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RCII - Q2 2015 Rent-A-Center Inc Earnings Call

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OVERVIEW:

RCII reported 2Q15 revenues of $815m. Expects 3Q15 EPS to be $0.40-0.46 and 2015 EPS to be $2.05-2.20.

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PRESENTATION

Operator

Good morning and thank you for holding. Welcome to Rent-A-Center's second-quarter earnings release conference call.

(Operator Instructions)

As a reminder, this conference is being recorded today, Tuesday, July 28, 2015. Your speakers today are Mr. Robert Davis, Chief Executive Officer of Rent-A-Center; Mr. Mitchell 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 of Finance, IR & Treasury*

Thank you, Shawn. Good morning, everyone, and thank you for joining us. Our earnings release was distributed after market closed yesterday, which outlines our operational and financial results for the second quarter. All related materials are available on our website at investor.rentacenter.com.

As a reminder, some of the statements made on this call are forward-looking statements, which are subject to many factors that could cause actual results to differ materially from our expectations. These factors are described in the earnings release issued yesterday as well as in the Company's SEC filings.

Forward-looking statements that may be discussed today include forecasted revenue, earnings, cash flow and business trends. 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, Maureen, and good morning, everyone. Thank you for joining us and your interest in Rent-A-Center. In the second quarter we beat our revenue and EPS expectations and we continue to see progress toward transforming our core business and profitably growing Acceptance Now.

Specifically regarding the core business, our core business had a second consecutive quarter of positive same-store sales. Expenses are down year over year and our operating profit increased. Our multi-year transformation of the core business continues to build momentum. We have introduced new levers to pull to reduce earnings volatility and improve profitability.

The Sourcing and Distribution initiative has met all of our critical milestones and is on track for full deployment in 2015. After many months of hard work, all five of our third-party US distribution centers are now fully operational. We also finished the sourcing waves for most product categories to optimize our assortment and gain cost efficiencies from the new supply chain. As we complete the balance of our sourcing activity in the back half of this year, we expect all product categories will be using and flowing through the new system by the fourth quarter of this year.

We expect significant improvement in replenishment lead times, going from 17 days to only 4 or 5 days from purchase order to store receipt of the product. In-stock rates will increase and inventory levels at our stores will decrease over time, since we will no longer have minimum order quantities by store. NFI, our distribution partner, is responsible for delivering, unloading and staging all product, reducing the time it takes our store coworkers to receive product. The roll-out of our new system will also provide improved inventory visibility.

The Sourcing and Distribution initiative is expected to drive $25 million to $35 million of annual run rate product cost savings by the end of 2015. The income statement benefit will be recognized as new products are rented and will be spread out over the life of the rental agreements. We expect the full income statement benefits to be realized by the end of 2016. To prepare for the launch of this initiative, we have been decoupling price from cost via our market-based pricing strategy to ensure we realize these benefits.

Since the national roll-out in June, our new Flexible Labor model has been introduced to over 800 core US locations, by filling open positions with part-time coworkers as attrition occurs. Hiring for part-time coworkers has averaged 300 to 400 new hires per week, driven by our operations and HR teams. Our part-time coworkers are initially focused on deliveries, allowing our full-time employees to have more time inside our stores with our customers and focused on sales and collections. Operations continues to embrace this initiative and it remains on track to generate $20 million to $25 million of annual run rate savings by eliminating the overtime premium by mid 2016.

As demonstrated in both Q1 and Q2 of this year, we expect to also continue to capture meaningful labor savings throughout 2015, even before the Flexible Labor model is fully transitioned. Our new model will provide store managers the ability to modify work schedules based on individual store demands. And looking further ahead to future phases, we believe there is additional opportunity by determining the optimal amount of store labor hours based on volume and activity.

Through the pricing initiative, we continue to transition to a data-driven market-responsive model in the core US segment. As you recall, smartphones were rolled out using a different pricing strategy than our historical cost-based pricing model, which resulted in higher volumes and gross profit dollars for that category. Our pricing tests continue with two successful tests deployed nationally. Ensuring our pricing strategy is value-based going forward will a allow us to capture additional opportunities.

Our more analytical approach to promotions is also bearing fruit with several promotions in the first half of 2015 seeing a significant lift versus plan. The valuable insights we have gained will help us make better decisions and understand which pricing levers to pull for each product category to optimize gross profit dollars and margin.

Regarding our new point-of-sale system, the pilot has been expanded with 150 core US stores running the new system exclusively. We expect general deployment of our new POS system to the remainder of our core US RTO stores to be complete by year-end, pending success at specific milestones. Our new system will provide us with tools to better serve our customers.

Turning to Acceptance Now. Acceptance Now continues to deliver solid revenue growth at industry-leading margins. Given we serve not only the under-banked but also the un-banked consumer, we deliver the highest approval rates and highest volumes in the industry and drive meaningful growth through our retail partners. We have developed and deployed technology to expand our sales channels and improve the in-store customer experience.

Leveraging that same technology, we began online approvals via the websites of several third-party retail partners using our proprietary application decision engine. This allows visitors to our retailer partner websites to select a rent-to-own payment option while shopping online. Our strong retail partnerships are a competitive advantage and we intend to continue to enhance our unparalleled value proposition for retailers and continue to drive growth in existing locations.

Using that same technology, we will also be piloting our virtual approval engine on rentacenter.com starting this quarter, as an additional step toward full online e-commerce capabilities. Web traffic this year on our website is up over 30% and total visits to our website are now tracking close to roughly 25 million per year. We believe these opportunities will allow us to gain access to new customers, take advantage of growing online traffic, and improve our value proposition.

To improve the customer experience, technology was also implemented to automatically populate the Acceptance Now application with customer information previously entered during the primary or secondary credit approval process. This technology was implemented in 120 locations via cascade/approval waterfall and in 94 locations via retail partner point-of-sale integration.

This seamless capture of customer information allows customers to complete a single application, helps Acceptance Now receive a higher percent of turn-downs, and lowers transaction times. Our [app head] enhanced staff locations continue to out-deliver those without and we are now employing both web portal and iPad-based solutions to seize this opportunity.

As you can see during the first half of 2015, we have been heavily focused on increasing our Acceptance Now sales channels and improving the customer experience. Since we deliberately took advantage of these opportunities, we now plan to roll out approximately 500 Acceptance Now direct locations by year-end.

No material changes to our 2015 financials are anticipated from the fewer number of direct locations, due to the expected benefit of the new sales channels. In looking at the overall market opportunity for Acceptance Now, we believe the market is in the $20 billion to $22 billion range and the number of new staff in direct locations will be robust for many years to come.

To summarize, our focus continues to be on achieving the desired balance between sales growth and margin improvement while providing a better experience for our customers and coworkers. Two of our largest strategic initiatives are just now in full-scale deployment and we expect meaningful benefits starting in the back half of this year. Now I'll turn the call over to Mitch to provide more detail on the quarter. Mitch?

Mitchell Fadel - *Rent-A-Center Inc. - President & COO*

Thank you, Robert, and good morning everyone. We are seeing signs in our business that the health of our credit-challenged customer base is improving. Demand is up, customers are paying off agreements more often and earlier and losses are down. As a matter of fact, our total United States same-store sales increased 7.5% versus a year ago and this will be our fifth straight quarter of growth domestically.

In the core segment, we continued to make significant progress on improving top line. Core same-store sales were up 1.4%, primarily due to smartphones and the higher merchandise sales. Given the current momentum we've built in the core segment, we expect essentially flat same-store sales for the balance of the year, even as we comp over the launch of smartphones.

The smartphone category's now 9% of core revenue after rolling out only a year ago. By offering our customers the ability to rent the newest technology of smartphones, we tapped into a new market and drove positive same-store sales in our core business. Now, approximately 60% of our customers that rent from us rent an additional item before ending their original agreement, so smartphones have had a positive compounding effect as well.

The contribution margin of the smartphones category, which is improving, is currently over 40%. This includes cost of sales, skip/stolen losses, damaged merchandise, refurbishment service and so forth.

Now that we're a year into the smartphone business, today we are focused on optimizing the category. So while already very profitable at over 40% contribution margin, we expect further profitability gains from numerous opportunities including asset protection strategies, service cost reduction, pricing and product assortment.

Our core US rent-to-own skip/stolen losses came in at 2.6% in the quarter, just 10 basis points higher than last year, even with smartphones this year. As you may recall, in the first quarter we were at 3.8% versus 2.8% a year ago or 100 basis points higher. So you can see the second-quarter performance at 2.6% showed significant improvement.

As I mentioned a quarter ago, we added the smartphone device protection locking feature in April as a way to protect our customers from theft as well as minimize our losses if customers fall past due. Already we have seen past-due data that is markedly improved from our focus on this category. The percentage of customers that are past due is declined when the software is installed. About 80% of our smartphones are being locked on delivery today and we have almost half of our current rental portfolio with the software installed.

Moving on the Acceptance Now segment, same-store sales were up significantly versus previous quarters at 31.6%, due primarily to the increase in the 90-day option transactions. In the quarter, we opened 48 manned locations and piloted 10 direct locations. As Robert discussed previously, we are capturing additional opportunities based on feedback from our retail partners to expand our channels. We remain focused on adding touch points so consumers can enjoy our leading value proposition.

The 90-day program has driven significant revenue growth for Acceptance Now and for our retail partners. In the second quarter, the 90-day program was available in 94% of our locations. It is driving incremental customers and more of our customers are attaining ownership, which truly enhances the customer experience. However, we do not believe the current gross profit margins we are seeing are acceptable and we're working with our retail partners to make improvements on that.

As you're aware, our Acceptance Now team has been focused on bringing our skip/stolen losses back in line by improving execution. The Acceptance Now skip/stolen losses were 7.7% in the second quarter, down 20 basis points from last year and flat sequentially. So good job there, and we expect to maintain lower losses relative to last year for the balance of the year.

Our Mexico segment has continued to see top-line growth, up 8.9% in local currency. In addition, we've seen a year-over-year improvement in profitability of $2.1 million.

As you saw in our press release, we closed 26 stores or about 15% of the overall fleet, which were underperforming. That will help us improve profitability and increase focus as we continue to implement and assess innovative business model changes and improve execution. We'll evaluate the progress on those initiatives to determine our next steps early next year.

In summary, we've stabilized core revenue and are successfully implementing our strategic initiatives to grow profitability. Acceptance Now continues to grow market share at industry-leading margins and we continue to expand our offerings to meet the strong retail demand. I'd like to thank our 20,000-plus coworkers for their hard work, their dedication in improving our business and the way they passionately serve our customers every day. Now I'll turn the call over to Guy to discuss our quarterly financial performance.

Guy Constant - *Rent-A-Center Inc. - EVP of Finance & CFO*

Thank you, Mitch, and good morning, everyone. This morning I'll walk you through the highlights of our financial results for the second quarter. I would also like to mention that as I refer to our second-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 $815 million which represents a 6.1% increase, driven by revenue increases in our Acceptance Now segment and a same-store sales increase in our core segment, offset by the impact of the 150-store consolidation we completed in the second quarter of 2014. And on a two-year basis, same store sales in the quarter have again shown sequential improvement versus the previous quarter, up 180 basis points in Q2 versus Q1. In fact, since the first quarter of 2014, two-year comp sales in the core have improved by 1,150 basis points.

Gross profit was up $1.5 million and gross profit margin fell 390 basis points to 66%. While there remains opportunity to improve gross profit margins, we are pleased that our year-over-year operating expenses improved by 470 basis points, more than offsetting the gross profit margin decline. Operating profit margins have improved sequentially for four consecutive quarters.

In the core segment, gross profit dropped by $10.9 million and gross profit margin fell 180 basis points. Gross profit as a percent of total revenue was negatively impacted by the lower gross margin on merchandise sales and a higher mix of merchandise sales, primarily due to smartphones.

Our Acceptance Now segment experienced gross profit growth of $14 million, however, at lower gross profit margins which were down 760 basis points versus a year ago. Gross profit as a percent of total revenue was negatively impacted by lower gross profit margin on merchandise sales and a higher mix of merchandise sales, primarily due to the increased usage of 90-day option pricing.

I would like to remind those looking at our merchandise sales and their respective margin dollars that these line items solely capture the final payment against the full remaining cost of the item. However, when looking at our 90-day agreements in totality, including the attributed rentals and fees, we are seeing a positive gross margin of approximately 10% on our 90-day option business.

Store labor, which includes the expenses associated with coworkers at our stores and at the district manager level, decreased by $9.7 million to 26.2% of store revenues, an improvement of 290 basis points versus last year. In our core segment, store labor was down $13.5 million, an improvement of 230 basis points and was positively impacted by labor hour reductions that occurred in the third quarter of 2014, lower healthcare costs, and lower store count year over year.

We have been able to decrease labor expense while increasing same-store sales and we expect to continue to do so with the roll-out of the new labor model. In our Acceptance Now segment, while labor was up $4.9 million, we continue to see improved leverage in the business with labor better by 330 basis points versus a year ago.

Other store expenses, which include expenses related to occupancy, losses, advertising, delivery costs and utilities, were essentially flat year over year on a dollar basis, however, 160 basis points better than a year ago. In our core segment, other store expenses were down $900,000 or about 10 basis points, driven primarily by lower store count in the core, higher marketing co-op contribution and lower fuel prices, offset by higher service costs in our smartphone category. Within Acceptance Now, while other store expenses were up $4.2 million, we are again seeing better leverage as other store expense improved 200 basis points versus last year.

Now I want to spend a couple minutes talking to some key balance sheet and cash flow items. Our inventory held for rent in the core is 31.9% of total inventory, which is up from last year 320 basis points. This is caused by our national launch of smartphones last year and our new distribution network which we started to put in place in Q2. When normalizing those numbers to exclude our distribution network and smartphone inventory, inventory held for rent in the core was 25.5%, up slightly 40 basis points versus the prior year.

As discussed previously, we expect to see an initial working capital increase of approximately $25 million due to our new distribution network, but this will vary by season. As an example, at the end of Q3 we will likely take ownership of product to stage in our distribution centers in anticipation of seasonally higher volume in the fourth quarter. As Robert noted previously, we will also benefit from shorter replenishment lead times, which will allow us over time to reduce inventory held at our stores as our store managers gain confidence operating with the new supply chain model.

We ended the quarter with approximately $70.5 million in cash and cash equivalents. Our quarter-ending leverage ratio was 3.1 times, well below our covenant requirement of 4.5 times and down almost a half a turn as compared to the end of 2014. This includes $170 million drawn on our revolving credit facility as of the end of the quarter, leaving approximately $400 million of available capacity.

And one final note. As you may have seen in our press release, we wanted to give some additional color on the balance of the year. Consistent with our original 2015 guidance, we expect EPS in Q3 to be down more than 10% year over year and Q4 to be up more than 20%. This equates to Q3 earnings per share of $0.40 to $0.46, and Q4 earnings per share of $0.63 to $0.72. At this point in time, with the additional visibility into the balance of the year, we now project full-year 2015 earnings per share to be $2.05 to $2.20. With that, I'll turn the call back over to Shawn to open the line for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Your first question comes from the line of J.R. Bizzell. Your line is open.

J.R. Bizzell - *Stephens Inc. - Analyst*

Good morning and thanks for taking my questions and congrats on the quarter.

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

Thanks, J.R.

Guy Constant - *Rent-A-Center Inc. - EVP of Finance & CFO*

Good morning.

J.R. Bizzell - *Stephens Inc. - Analyst*

Very interesting, smartphones continue to be a nice positive driver of the comps in the core stores. I was wondering, could you talk about your expectations for the back half of the year? I know, Mitch, you referenced it that you are -- you're going to start lapping that product in the back half of the year, and the initiatives you have in place to lap over those sales and how we should think about that moving forward.

Mitchell Fadel - *Rent-A-Center Inc. - President & COO*

Sure, J.R. As I mentioned, where we've built the portfolio at this point going into the quarter, we're comfortable that we'll be essentially flat the remainder of the year. Part of the way you do that, as I mentioned, about 60% of our customers, when they rent their first item from us, rent another item before that agreement comes to fruition, either through a pick-up or paying it out.

You automatically get a compounding effect there and smartphones have worked the same way for us as other categories. So you get 60% wind at your back when they rent another item, on average.

I think the rest of it has been demand has been strong so far this year. The portfolio is in a good place. And quite honestly we're not even happy with flat comps the remainder of the year. I guess that's pretty good comping over the smartphone roll-out. At the same time, we strive for even more.

Of course, we balance that with the gross margin, improving on the gross margin as well. I think it's where the portfolio is today, demand has been strong. We do believe we're seeing improvement in that credit-challenged customer. We see it in demand. We see it in our losses being down.

I talked about the loss improvement on the smartphones. Heck, we're 10 basis points over last year when there was no smartphone losses, and 90 basis points better on a year-over-year comparison than we were just a quarter ago. So a lot of positive things we're seeing with the customer. Like I said, the way the portfolio is now, plus the other units those customers have rented, we're comfortable that we're going to be essentially flat the last two quarters of the year.

J.R. Bizzell - *Stephens Inc. - Analyst*

Great, thanks for the detail. And Mitch, building on that, you spoke to that locking device and the improvement you are seeing there in the skips and stolens around smartphones. Wondering if there's more initiatives that you're going to put in place to continue to lever that and decrease those skips and stolens? Or is it more of a function of the stores learning how to continue to use that locking device and leverage that moving forward?

Mitchell Fadel - *Rent-A-Center Inc. - President & COO*

I think it's a combination of things, J.R. Certainly the store execution piece continues to improve, not only with the locking device but with the upfront verification of the consumer, and verifying smartphones a little differently than, let's say, a living room group. So I think we're executing better and we'll continue to strive for that.

Keep in mind also that right now only about half of our smartphones have the device working on them, because a lot of smartphones are already on rent. We can download the software into most models, but the consumer has to accept the download just like all the rest of us on any updates on our phone.

So we're only up to about half of the phones being covered. Now about 80% that go out every day are covered. There's a couple of models that we're still waiting on the technology to catch up so that we can put the locking device on it.

I guess the short answer is, J.R., the improvement you're seeing on smartphones, we're only about halfway there on the locking device. So we've got another whole half to improve upon. So it can only get better from here.

J.R. Bizzell - *Stephens Inc. - Analyst*

Great, and last one from me. Thinking about the 90-day buyout and that is clearly driving volumes, and I know you all referenced from a margin perspective you would like to improve that. Wondering if you could build on that and walk us through some initiatives or some changes you're going to make or have made to continue to drive that margin moving forward. As we know, the gross dollar amount is improving, but the margin improvement, how to think about that moving forward.

Mitchell Fadel - *Rent-A-Center Inc. - President & COO*

Well, without getting into too much detail, as I mentioned, those are conversations we have with our retail partners on where we can improve the margins, whether it's an enhanced rebate from our partners or based on our markup to the consumer and so forth. So those vary by retail partner.

Suffice it to say, we're driving a whole lot more traffic for our retail partners. And what we've seen so far, they're very open to us improving our margins there. Like I said, they're individual conversations on how we get there. But we believe we can get some improvement there by working with our retail partners and making some real enhancements here as we go through the rest of the year, without materially hurting the traffic it's driving now.

J.R. Bizzell - *Stephens Inc. - Analyst*

Mitch, what percentage of transactions utilize the 90-day buyout this quarter?

Mitchell Fadel - *Rent-A-Center Inc. - President & COO*

About a third of all of our transactions end up buying out within the 90 days.

J.R. Bizzell - *Stephens Inc. - Analyst*

Great. Thanks and congrats again on the quarter.

Mitchell Fadel - *Rent-A-Center Inc. - President & COO*

Thanks, J.R.

Operator

Your next question comes from the line of Brad Thomas. Your line is open.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Thank you. Good morning and let me add my congratulations on a good quarter as well.

Mitchell Fadel - *Rent-A-Center Inc. - President & COO*

Thanks, Brad.

Guy Constant - *Rent-A-Center Inc. - EVP of Finance & CFO*

Good morning.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Just one more follow-up on comps in the core. Could you tell us how the stores that had originally piloted the smartphones have done as we've got another quarter in the books that we've lapped their roll-out?

Guy Constant - *Rent-A-Center Inc. - EVP of Finance & CFO*

Yes, Brad, this is Guy. We do continue to track those, and as you know, the first of the markets that we rolled out, rolled out in the fall of 2013. So we're now 21 months into the roll-out of that particular market. And then we had a couple other markets early in 2014, so call it 15 months through those.

The longest of the markets still perform slightly positively, so not quite as good as the rest of the system, but was still positive on a year-over-year basis for comps. And the other markets were slightly negative. So I'd say hovering around that flat mark versus where the rest of the system was up at 1.5%.

So it's still early. Of course, we always provide some caution there because being unique geographical markets, there could be competitive circumstances or unique economic performance going on in those markets that might not be reflective of the entire system. But certainly as an early indicator, certainly nothing that causes us great concern that we won't be able to accomplish the core sales that Mitch just outlined a few minutes ago.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

That's great and encouraging to hear. On Acceptance Now, with respect to the number of doors you plan to be in on the direct channel, could you give us a little bit more color on why 500 stores rather than 1,000? And is there any change in the number of partners that you'll be working with on this roll-out?

Mitchell Fadel - *Rent-A-Center Inc. - President & COO*

No, Brad, I think as Robert mentioned, these other sales channels like being on our retail partner's websites, at least eight of them at this point, as well as the different channels that Robert talked about within the stores, whether it's integrating into their POS system, providing the iPads, being on their website, providing a cascade waterfall, we're working with our partners on different channels as well as continuing to open demand.

It's such an evolving business model with our retail partners. It changes consistently. And what their needs are change consistently so our initiatives have moved around a little earlier in the year, and we've added channels using technology to add those channels. So the direct this year has been shortened down to 500 versus the 1,000 you were talking about because our focus has been on providing those other channels.

Doesn't mean that the demand's not there. Robert talked about that, we see it as a $20 billion industry. We'll do a ton more than that next year. The demand is there. We're not working with any less retail partners. It's just a matter of spreading the focus out over a few different areas to increase our channels versus just being focused on the one.

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

Yes, Brad, I'll just add that as mentioned in my prepared comments, we deliberately chose to do that, particularly as a byproduct of the conversations we were having with our retail partners. As you know, as you look around this virtual space, the relative demand on a direct model or virtual model we believed, and are seeing in fact, enhanced performance in these other channels versus what we could have achieved through the direct model.

So from a return perspective, 1 or 1.5 more deliveries a work by being on a retail partner's website or having the cascade waterfall approval was worth more to us in the near term than perhaps a half a delivery a week in a direct model, as an example. So no doubt the demand is still there and we will focus on that going forward as well, but this other stuff took higher priority.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Got you, that's very helpful. I appreciate the color there. A couple of financial housekeeping items, if I could. Guy, as you think about the savings initiatives that you all quantified today, how much from sourcing and labor do you think falls into 2015?

Guy Constant - *Rent-A-Center Inc. - EVP of Finance & CFO*

Into 2016, Brad? Is that what you're saying?

Brad Thomas - *KeyBanc Capital Markets - Analyst*

2015 and 2016. I think you gave us numbers that you expect to hit by -- as run rates -- by year-end. I'm trying to get a sense for how much you think in dollars this year we might hit.

Guy Constant - *Rent-A-Center Inc. - EVP of Finance & CFO*

Sure, Brad. On the labor model, we would expect to see pretty consistent savings on the labor model as we've seen earlier this year. Earlier this year it's been driven more by the reduction in hours that we made late in the year last year, but we will lap that as the year goes on.

But then the new flexible labor model will start to pick up the slack. So I think you can expect to see fairly consistent reductions in our labor dollars continue through the rest of 2015 as you did early in 2015. And then of course through to the middle of 2016, we'll continue to see the benefit of the flex labor model, anticipating being at the run rate of $20 million to $25 million by the middle of next year.

On sourcing and distribution, we would expect to start to see the impact of that initiative in the fourth quarter of this year. We'll start to see gross margins improve in the fourth quarter of this year as a result of the sourcing and distribution model.

We're seeing the cash savings now of, course, as we're making the purchases. But as those items start to go on rent now here in the third quarter with all of the distribution centers delivering, over the life of the rental agreement through 2016, we should see a pretty ratable growth towards the $25 million to $35 million of savings that Robert outlined earlier.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Very helpful. And then lastly, the expectations for CapEx and free cash flow for the year, if you wouldn't mind.

Guy Constant - *Rent-A-Center Inc. - EVP of Finance & CFO*

Sure. We expect the capital to be between $70 million and $80 million as we outlined, so pretty consistent with what we've been seeing most of the year. Then on free cash flow, we expect to be a little less than $100 million that we estimated earlier in the year. I think also in that $70 million to $80 million range as well.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Great, thanks so much and thank you for all the color today.

Guy Constant - *Rent-A-Center Inc. - EVP of Finance & CFO*

Thank you, Brad.

Operator

Your next question comes from the line of Laura Champine. Your line is open.

Laura Champine - *Canaccord Genuity - Analyst*

Good morning. My question is on the change in the number of Acceptance Now locations that you expect to have a virtual platform out on. I think that changed from 1,150 to 500 on this press release. I'd love more information about what changed in the Company's strategy there.

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

Laura, really what we were describing just previously was the fact that the demand for our Acceptance Now direct locations remains robust. However, in discussions with our retail partners during the first half of this year, there was a larger appetite for many of them to have us focus on leveraging our technology by putting that decision engine, if you will, and new technology on their website for additional traffic building into their locations. As well as integrating into their POS systems from a seamless perspective with their coworkers, as well as a cascade waterfall approval that allows for a seamless application process from the consumer's perspective when they apply for either primary or secondary credit.

So we believe that those two or three different initiatives had more value to us in the near term. We're seeing the traffic pick up in those instances versus what the direct model we believe looking around the space can deliver in terms of deliveries per week or per month. No doubt we'll still continue to reach out to those in the back half of the year for the 500, if you will. But from a return perspective, there's more value in pivoting towards the other channels, as I've mentioned.

Mitchell Fadel - *Rent-A-Center Inc. - President & COO*

To further that, Robert, we're more caught up on doing more business than necessarily how many doors. But if we wanted to count locations, just the eight websites that -- our retail partners' websites, about 500 locations. So we're driving the traffic through their website, through the approval on their websites.

So We added 500 stores. We increased the volume of 500 stores, some actually are adds. We added 500 stores by going through their website and pushing the traffic into their stores. If we wanted to count -- if that number was as important to us, we could count 500 more just through the eight websites that we're on so far, and that's going to grow by the end of the year, that number of websites.

Laura Champine - *Canaccord Genuity - Analyst*

Got it. And then lastly, on the quantification of the savings on product cost, $25 million to $35 million, is that net of any adjustments that you will make on pricing? Or how much would potentially lower pricing eat into that?

Guy Constant - *Rent-A-Center Inc. - EVP of Finance & CFO*

That's a good question, Laura. Just to clarify, it is net of the costs that we'll pay to NFI for doing the distribution model. So it becomes the pool of opportunity, I guess that's the way I would phrase it, available to us to either allow that to flow to gross margins or to take advantage of pricing opportunities on those categories where it would matter.

I guess what I would tell you is if we choose to deploy some of it to pricing, then I would say the $25 million to $35 million of opportunity goes up. Because the only reason we would invest it in pricing is if we thought it would provide more value to us than letting it flow to the bottom line. That should be only upside should we choose to invest it in more elastic categories where the pricing opportunity would matter to customers.

Laura Champine - *Canaccord Genuity - Analyst*

Got it, thank you.

Operator

Your next question comes from the line of John Baugh. Your line is open.

John Baugh *- Stifel Nicolaus - Analyst*

Thank you. My question is first on the Acceptance Now. Is there a rough breakout of how much the 90-day same-as-cash helped the comp?

And then you mentioned 94%, I believe, that you're now in. So I assume that's pretty much full. I'm just curious as we go through the next three quarters, how that laps with a year ago and how much headwind we have against the comp from that anniversary date.

Guy Constant *- Rent-A-Center Inc. - EVP of Finance & CFO*

Hey, John, it's Guy. So yes, I can give you the breakdown. Rentals and fees, if you exclude the merchandise sales and just look at the rentals and fees growth, it was almost 22% in the quarter. So still very strong rentals and fees growth outside of merchandise sales.

But the merchandise sales themselves, which is where most of the 90-day cash came from was up about 70%. So the balance of the two is how you get to the 32% comp in Acceptance Now.

Merchandise sales up a lot, but rentals and fees still very strong. So we feel very confident that the underlying staffed business outside of 90-day cash continues to generate good, strong, positive comp growth.

In terms of 94% of the doors that we're in, last year in the third quarter, so the one that we're in right now we were in about 45% of the doors. And then by the end of the fourth quarter we were in, call it, 65% of the doors. So as you think about how that laps over, you'll see that's the difference we expect from Q3 and Q4.

John Baugh *- Stifel Nicolaus - Analyst*

That's great, thank you very much for that. And then on the direct business that you're doing, are you currently only banked on that? Or are you doing un-banked as well? And if you're not, is there a plan time-wise when you might entertain that?

Guy Constant *- Rent-A-Center Inc. - EVP of Finance & CFO*

So John, today in the direct model we would be only banked. But obviously the opportunity that we think exists, that we think is unique to our business, is to take the years and years of history we have with dealing with the un-banked or the under-banked customer, and bring that experience to bear in the decisioning that we would do within the direct model.

But as of today, when we roll out the direct model, we would be dealing only with the banked customer. But obviously that would be high on our priority list to get the same sort of advantage we have in approval rates versus everybody else in the industry and the staff model, to also bring that to bear in the direct model as well.

John Baugh *- Stifel Nicolaus - Analyst*

Great. And then you mentioned something about a $25 million revenue thing with the website or something. I wasn't clear, rentacenter.com is doing that amount of volume today or will be shortly? I didn't get that comment. Thank you.

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

John, that was me, Robert, in my prepared comments. Essentially what we were updating the group on was the fact that we're leveraging that same technology, that same decisioning technology to just like we're on our retail partner websites in Acceptance Now, we're going to put that same technology on our website, rentacenter.com.

We're already closing about 15,000 web orders per month on our current website. But that's really where an order form's e-mailed to a store and there's manual intervention. Whereas the new technology, the customer walk into the store already pre-approved with the dollar amount to purchase.

We're going to put that same technology on our website to enhance that 15,000 conversions a month, if you will. And the $20 million to $25 million was really the number of visitors that we're tracking towards this year, given that our web traffic is up 30% over prior year.

John Baugh - *Stifel Nicolaus - Analyst*

Great, that's helpful. My last one, quickly, was on the pricing in the core. Either the quarter just ended or maybe the outlook as well, where do we wind up on price? About the same? Higher in some categories? Lower in others? Maybe down a little? Maybe up a little? Just curious how that influences gross margin. Are you going after contribution EBIT dollars? Any color there. Thanks.

Mitchell Fadel - *Rent-A-Center Inc. - President & COO*

Yes, John, I think the big thing in our pricing is, as we've talked about, the Sourcing and Distribution initiative which lowers the cost. I think if we use any of that on price it will be because we can compound that opportunity into more gross margin dollars by using it on price.

I don't see overall pricing going down from the sourcing and distributions by paying less doesn't mean our pricing has to go down. You know it would have if we were on the old cost based model. That's why we switched to customer-centric data-driven model, so that it doesn't go down automatically by just calculating a rental rate and a term based on cost.

So with the new pricing model, nothing gets calculated off of the cost. So it's just whatever the market allows, so to speak. And demand's been strong so far this year, their spend.

Our APU's down a little bit this year, primarily driven by continued deflation in the electronics categories. TVs specifically. We're hopeful that the new television technology, the 4K ultra HD can turn that category into the plus side for us again, as far as the ticket.

I'd say we end up -- it's hard to predict which way the market's going but I don't see it getting any lower, the pricing, based on sourcing and distribution of the margins. So if we hold our pricing and with our lower cost margins only go up, as Guy talked about, starting in the fourth quarter.

John Baugh - *Stifel Nicolaus - Analyst*

Great, thank you. Great labor number. Good luck.

Mitchell Fadel - *Rent-A-Center Inc. - President & COO*

Thanks, John.

Operator

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

David Vargas - *Raymond James - Analyst*

Good morning, this is David Vargas on for Budd. I was hoping that you could talk about the incremental savings that you're -- where they're going to come from to get to that 400 basis points of operating margin leverage you talked about by 2017. You've outlined $45 million to $60 million in savings on a run rate by the end of -- by sometime in 2016. But where is the rest of that savings going to come from?

Guy Constant - *Rent-A-Center Inc. - EVP of Finance & CFO*

Hey, David, thanks for your question The original 400 basis points that we outlined, the vast majority of the benefit was going to come from the labor savings and the supply chain benefit, and then the leverage associated with the growth in revenue in our Acceptance Now business.

What's interesting about this past quarter is if you look at the operating margin improvement we had in the last quarter, we almost got there about a couple years earlier than we thought we were going to get. Which I think bodes very well because we're just starting the roll-out of the Sourcing and Distribution and the labor initiatives.

I think as we talked about the 400, I think we always believed there was more opportunity than that. And I think the second quarter points to that, that opportunity does exist.

But we believe there are a number of other initiatives. I don't think that we're ready to talk about all of them just yet, but other opportunities within the business that we can drive that margin improvement even higher beyond the benefit we'll see from sourcing and distribution and the new labor model.

David Vargas - *Raymond James - Analyst*

Okay, great. And then for the comp guidance for the core, relatively flat for the balance of the year, does that take into account the benefit you're going to see from the online, the capability to order online at rentacenter.com?

Mitchell Fadel - *Rent-A-Center Inc. - President & COO*

No, David, we have not factored anything for that. That's all upside, how that performs. We're going to pilot it in the next probably 30 days. So without even piloting it yet, it would be hard for us to calculate what the improvement will be, so that's just all upside at this point.

David Vargas - *Raymond James - Analyst*

Okay, but that will did into the comp, right? That will be part of comp store sales?

Mitchell Fadel - *Rent-A-Center Inc. - President & COO*

That's our intention.

Guy Constant - *Rent-A-Center Inc. - EVP of Finance & CFO*

That's right.

David Vargas - *Raymond James - Analyst*

Okay. And then last question from me, in terms of the increase in held-for-rent inventory year-over-year in the core, you mentioned most of it was from smartphones. Any indication on what the level of Acceptance Now returns are in the core stores, about what percentage of held-for-rent?

Guy Constant - *Rent-A-Center Inc. - EVP of Finance & CFO*

David, this is Guy. The increase in held-for-rent inventory, it's really related to two factors. It's the smartphones year-over-year. Last year in the second quarter we had started to see some smartphones come into inventory, but we weren't all the way there until the third quarter when we started to roll out. So the difference now of having a fully ramped-up smartphone category and only partially ramped-up in terms of inventory last year, is part of it.

As I mentioned, the fact that we're now five distribution centers fully operational, that actually is -- the stocking in of those distribution centers, the $25 million that we anticipated we would see, is also a big part of the increase in inventory held-for-rent as well. So those are the two big things that are driving the increases in the inventory held-for-rent.

Mitchell Fadel - *Rent-A-Center Inc. - President & COO*

In addition to that, David, the 90-day options in the Acceptance Now have driven more payouts, as we talked about, which has had a compounding effect in driving at least on a percentage basis, lower returns. The more payouts in Acceptance Now has actually slowed down the returns going into the core stores, not in overall numbers, because Acceptance Now has so much growth in it. But it's kept it pretty flat with last year, the returns going into the core business, even though they've had all that growth in Acceptance Now.

It's been a nice compounding effect. It's better customer experience, certainly, when they take ownership of the product. And we have not had a material increase in returns in the core business, even with the growth of Acceptance Now in the last year, because more people are taking its ownership. So it's been a nice side effect of that.

David Vargas - *Raymond James - Analyst*

Okay, thanks a lot and good luck for the rest of the year.

Mitchell Fadel - *Rent-A-Center Inc. - President & COO*

Thanks, David.

Operator

Your last question comes from the line of Anthony Chukumba from BBT Capital Markets. Your line is open.

Anthony Chukumba - *BBT Capital Markets - Analyst*

Thanks for taking my question. Had a couple questions, just wanted to dive a little bit more into the merchandise sales. Certainly understand a lot of the increase was Acceptance Now and adding the 90-day option to more of those locations. I was wondering, if we were looking at merchandise sales just in the core US business, was there an increase there as well?

Guy Constant - *Rent-A-Center Inc. - EVP of Finance & CFO*

Yes, Anthony, there was, which we think is also related to two different items. Smartphones is driving some of that because smartphones overall is a lower absolute ticket.

So like a smartphone, if you were to pay out a smartphone, obviously it would cost a lot less than paying out a living room group. So that lower absolute ticket's a little more achievable for a customer to make a payout than it might be if it was a more expensive item. So having a greater mix of smartphones is part of the contribution.

But I think as important a factor, and Mitch referenced this in his comments, our consumer's in a better position now than they were a year ago. They're in a healthier spot. Lower fuel prices, the job market's been really strong at the bottom end, some of the minimum wage increases starting to filter in is very good for our customer. All of those things I think are putting our customer in a healthier position.

And so we're in a nice spot now where payouts are higher, yes. That used to come, historically, at the expense of the portfolio of the business. People would pay out and then we wouldn't see as many items on rent. We're getting both now. As Mitch said, the portfolio is healthy and we're seeing the payout, which I think is the strongest indicator of our consumer being in a healthier position.

Anthony Chukumba - *BBT Capital Markets - Analyst*

Got it. And now that you do have the 90-day option in 94% of your Acceptance Now doors, would you expect merchandise sales, or the growth in merchandise sales, to start to level off because you're not adding it to a bunch more locations?

Mitchell Fadel - *Rent-A-Center Inc. - President & COO*

Yes, definitely. And level off also because of seasonality. As we get farther away from income tax time they level off as well. So yes, that should level off or go down a little bit as we go through the rest of the year because of the seasonality as much as anything. And the fact that it has been in all the stores now for much more than 90 days, or virtually all the stores, at least.

Anthony Chukumba - *BBT Capital Markets - Analyst*

Got it. One last thing. Maybe this is an overly simplistic way of looking at it, but if I look at your table 5, where you have the consolidated statement of earnings, if I looked at the cost of merchandise sold as a percent of merchandise sales, for the months ended, or second quarter of last year, the gross margin on those merchandise sales would be about 21%. And in this quarter it looks like it's essentially almost like breakeven. So I was wondering, is there anything that's going on there in terms of why the gross margin on the merchandise sales would be so much lower year over year?

Guy Constant - *Rent-A-Center Inc. - EVP of Finance & CFO*

Anthony, what you're seeing there is the difference between -- again, it's driven by the 90-day cash option. The difference between early payout, which might have occurred beyond 90 days historically, and a 90-day payout that's occurring right now.

It's also compounded by the fact, as I mentioned in my prepared remarks, is if somebody were to pay out at the end of the 90-day option period, the first two monthly payouts they would have made would have showed up with a rental and fee, with the typical margin you would see on a rental and fee transaction. And then when they get to their third pay-out and they decide to pay out the balance of the product, then we're taking the full remaining cost of that item against the remaining payout, which results in what looks like a lower merchandise sale transaction. But if you take into account all of the money paid on that 90-day transaction versus all of the cost, it's really more like about a 10% margin transaction versus what we would have seen before at an earlier payout that would have been at a higher margin transaction if the customer took it beyond 90 days.

Mitchell Fadel - *Rent-A-Center Inc. - President & COO*

By the way --

Anthony Chukumba - *BBT Capital Markets - Analyst*

Okay.

Mitchell Fadel - *Rent-A-Center Inc. - President & COO*

Anthony, as we've talked about, though that's been a very successful program for driving revenue and gross profit dollars, as I mentioned earlier, we're not happy with those gross profit margins on the 90-day program and we are working with our retail partners to enhance that program a little bit. It's driving a lot more traffic and it needs to be tweaked a little bit. So we think we can maintain the traffic but also improve those margins in that program as we go through the rest of the year.

Anthony Chukumba - *BBT Capital Markets - Analyst*

Got it, that's very helpful. Thank you.

Mitchell Fadel - *Rent-A-Center Inc. - President & COO*

Thanks, Anthony.

Operator

That concludes today's Q&A session. Mr. Robert Davis, I turn the call back to you.

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

Thank you, Shawn. Again, we are very pleased with our second-quarter results and optimistic about our future, again, particularly given that two of our largest strategic initiatives are just now getting started in earnest.

As CEO and on behalf of our management team, I do want to take a moment to acknowledge all of the hard work that continues to take place both in field and at our field support centers. So thank all of you. As well, I'd like to say thanks to our supporters on the phone today and thanks for your interest and look forward to reporting back next quarter. Thank you.

Operator

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