another. Very exciting initiative that is transforming our business and one we believe will continue to drive more revenue and profit into our core business.

Now on to Acceptance Now. Same-store sales in Acceptance Now remained strong again in the fourth quarter. As you saw in the press release, more than 28% versus a year ago. And in addition, we opened a net 47 new locations in the quarter.

Gross margins were down 440 basis points in the quarter as compared to a year ago. This was primarily driven by the expansion of the 90-day ownership option offerings to now about 60% of our locations.

While the 90-day offerings negatively impact gross margin percentages, it also drives the needed uplift in sales to drive an increase in overall gross profit dollars, which is the most important measure in our view. And while we would expect to the expansion of this program to continue, we will continue to monitor and ensure that the overall gross profit dollar impact is in place to warrant that expansion of the program.

Since the second quarter of 2014, we have seen losses increase in Acceptance Now. Some of this is to be expected. The average age of an Acceptance Now store is 2.5 years old. So as the number of customers grows and they get farther along in their agreement, it is natural to expect losses to increase.

Also Acceptance Now has grown from what was previously almost exclusively a furniture business to now a business that is in more multi-line retailers and it is also normal to see higher losses on consumer electronics and furniture. So both those two items would result in higher losses.

However, this still does not fully explain the losses we have seen in 2014. Much of this was self inflicted and is being addressed with better execution going forward.

During the past two quarters, the Acceptance Now team has made in a huge push to improve execution and get our losses back in line. And while it takes some time for any change in loss rates to work their way through a funnel of 150 days, we have already seen signs in our pass-through numbers that our losses should get back in line by the end of the first quarter.

Let me give you some more data on that. While overall skip and stolen losses in Acceptance Now were up 170 basis points in the fourth quarter year over year, they are trending better as we speak.

December was the best month of the fourth quarter, with 100 basis point increase over the prior year. And January has also come in at about 100 basis points above the prior year. So again, 170 basis points worse than the year before for the quarter, but December was the best month, at about 100 basis points higher. And then January has come in also at about 100 basis points higher on a year-over-year basis.

So positive trends there. And additionally, when we look at our current aging, we believe we will be flat year over year by March. So these more recent trends give us confidence that we can make some meaningful improvement on what have been unacceptable losses over the past couple of quarters.

As Robert mentioned, in the Acceptance Now business, we have now deployed our iPad-based selling tool and we are in over 650 existing manned locations now. I'm pleased to report we successfully passed the Black Friday stress test without incident and even more pleased to share that the early analysis shows iPad-enhanced manned stores are realizing a significant business lift as compared to locations without the technology due to the improved customer experience and shorter transaction time.

You will also recall the original goal for this technology was to penetrate the vast market of retailers who are best suited to an unmanned technology-based solution. We expect to deliver on that expectation by beginning the rollout of the virtual kiosk in the second half of 2015, with a plan to open 1,150 new virtual locations in the latter half of this year.

We will also continue to build on the success of our staffed Acceptance Now model by opening 150 new manned locations. And we now have the ability to optimize our model and will do so by converting approximately 100 of the lower volume staffed models to the virtual unmanned model.

So in summary, in addition to our smartphone product, we believe our additional initiatives will further stabilize the core and also provide more revenue and bottom-line profit growth in our Acceptance Now segment. I would like to add my thanks to the 20,000-plus coworkers for the passion they bring to our business and their continued effort to building and satisfying customers on a daily basis. Guy?

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

Thanks, Mitch, and good morning, everyone. This morning, I will walk you through the highlights of our financial results for the fourth quarter and our 2015 and longer-term guidance. I would also like to mention that as I refer to our fourth-quarter performance, either this year or versus a year ago, all numbers will be presented on a recurring basis, excluding special items.

In addition, you will note that we made some changes to our P&L that we hope will provide you with added transparency and more insight into our business and will help drive more accountability for results. This includes separating the line previously known as salary and other expenses into two lines: store labor and other store expenses.

We also have taken all of our depreciation and amortization expense and included it as its own line on the P&L. In addition, we no longer will be allocating overhead to our segments in order to provide you greater transparency into the true performance trends of each segment.

In addition to the format changes to the P&L and in light of the current attention on revenue recognition standards, we took the opportunity this quarter to address a number of our revenue recognition policies. Although the full-year impact was only slightly negative, the overall impact of these changes lowered our fourth-quarter pre-tax earnings by approximately $3 million, including lowering total revenues by approximately $8 million, lowering cost of revenues approximately $7 million, and increasing other store expenses by approximately $2 million.

From this point forward, our reported results will incorporate these changes as will the 2015 and longer-term guidance I will detail in a few moments. In order to assist you with your modeling, analysis, and review, the past two years of quarterly history, using the new presentation format and incorporating the changes that I just outlined, have been posted on our website.

As outlined in the press release, total revenues for the fourth quarter were $797 million, which represents a 4% increase, driven by revenue increases in our Acceptance Now and Mexico segments and a stabilization of revenues in our core US retail segment, offset by the impact of about 150-store consolidation we completed in the second quarter.

We are encouraged that our fourth-quarter consolidated same-store sales numbers represent a sequential improvement of 310 basis points versus the year-over-year change seen last quarter. Our total US same-store sales, when you include all of our US formats, was up 4.4% versus a year ago, the third consecutive quarter with a year-over-year increase and representing a sequential improvement of 300 basis points when compared to last quarter.

And on a two-year basis, same-store sales in the quarter have again shown sequential improvement versus the previous quarter, up 250 basis points in Q4 versus Q3. In fact, since the first quarter, two-year comp sales in the quarter have improved by 870 basis points.

Turning to the expense side of the business, gross profit margin fell 210 basis points to 68.4%, primarily driven by a higher mix of sales in our Acceptance Now business, which comes out lower margins, particularly with the expansion of the 90-day cash option program that Mitch covered earlier.

Store labor, which includes the expenses associated with coworkers at our stores and at the district manager level, decreased by $15.4 million to 28.1% of store revenues, an improvement of 310 basis points versus last year, driven by better leverage on Acceptance Now sales, the benefit of store closures, and the reduction of labor hours at the store level.

Other store expenses, which include expenses related to occupancy, skip/stolen losses, advertising, delivery costs, and utilities, were up $12.7 million, 60 basis points worse than a year ago, driven primarily by higher losses in Acceptance Now and a higher mix of smartphones in the core business, partially offset by lower fuel prices.

Special items in the quarter consisted primarily of a reduction in revenue due to consumer refunds as a result of an operating system programming error, additional costs related to the core US store closures done in the second quarter, and store closures in Mexico that will occur in the first quarter of 2015.

We ended the quarter with approximately $46.1 million in cash and cash equivalents. Our quarter ending leverage ratio was 3.56, below our covenant requirement of 4.5. And we project that the leverage ratio has peaked and will decline throughout 2015, leaving us well positioned to execute on our initiatives.

2015 diluted earnings per share are expected to range between $2.05 and $2.30 or up 5% to 18% versus a year ago, including approximately $0.10 to $0.12 dilution related to our Mexico operations. In the first and third quarters, we expect EPS to be down more than 10% year over year, while we expect the second and fourth quarters to be up more than 20%.

We project 2015 consolidated total revenue growth of 3% to 6% or between $3.25 billion and $3.35 billion, including core same-store sales of negative 1% to positive 1%. We expect 2015 Acceptance Now total revenues between $800 million and $825 million, including comp store sales growth of 15% to 20%, 150 new manned locations, 1,150 new unmanned locations generating 2015 revenues of approximately $4 million, and the conversion of approximately 100 manned locations to unmanned locations, as well as approximately 50 closures.

Gross profit as a percent of total revenues is expected to be down 50 basis points to 100 basis points due to the full-year impact of the expansion of the 90-day cash option and Acceptance Now as well as lower cash pricing on smartphones, partially offset by product cost savings from our sourcing and distribution initiative.

We expect store labor to improve 100 to 150 basis points as a percent of store revenue, driven by sales leverage on Acceptance Now, the impact of the reduction of hours at the store level already implemented in 2014, and the introduction of our flexible labor model. Other store expenses are expected to increase 25 to 75 basis points as a percent of store revenue, driven by higher core losses due to the increasing mix of smartphones and higher advertising costs, offset by lower fuel prices and sales leverage from Acceptance Now.

General and administrative expenses are projected to total $180 million to $200 million, up versus a year ago due to incentive compensation planned at target and startup costs on our initiatives.

Over the longer term, the net effect of our current strategies and initiatives, we believe, will deliver annual consolidated revenue growth of between 3% and 5%. We project consolidated operating profit margin improvement of 400 basis points by 2017, driven by Acceptance Now sales leverage, changes to our supply chain model, and changes to our labor model. And we are establishing a target leverage ratio of 2.2 times on a debt to EBITDA basis.

With that, I will turn the call back over to Robert.

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

Thanks, Guy. And before we take your questions, let me just say again that we are not satisfied with our fourth-quarter results. We know there is work to do before we can become the reliable and predictable Company that we both desire and is worthy of your trust.

Yet even with the results of this quarter, we do see some encouraging signs. Core comp store sales were essentially flat, a sharp change in trajectory versus the negative trends of the past two years. Core operating earnings were up year over year and the flow through of profit has shown dramatic improvement since the second quarter.

Loss trends, while still high, have begun to move down on a year-over-year basis and the four trends look to be solidifying. Our key initiatives have moved from the planning stage to the implementation stage and are set to provide meaningful results in 2015.

As I said, still a lot of work to do, still a lot of improvement to make, still a lot of ground to cover, but we believe very strongly that we have the plan to execute and deliver on our promise of balanced growth of top-line revenues and margin improvement.

With that, I will ask Mike to now open the line for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Brad Thomas, KeyBanc Capital Markets.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

A couple of questions. I wanted to first dig in just on the trajectory of the core business, if I could. The comp in the core coming in as essentially right in line with your guidance.

Could you give us a little bit more color around how the smartphones performed relative to your expectations? What kind of cannibalization you are seeing and what the health of your core customer really looks like right now?

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

Sure, Brad. This is Mitch. I will take that. As we say in the press release, it is about 7% of our business, probably heading towards the 10% we have talked about since we tested smartphones a little faster than we had anticipated.

If anything, they have gone -- like I said, you use the word trajectory -- our trajectory towards 10% smartphones is probably a little faster than we modeled internally.

It has been -- there has been some cannibalization. It is pretty hard to peg that exactly how much cannibalization, because it is hard to measure intent of each customer who walks in the door. But from all the data we have in front of us, it is somewhere between 25% and 50%. It is somewhere in that range.

So it is cannibalizing, but the trajectory is good. It's -- as you can see in our forecast for next year, forecasting basically flat same-store sales coming off a year that is overall for the year minus 4%. But certainly trending better at the end of the year.

So certainly some positive stuff there and with the expense initiatives that Guy talked about from a labor standpoint, a sourcing standpoint, we can get leverage out of it. And as I mentioned also, Brad, in my prepared comments, we had a good fourth quarter. I mean, there was traffic. It was a good quarter for us.

We didn't have a revenue miss. This isn't overall a revenue miss. It is more of an expense miss, primarily on -- a little bit on operating margin and some in -- mostly in losses that, as Robert mentioned, are now going in the right direction.

So the health of the customer seems to be back, stronger than it has been over the last couple of years. At least that is what we saw in the fourth quarter and so far this year.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Great. And that leads into my second -- my follow-up question. Just around the assumptions on the losses, the skips and stolens. First of all, from a guidance standpoint, what are you assuming in terms of the 2015 guidance?

And then more just at a practical level, why do you think these issues have come up? Is it the nature of some of the new products, like the phones? Is there something changing about your consumer right now? Or has it just been execution as you've had other things going on. What do you think the big culprits have been here on the losses side?

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

I think it varies by segment. I think in the core business, it has been smartphones. They vend at a higher rate. I mentioned a couple things in my prepared comments that we've -- some we have already done and some we are going to do going forward to reduce that.

The bottom line on smartphones is they are at a lower margin, both gross margin and because of the losses, but they are helping our profit margin go up for the first time in many years because they are incremental to the business. And though they are not as high a margin as some of the other things, they are certainly -- when you add them on, you get more leverage out of the business.

So I think in the core business, it is smartphones. But we are not just sitting here using that as an excuse, saying its smartphone and we can't do anything about it.

I mentioned we are now registering them, which makes it almost impossible for consumers to monetize those phones using the central registry. And we are also in the process of working out the technology where we can lock them down, which we should have by the end of the first quarter, where we can lock them down in certain circumstances.

So working hard on the smartphones. That is the core business. On the Acceptance Now side, a little of it is normal, based on as the business matures. I think the majority of problem has been execution. Our Acceptance Now management team would say the same thing if they were talking to you. It has been execution.

Probably, Brad, we have grown fast. It is a business that did hardly no volume just five years ago. And as you see in our guidance, it is an $800 million-plus business now.

We've put new technology out there from an iPad standpoint and there has been a lot going on. So I think we went backwards from an execution standpoint, really a heavy focus in the last two quarters and we are seeing it. December was the best month of the quarter and January comes in the same way. And when we look at what is in the pipeline right now that is due to write-off in February and March, we are going to be flat -- we should be flat in March year over year.

So that has been mostly a focusing on Acceptance Now. A lot going on and it is not an excuse. It is just a fact. And the fact is we need to get better and we already are getting better.

As far as what is in the guidance for losses, I don't know if I have that specific that I can look at some numbers. Guy, do you have that right up the top of your head?

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

Yes. I think what we have in guidance for the core is that we expect losses -- we expect early in the year to see some more losses to the smartphone that we saw earlier, but we expect the overall impact to still be down or losses to be a little bit worse in the core year over year as we have the full-year impact of smartphones for the entire year.

On Acceptance Now, we actually expect that the trends that we have will continue. As Mitch outlined, we are flat -- we believe we will be flat year over year after the first quarter, when our losses were in line. You may recall that our losses got worse from the second quarter through the fourth quarter on.

And so it is our belief if we can get the losses in line by the end of the first quarter, as we expect, that we should be able to make some progress and actually have lower losses year over year for the last three quarters of the year.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Great. We know you're working on a lot of exciting things and so I wish you good luck with that.

Operator

John Baugh, Stifel Nicolas.

John Baugh - *Stifel Nicolaus - Analyst*

I was wondering if you could delve into the gross margin commentary around smartphones. With the pricing being where it is, the puts and takes on -- you mentioned it is a lower gross margin product.

Are we seeing higher early payouts on that or just walk through all the various pieces of that gross margin calculation.

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

Sure, John. Yes, it's -- when I say lower margins on those, it is primarily around the 90-day same as cash pricing to be competitive in the marketplace on no contract phones. So it is the 90-day option that is lower than our normal margins. Maybe the overall rent-to-own is a little bit lower, but it is primarily in the 90-day area. And you do get them paying out a little faster on the early purchase option.

So yes, that is where that is, is it is in the 90-day and the early purchase option arena.

John Baugh - *Stifel Nicolaus - Analyst*

Okay. And --

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

It is not like they are dramatically lower. I mean, the difference in lower -- you know our average -- when you think about gross profit, the way we calculate it between 70% and 75% on our core products. I am talking about smartphones coming in in the 65% range. It is not like it is 20 -- 200 or -- I'm sorry. 20% lower or anything like that. It is a difference between a 70% to 75% range and actually coming in at 65%.

John Baugh - *Stifel Nicolaus - Analyst*

Is there service revenue in there that would also dilute that number?

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

The service expense is in there that would reduce it some. That is certainly part of it is the higher service cost.

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

John, if you're asking about the airtime that we sell -- is that what you mean by service revenue?

John Baugh - *Stifel Nicolaus - Analyst*

Correct. And I assume that is more of a pass-through. You have a small markup on that and that would hurt your gross margin percentage.

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

I would say it comes at a very high margin because it is a commission on the sale of that product. So the revenues are -- well, they are quite good in the early months and then we land at a lower commission rate as the airtime stays on. But given there is really sort of no expense associated with that, it comes at a pretty high margin, but.

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

High margin once we get the small percentage of what the customer pays for the service.

John Baugh - *Stifel Nicolaus - Analyst*

Okay. So it actually helps gross margin. Okay. I was wondering on Mexico, the loss there surprised me. I noticed the gross margin there was down materially from where it has been. Could we just talk Mexico for a minute and what you are thinking about that business going forward?

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

This is Robert. I think as we indicated last year, we stopped deploying capital down to Mexico as of last June and wanted to allow essentially 12 months of opportunity for our operators to marinate on some of the changes that we were making to improve the overall health of that business.

We do have many markets and many stores that are very, very profitable and positive cash flow. But there are others that we believe have opportunities for improvement. And so we are going to continue to evaluate that over the course of the next six months.

And so June of 2015, we will evaluate our performance there and consider several different options of how to move forward. But right now, we are optimistic that we can make an impact and improve those results, given the initiatives. We will just be evaluating that over the first six months of this year.

John Baugh - *Stifel Nicolaus - Analyst*

Is there a traffic problem in the stores that are not doing well? Is there a specific -- loss is high? Any kind of color on what to expect?

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

Yes. I think -- and, Mitch, feel free to weigh in. I think from our perspective, it is not a traffic problem. It is more of a loss problem as well down there in Mexico and verifying (technical difficulty) in residences and things of that nature.

We are making changes in how we are addressing our operating guidelines as it relates to verification and things of that nature.

And so traffic has not been the problem, but collecting on the money and managing the losses have been. And we have got a number of initiatives to address that. And I don't know if you want to add some more color, Mitch.

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

Well, you mentioned it is primarily the initiatives really relate primarily to a different verification program than we are used to using here in the US. And not to get into much detail, but basically, you have to verify in the field versus over the phone and that changes the systems and so forth so that you can collect and control the losses.

So it is kind of reengineering our business model to really on the front end, John, the verification process is in the process of looking tremendously different. And that is the initiative that we are watching to see how that works. And we will know more by the middle of the year on what direction we should go in Mexico.

John Baugh - *Stifel Nicolaus - Analyst*

Okay. Great. And my last question, quickly, maybe for Guy, is if you are charging off 150 days, that is 5 months. And you are referencing that you think the charge-offs will be flat by the March quarter.

So you have visibility into all the delinquencies buckets going into that. Is there a thought process about giving us one or two data points in the future on delinquency trends?

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

Yes, John. As Mitch said, we have been able to see really since probably the middle of November our year-over-year past due metrics come into line versus where they were a year ago. Whereas if you would have looked at those back for the entire year of 2015, you certainly saw gaps in those two lines. Our 2014 pass-through metrics were running higher than 2013.

So by having our pass-through metrics in line sort of since early to mid November, that gives us a lot of confidence that when those come out at the end of the funnel, by February, March, end of the first quarter, that we will be back in line year over year from where we were in the first quarter of 2014, which was still an okay number.

The numbers went up in Q2, Q3, and Q4. Those are the numbers that if we can extend the trends we are seeing now, we will start to see year-over-year improvement as opposed to just lesser deterioration, which would be progress.

But in terms of specific numbers, I guess the ones I could give you are since November, our year-over-year pass-through metrics are in line with where they were a year ago.

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

And that is primarily a 30-day plus metric that we look at in that business. Because it is a monthly model, John, we look at 30-plus as the leading indicator.

John Baugh - *Stifel Nicolaus - Analyst*

And any thought about giving that on an ongoing basis or not sure you want to do that or what?

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

If we feel it would be helpful, I think, to telling the story, should it change from where we think or expect things to happen, John, we could provide you additional color. But given where we think it is going right now, I think the color we have given you today on the pass-through metrics hopefully is helpful to getting you comfortable that we can get those numbers back in line by the end of the quarter.

John Baugh - *Stifel Nicolaus - Analyst*

Thank you. Good luck.

Operator

John Rowan, Sidoti.

John Rowan - *Sidoti & Company - Analyst*

Do you know what the comp in the core stores would have been ex-smartphones?

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

Well, I mentioned we put the cannibalization in a range of 25% to 50%. So if you think about flat in smartphones being 7%, then you are somewhere from negative 3.5% to negative 4.5%, in that range.

And if you think about where we're -- if you look at the trend we were running, we were running -- if you go back to the second quarter, I think it was minus 4.7% and improving. As you can see, the second quarter was better than the first.

So I think it is somewhere between 3.5% and 4.5% or if you want to widen that range, it would be between negative 3%, negative 5%.

John Rowan - *Sidoti & Company - Analyst*

Okay. The inventory you mentioned was up on a year-over-year basis. Can you give us an idea of why that is? I just want to make sure that it is not more goods coming into the core business from Acceptance Now.

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

Good question. As I mentioned, we calculate it and it is going to be a lot higher until we comp over the smartphone rollout, having all those smartphones and now you have a lot of different models on the display shelf and so forth.

But it was 26.8% without smartphones in the core, lower than last quarter. There is a lot of things are going to move around in that number this year with the sourcing and distribution initiative and so forth.

But we will continue to give you metrics so that you can compare year over year and so you can get comfortable that it is not more merchandise coming back from Acceptance Now. And I can tell you it is not more merchandise coming down from Acceptance Now. It is a little lower than it was last quarter. And that $60 million or $70 million in the idle inventory is all the smartphones.

John Rowan - *Sidoti & Company - Analyst*

Okay. And then just last question. I think it was probably Guy gave some color on the quarterly distribution of earnings. Can you just repeat that? I want to make sure I had it right.

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

Yes, John. We are expecting that in the first and third quarters, our EPS will be down more than 10% year over year. And in our second and fourth quarters, we expect it to be up more than 20% year over year.

John Rowan - *Sidoti & Company - Analyst*

Thank you very much.

Operator

Matt McCall, BB&T Capital Markets.

Matt McCall - *BB&T Capital Markets - Analyst*

The G&A line jumped out at me. You gave some color. I think you said incentives and some initiatives, investments. Can you talk about those? Because if I do the math right, it shows that G&A number up about 17% at the midpoint from what you just reported for 2014, yet sales only up modestly.

So what is the incentive assumption? I think you said full incentive, if I wrote it down correctly. And is any of that spending, quote-unquote, temporary?

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

So Matt, as it you would know, whenever we start a planning season, we typically plan our incentives at target. And hopefully, we have an even better year than we think in our G&A number, it goes up from there because we pay more incentive compensation, which I think you guys would want to.

And obviously, our G&A expense would go down if we didn't have as strong a year as we thought. That was the case this year. The year didn't turn out as well as we would have thought. So as you can imagine, our incentive compensation paid out at less than target.

And so there is a difference year over year on our short-term and our long-term plans when you plan at target versus the achievement that occurred this year.

The other part of G&A that has gone up is we are now, as I think Mitch outlined, operationalizing a lot of the initiatives that previously we might have spent in the professional fees line or in the consulting line, all of these initiatives are hitting the store now.

Our point of sale system, as Robert mentioned, did it one store and going to roll out this year our labor model in sort of the second stage of pilot. Expecting that to roll out to all the stores this year.

Our supply chain model rolling out to stores in the second half of the year and really a lot of work going on as we do that. So in order to get those initiatives stood up, there is a lot of work going on by people not just at our stores, but here at the field support center, to get that underway.

There likely is an opportunity to back off some of those startup costs in those initiatives once they get in place and operationalized. But this year is a combination of both the incentive comp and some of those costs to get things stood up.

Matt McCall - *BB&T Capital Markets - Analyst*

Can you talk about the buckets there, what part is incentive comp? What is the assumption there? What part's initiatives? And then if there is that temporary component, what would the estimate be for the total?

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

Yes, I don't have it right in front of me, but my guess is it is about half and half -- half related to the increase in incentive comp and half related to the startup of the initiative.

Matt McCall - *BB&T Capital Markets - Analyst*

Okay. And the entire half that is the startup to the initiatives, is that -- how much of it is ongoing and how much of it is kind of one time?

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

It is hard for me to say. A component of that would be just the ramp-up time that we are undergoing right now, but I couldn't put my finger on exactly what the number is.

Matt McCall - *BB&T Capital Markets - Analyst*

Okay. All right. So moving onto the commentary around margins in 2017. You talked about 400 basis points. Can you talk about what your gross margin outlook is and then the SG&A levers that you are assuming?

And in there, continuing on that last question, are there temporary items that we need to keep in mind? Or incremental improvement in Mexico. What gets you to 400 basis points of improvement?

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

It is mostly the three items I listed out, Matt. So acceptance, growth in leverage on Acceptance Now sales, which would come in the labor line on Acceptance Now. Would also come in terms of leveraging the G&A as a result of growth of sales in that business. Which, you know, as you can see, with 1,150 unmanned locations coming on, while a fairly small revenue impact in 2015, clearly, we believe that is a good revenue generator in 2015 and beyond.

And then we have given you a feel of the overtime opportunity in the labor model being $20 million to $25 million and getting to a run rate on that at some point later this year, with that additional opportunity by having the flexible labor model in order to adjust our staffing to account for peaks by season, by day of week, or by daypart. So that is a big component as well.

And then supply chain, which may not have a dramatic impact in 2015. I mean, we think it will on the cash side, but not necessarily on the P&L side. But late in 2015 and, of course, in 2016, we expect to see a lot of cost improvement on the total cost of revenue line related to our sourcing and distribution initiatives.

So those would be the three big pieces of where we believe we will deliver on that 400 basis points of margin improvement.

Matt McCall - *BB&T Capital Markets - Analyst*

Okay. All right. And so one more. If you net out the converted manned stores to unmanned and you net out the closure, it looks like the total number of manned locations is going to be flat in 2015 versus 2014, if I do that math right.

Is this -- are we kind of hitting a saturation point from a manned perspective and you are going to see -- obviously, we'll see more growth from unmanned, but are we going to continue to see additional stores on the manned side and this year is just an adjustment period?

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

Matt, I don't think we have reached anywhere near saturation point on the manned side. Remember, we are opening 150 stores. So there is still plenty of opportunity there.

Once we have the technology for unmanned, it just makes sense to us to convert the lower volume stores that are teetering on whether they are profitable or not because there is not enough volume in them. And by having a manned solution in there, obviously, we are not -- well, we're not making much at our bottom 100 stores, if anything at all.

So it is an opportunity to move them over to the unmanned to make them profitable right away. So I think it is just a matter of using the opportunity to take out the bottom 10% of the stores and move them over to the unmanned, which will increase profitability. But no, the 150 stores range every year on manned locations going forward, that opportunity is still there.

Matt McCall - *BB&T Capital Markets - Analyst*

Okay. Okay, thanks. Remind me of the profitability difference, manned versus unmanned, when you reference net.

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

Well, there is a difference in volume. The manned will do more volume than the unmanned. And from a profitability standpoint, I don't have that model in front of me on the unmanned.

We will, once it is up and running and especially after we have a few open, we will put the model on the website, just like we have the manned. But without even one opened yet, we have got an internal model. We will post that once we get a few up and running and then we are more comfortable with it.

But it will be -- we like the profit numbers. The return on investment is fantastic. And we like the profit numbers, but it is done at a lower volume, lower cost.

Matt McCall - *BB&T Capital Markets - Analyst*

Okay. Thank you, Mitch.

Operator

Carla Casella, JPMorgan.

Carla Casella - *JPMorgan - Analyst*

Can you just clarify where you stand in terms of the total number of stores today? I think I missed that. And then planned open closures for the core business, if you can give us the cadence for it for 2015?

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

Let me answer your last question first, Carla. So we haven't planned significant store closures for the core. I think we -- as you may be familiar, our average lease length in the core is 5 years.

So in theory, we have about 20% of our locations coming off lease every year or at least be up for being renewal every year. And so that does give us a lot of opportunities to look hard at whether it makes sense to keep a particular store open or not. And we will look at opportunities to do that.

But in terms of planning, really all we have in terms of change in capacity is just the lapping impact of the 150 stores that we closed in the second quarter last year. So our capacity is down in the core for the first quarter and for part of the second quarter until we lap that change.

In terms of the overall business, most of the store growth is coming in Acceptance Now, as Mitch mentioned. We have about 50 -- I think it was 47 openings in Acceptance Now in the fourth quarter. And then, of course, Mitch and I both provided the detail of the openings we will have think next year and that's it.

Carla Casella - *JPMorgan - Analyst*

Okay. So the total core stores ended the same as third quarter -- the 2,841?

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

It was down a little bit. We did a sale of some stores late in the quarter, but overall, we are at 2,824 stores. So a little bit down in the core from where we were at the start of the quarter.

Acceptance Now locations are up a little over 1,400 now -- 1,406. And Mexico has stayed pretty flat, at about 175.

Carla Casella - *JPMorgan - Analyst*

Okay, great. Thank you.

Operator

Karru Martinson, Deutsche Bank.

Karru Martinson - *Deutsche Bank - Analyst*

Just wanted to get a little bit of clarification on the $100 million free cash flow target here. I was kind of surprised to hear you talk about an uptick in working capital for 2015.

Have you -- walk me through the confidence and will that flow through similar to the EPS on first quarter or third quarter being down and then kind of regaining that in the second and fourth quarter?

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

Yes, Karru, save for the impact of standing up of the working capital, which will come in the first six months, say, of the year. It is probably a reasonable assumption to assume that the free cash flow works its way similar to the EPS trend through the quarter or through the quarters as the year goes on.

I think when you look at overall free cash flow, as you may recall, last year, we had the negative impact of the deferred tax liability reversal. Of course, we don't have that this year. So that takes a negative free cash flow to -- that drag on free cash flow that resulted in a negative last year won't be there this year.

And then of course, we believe we will continue to have strong earnings growth in Acceptance Now, stability in the core, as Mitch and Robert have talked about, and less dilution in Mexico are all factors that contribute to the free cash flow going up this year.

Karru Martinson - *Deutsche Bank - Analyst*

Okay. And that $100 million target, that is before the dividends, correct?

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

Yes.

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

Yes.

Karru Martinson - *Deutsche Bank - Analyst*

Okay. And then just lastly, you mentioned leverage has peaked and it will decline through the course of 2015. Is that -- is your view that that will be declining through kind of EBITDA growth or you using that cash flow, especially in the second half, to pay down debt?

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

The combination of factors, Karru. We want to work both sides of the fraction, right. So we can do that by paying down a little bit of debt as a result of the free cash flow and also supporting that with strong earnings growth. We believe we can move that number more materially if we do both.

Karru Martinson - *Deutsche Bank - Analyst*

Thank you very much. Appreciate it.

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

I believe that was the last question, so I just want to thank everyone for their time and attention today. Again, some very positive things going on in the business.

Certainly disappointed with the results for Q4. I think that strengthened our resolve as a management team and we look forward to providing you further updates at the end of the first quarter. Thank you very much.

Operator

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