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Rent-A-Center, Inc. (RCII)

Q3 2015 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and thank you, for holding. Welcome to Rent-A-Center's Third Quarter 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, October 27, 2015.

Your speakers today are Mr. Robert Davis, Chief Executive Officer of Rent-A-Center; Guy Constant, Executive Vice President of Finance and Chief Financial Officer; and Ms. Maureen Short, Senior Vice President of Finance, Investor Relations and Treasury.

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

Maureen Short
Senior Vice President - Finance, Investor Relations and Treasury

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

As a reminder, some of these 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 our 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 Dale Davis

Chief Executive Officer & Director

Thank you, Maureen. Good morning, everyone and thank you for joining us. For many of you this is probably the first time that you've participated in a Rent-A-Center call without the presence of Mitch Fadel, our former Chief Operating Office. As many of you know, Mitch recently left the company to pursue another opportunity. And I wanted to take just a brief moment to acknowledge all of the great contributions that Mitch has made to the Rent-A-Center business, thank him for his many years of service and to wish him the very best in his new opportunity.

Now I'll turn our attention to the great opportunities that are present in our own Rent-A-Center business. As promised, last quarter, Acceptance Now has expanded into the direct or virtual channel and we have done so with a flourish. I am pleased to say that we grew our overall location count by 15% this quarter which is the strongest growth we have seen in several quarters. While I believe the fast model will continue to be the gold standard for the industry, given its superior ability to drive volume and profit dollars, our new direct model enables the expansion of our offering to lower volume locations and broadens our scope of potential retailers. And while the majority of the growth this quarter came in the direct space, the outlook on the pipeline of both staffed and direct locations remain strong and we're aggressively pursuing these opportunities.

Retailers with lower volumes have been anxiously awaiting our direct program and are rapidly signing up. It is still early in the rollout but the volume we're seeing in the direct locations is meeting our expectations, and we're even finding some locations are doing enough business that they are very likely to become staffed locations. We strongly believe that retailers that do not currently have a lease-to-own option in their stores are missing out on a significant sales growth opportunity.

As evidenced by the retailers that have already embraced the sales driving model Acceptance Now typically increases retailer sales volume by 3% to 5% and with the right partnership can be as high as 18%, many times larger than any competitor in the space. We are in the process of enhancing our commercial B2B capabilities in order to ensure that we capture the lion share of this $20 billion market as more and more retailers recognize the market leading opportunity that Acceptance Now brings to their business.

In the past two quarters, we have seen dramatic revenue growth due in part to the introduction of the 90-day cash option in our retail partner network. While customers have clearly embraced this offering, the higher mix of this transaction in our business has put pressure on overall Acceptance Now gross margins. Over the past quarter, we had committed to you that we would identify ways to work with our partners to enhance the profitability of this offering while maintaining the compelling value proposition to the customers. As promised, we have had discussions with a number of our retail partners regarding 90 day option economics and they have been very productive. Our retail partners have collaborated with us to ensure the partnership is truly a win-win relationship. And we expect the profitability of the 90 day option to improve as we move into 2016 and beyond.

The unique bond with our retail partners is forged and cemented by the relationships between the Acceptance Now co-worker and the sales staff for our retail partners. And is the primary reason that enables us to see more turndown customer opportunities and ultimately drives our volume to be 8 to 10 times that of our largest competitor.

From a technology perspective, in addition to growing the number of locations as mentioned last quarter, we are using technology to drive traffic and increase revenue in existing locations and are making tremendous progress. Most of our retail partners currently have primary and secondary financing options for customers that qualify for credit and Acceptance Now acts as a tertiary option.

We offer several technology options for our retailers which allow customers to complete one application for primary credit, secondary credit and lease-to-own at the same time increasing our capture rate for customers that are turned down for traditional credit. Retailers have the option of either integrating the Acceptance Now approval process into, one, their existing primary and secondary financing process, their point-of-sale system or via a standalone kiosk. The number of Acceptance Now locations with these seamless approval technology options has doubled this quarter and is already available in about 30% of our staffed locations.

Acceptance Now's approach is to have an open platform that allows us to partner with the established best-of-breed primary and secondary financing companies already in retailer locations rather than entering into the secondary financing space ourselves. This gives our retail partners the flexibility to choose which financing companies to do business with using the seamless integration capabilities that we have with the top three leading secondary finance companies. We plan to focus on our core competency, the lease-to-own opportunity which has higher margins and operate under a different regulatory framework than secondary financing. Our approach is to provide retailers and customers with full transparency about the lease-to-own transaction through customer facing technology and allowing in all cases for customers to return the product at any time with no penalty.

The Acceptance Now rent-to-own option is also currently available on the website of 15 retail partners including Value City, HH Gregg, Bob's Discount Furniture which are three of our top five retailers. These websites are driving incremental business to approximately 500 locations again double the count from last quarter. There are many more retailers in the pipeline for both of these technology initiatives and we're continuing to explore innovative ways to further the customer and retailer experience.

In the Core rent-to-own business, I am pleased with the progress we have made on the transformational initiatives. The upfront work associated with our flexible labor and sourcing and distribution initiatives is substantially complete and they remain on-track for the expected annual run rate benefits of $45 million to $60 million.

With our new supply chain, we're now beginning to look at subsequent opportunities including last mile logistics improvements, product redistribution opportunities and optimizing store inventory levels. The operations team continues to raise our flexible labor initiative. The new labor model has been introduced in approximately three-quarters of our stores and over 5,500 new part-time co-workers have joined the company. Only about 100 stores have migrated to the full in-state labor model, and with the introduction of part time labor and full time co-workers with no scheduled overtime. The benefits of both the sourcing and distribution and the flexible labor initiatives have just started this quarter and will primarily benefit 2016 and beyond. So we are still in the early innings of seeing the financial benefits of these initiatives.

As we have promised we will ensure that every margin improvement initiatives that we implement will not only benefit the company but more importantly the customer and our co-workers. We know there is a wrong way to cut cost and we simply will not sacrifice the customer or the co-worker in pursuit of short-term profits. In order to further optimize our store portfolio approximately 100 underperforming stores were closed or sold during this quarter including exiting the majority of our Canada stores. Removal of these stores from our portfolio allows us to place even greater emphasis on achieving the benefits of our initiatives and improve our return-on-invested capital.

Through additional initiatives such as labor hour reductions and the smartphone locking feature, store expenses have been reduced by over $40 million since the beginning of 2015 which reflects clear progress on implementing the strategic initiatives that will help ensure sustained profitability. We believe there are many other margin improvement opportunities in the Core business that will provide ongoing benefit for at least the next two to three years.

In Q3 we launched the first pilot in virtual approval on Rentacenter.com as an additional step towards full online eCommerce capabilities. Recently, the first major website redesign since 2012 was completed and we've also taken positive moments forward in social media. We've also setup an online customer community focus group in order to receive feedback from customers on a consistent basis and gain insights on what customers truly value. Building on the customer segmentation work completed last year, these are additional steps in our journey to becoming a more customer-centric organization.

So, to summarize, Acceptance Now continues to grow rapidly and we're enhancing and expanding our offering through new technology, within the Core rent-to-own business we're seeing signs of improved profitability and our outlook on the positive impact of existing and future cost efficiency initiatives is strong. By approving the return profile of existing assets through our strategic initiatives and by optimizing the store base we are able to reinvest in the rapidly growing Acceptance Now business and drive shareholder value.

Now I would like to turn the call over to Guy to provide more details on the quarter. Guy?

Guy J. Constant

Chief Financial Officer, Treasurer & EVP-Finance

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

As outlined in the press release total revenues were $792 million which represents a 3.6% increase driven by revenue increases in our Acceptance Now segment. Third quarter revenues were lower by about $6 million due to the foreign currency impact in our Mexico business, the sale of stores to franchisees and continued rationalization of the Core store footprint.

As a matter of fact our total U.S. same store sales combining the Acceptance Now and Core performance increased 5.2%versus a year ago marking our sixth straight quarter of domestic same store sales growth.

Acceptance Now same store sales continued to impress up 24.5% for the quarter even as we begin to lap the broader rollout of our 90 day option program. As Robert outlined in his comments, we continue to experience rapid growth and adoption of our innovative technology solutions throughout our retail partner base. Our technology platform coupled with our staffed model will continue to differentiate us in the marketplace as it enables us to drive more sales opportunity for our retail partners than any other competitive alternative.

In our U.S. retail business, Q3 marked the beginning of our last of the smartphone rollout from a year ago. Same store sales were down 0.2% which was in line with our expectation. While we have seen positive momentum in other major product categories, we are challenged by computers which are down double-digit similar to the industry at large and we have seen some headwinds in oil industry affected markets such as parts of Texas. On a two-year basis same store sales in the quarter remain up over 1,100 basis points since the first quarter of 2014.

As we lap the introduction of smartphones, we see a number of sales drivers for our Core business, the broader product assortment that's enabled by our supply chain initiative, the availability and flexibility of labor which will allow us to be correctly staffed during peak period such as those we'll see in Q4, pricing that's more reflective of the competitive marketplace and the roll out of eCommerce in 2016. As well as the macro trends that of lower gas prices, a better job market and minimum wage increases all of which will benefit our customers disproportionately, provide us with the opportunity to deliver continued strong sales results in the quarter. Now, we won't build a cost structure that's dependent on that strong sales growth but if we can deliver on the opportunity that's available to us with a lean cost structure, the earnings growth opportunity in the Core is meaningful.

Consolidated gross profit was down $9.4 million and gross profit margin fell 360 basis points to 66.1%. In the Core segment gross profit margins were down 170 basis points from a year ago but have stabilized sequentially. 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. Product that was sourced through our supply chain initiative is now showing up in stores and going out on rent. So we should start to see Core gross margins improve starting in the fourth quarter.

Our Acceptance Now segment experienced gross profit growth of $9.8 million. Gross profit margins stabilized flat sequentially but still 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 popularity of 90 day option pricing.

I want to remind you that as we look at our merchandise sales and the respective margin dollars, these line items fully 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 in fact seeing positive gross margins of approximately 10% to 15% on our 90 day option business along with driving incremental volume.

As Robert mentioned in his remarks with gross margins stabilizing and mutually productive discussions we've had with our retail partners regarding the 90 day option transaction, we would expect gross margins to improve in our Acceptance Now business starting in 2016.

Consolidated store labor which includes the expenses associated with co-workers at our stores and at the district manager level decreased by $8.7 million to 26.7% of store revenues, an improvement of 210 basis points versus last year. In our Core segment, store labor was down $11.7 million, an improvement of 160 basis points and was positively impacted by lower store count year-over-year, our labor hour reductions that started in the third quarter of 2014, our new flexible labor initiative and lower insurance costs. Year-to-date, our operators have delivered, lowering our Core labor expense by $35 million while increasing same store sales, a great result. And we expect to see continued labor reductions as we're still in the early innings of our flexible labor rollout.

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 240 basis points versus a year ago. Other store expenses which include expenses related to occupancy, losses, advertising, delivery costs and utilities were down $6.8 million year-over-year on a dollar basis, 190 basis points better than a year ago.

In our Core segment, other store expenses are down $5.9 million or 60 basis points driven by a lower store count, lower gas prices, and lower training cost for smartphones partially offset by higher product service costs from smartphones. Within Acceptance Now, while other store expenses are up $5.6 million, we're seeing better leverage as other store expense improved 40 basis points versus last year.

In total, our store operators delivered on our promise of improving operating margins. Despite the opportunity we have to improve our gross profit margins we have continued to drive lower year-over-year operating expenses translating into an improvement of 410 basis points. Third quarter operating profit margins are up last year by 50 basis points building on the momentum that started last quarter and we expect that to continue in the fourth quarter as well.

Our Core U.S. rent-to-own skip/stolen losses came in at 3.4% in the quarter, flat to last year even with the addition of the smartphone category. As you may recall, as recently as Q1 this year, our skip/stolen losses were 100 basis points higher than a year ago. Once again our operators and the teams that support them have delivered on the promise to improve an area that needed to be addressed.

As you're aware, our Acceptance Now team has been focused on bringing our skip/stolen losses, back in line by improving execution. While we were able to achieve this for the first half of 2015, we are disappointed in our performance in Q3 as skip/stolen losses were 8.2%, up 130 basis points from last year. We now expect Q4 losses to be slightly above 10% in line with last year. We continue to see the Acceptance Now customer being over stretched by higher levels of sub-prime consumer debt and sub-prime auto debt both of which are impacting their ability to stay current on their payments. We are currently reviewing the account management process in our Acceptance Now business and we expect to make some changes to permanently improve this result in 2016 and beyond.

Now I want to spend a couple of minutes talking to some key balance sheet and cash flow items. Inventory on rent is down approximately $15 million versus a year ago. Typically, in the third quarter we do see inventory on rent decrease due to the slower summer season. A year ago due to the rollout of smartphones this was not the case but now that we've lapped smartphones were back through our historical seasonality. The write-down on smartphones also lowered the value of some phones that are currently on rent. Inventory held for rent is down approximately $21 million which is a reversal of year-over-year increases we've seen since the introduction of smartphones a year ago.

In addition to the normalization of the year-over-year numbers due to the lap of smartphones the write-down discussed earlier also lowered the value of phones that were idle. This result came despite the fact that we are investing in inventory both to stock our newly opened distribution centers and in anticipation of our busier holiday seasons. Our inventory held for rent in the Core is 34.4% of total inventory which is essentially flat to last year.

We ended the quarter with approximately $60 million in cash and cash equivalents, our quarter ending leverage ratio was 2.9 times well below our covenant requirement of 4.5 times and down over a half a turn as compared to the end of 2014. In fact our total debt is down almost $130 million since the end of 2014. This includes a $150 million drawn on our revolving credit facility as of the end of the third quarter down $20 million from last quarter and leaving approximately $430 million of available capacity. And during the quarter, we were also able to complete the repurchase of approximately $7 million of our 6.625% 2020 senior notes. This is consistent with our plan to lower our debt ratio to 2.5 times over the next year which will free us from the current restricted payments basket increasing the flexibility the company will have to make optimal capital allocation decision.

During the third quarter, we determined it was necessary to adjust our smartphone inventory upon standing up the category a year ago we purchased inventory to support a spectrum of option including both newer and older generation phones consistent with our good, better, best approach in other product categories. Over the past year, the demand for a newer generation phones has exceeded our expectations but older generation phones have fallen short which has resulted in excess smartphone inventory.

In the third quarter, we finalized the sale of excess phones in the secondary market as well as taking several steps to move through older generation phone inventory, via bundling offers, clearance sales and repricing all of which have seen some success. However, we did not move through as much of the excess inventories as we would have liked so we deemed it necessary to correct our inventory position and our writing down the value of our smartphone inventory and accelerating the secondary market disposition of excess phone inventory.

In connection with this decision, we recorded a pre-tax $35 million inventory write-down in cost of sales during the quarter. As we've discussed previously, over the past two quarters, we have dramatically improved the profitability of our smartphone category and as we move forward with this category, we will continue to refine our approach taking the learnings from our initial year of experience and making the category an even richer contributor to the future success of our core business.

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. Comparable store sales in the quarter for Q4 are projected to be flat to down 1% and Acceptance Now comps are now expected to be approximately 20%. And as mentioned earlier, we expect Acceptance Now losses similar to Q4 of last year until we are ready to implement the changes to our account management process. Given these expectations, we now project full year 2015 EPS to be $2 to $2.10 which equates to Q4 EPS of $0.52 to $0.62.

With that, I'll turn the call back over to Amy to open the line for questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] . Your first question comes from the line of Brad Thomas with KeyBanc Capital Markets. Brad, your line is open.

Bradley B. Thomas
KeyBanc Capital Markets, Inc.
Q

Hi guys, thank you, good morning, Robert, Guy and Maureen, a couple of things I wanted to ask about, I know there will be lot other people wanting to ask questions, so maybe I could just first ask about guidance and then secondly ask of is phones. With respect to guidance and specifically the outlook for same store sales in the Core business, could you share a little bit more about what you've been seeing over the last few months as you have anniversaried the rollout of smartphones?

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance
A

So, as you saw with the third quarter cost Brad we held close to that flattish expectation that we were expecting as we started the first quarter of the lap of the smartphones so we felt good about how the first quarter has gone. The other categories other than smartphones have all continued to improve sequentially as we expected as we went through the lap of the smartphone and as we see by our guidance today our expectation is to stay pretty close to that flattish expectation that we expected a year ago.

The portfolio remains strong similar to where it was last year, may be slightly down which is the best indication we've got going into the quarter of what we think comps, the result of comps will be but clearly the fourth quarter is a high volume quarter for us and so we need to be able to continue to add to the portfolio as we go through this busier volume season that we're about to embark on here in a couple of weeks.

Robert Dale Davis
Chief Executive Officer & Director

A

And just one additional comment Brad, I think in Guy's prepared comments and may be the press release even talked about the old affected markets just a little bit more color there. Texas, the state of Texas, our comps were down about 4% in Texas and higher than that in some of the Odessa markets and Houston markets as an example. So, if Texas had been just flattish like the majority of the rest of the business, our comps actually would have been a positive point to given the 10% of our stores in revenue really comes from the state. So, that macro impact really had an effect as well.

Bradley B. Thomas
KeyBanc Capital Markets, Inc.

Q

Got you. And Guy I think you mentioned the on rent merchandise is down 15% and just so I understand you right, that's what you normally would see seasonally from the end of 3Q and to the start of 4Q, so that number still makes you feel comfortable as you guide to comps for the fourth quarter?

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance

A

Yeah, so actually it was down $15 million, Brad not 15% but yes we still have that comfort level that our customers in the summer season tends to be a little more challenging for them, so it tends to be our lowest volume season. And also the season where it's a more challenging to collect from our customers and if you look back before last year, you will see typically that this is the low point of our inventory on rent number. So, last year was a bit of an anomaly because we were rolling out smartphones during that season, so not typical what we usually see.

Bradley B. Thomas
KeyBanc Capital Markets, Inc.

Q

Right, right. And then, just on phones and I'm sure others will ask about this but two questions, for one, how much was this an acute issue due to the new models that have just come out in the last few months versus something, you know, has been sort of ongoing and how you've been planning your inventory over the course of the last year that you've been in smartphones in all of your stores? And then, just how much might this affect the profitability on a go-forward basis for phones?

Bradley B. Thomas
KeyBanc Capital Markets, Inc.

A

So, Brad, it's more a product that's standing up in the category, a new category. For those who have followed the company for some time, we don't have write-downs like this and we have in our historic categories that we have a lot more experience managing and did very well. Smartphones were a new category and while we were able to test in some markets, it's difficult to test everything associated with smartphones like what national media will [ph] do (29:39), so it's hard to test that in a regional market. And so, we entered into the category with a broad assortment of phones sort of a good, better, best approach is what we typically do with our other categories.

And what we've seen over the year as we've learned a lot of being driven by our own business but some of what you see out in the marketplace where newer phones are starting to become much more common as the carriers and the manufacturers make it much more simpler through their agreements for you to always have a newer phone. While our customers can't necessarily tap into that, it does create an expectation in the marketplace that phones tend to be newer and what we've seen is newer phones performing very well and older generation phones be a little more challenged.

And so, I think as we move forward with the category, we likely will see probably more of a skew towards new generation phones in the category moving forward. We'll have to look at our pricing and want to look at inventory levels to make sure that we have those right and we probably want to look at our depreciation policy to make sure it's consistent with how quickly those newer models turn over. But we do expect that a momentum we've seen recently with locking and some of the progress we've made on service cost will continue in the future and we think it will be a profitable category and we plan to stay in it.

Bradley B. Thomas
KeyBanc Capital Markets, Inc.

Q

Got you. So, just to be clear knowing what you know today about you do think that this can continue to be a profitable category for you?

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance

A

Absolutely.

Robert Dale Davis
Chief Executive Officer & Director

A

We do and knowing what we do today, we would have not had as many older generation phones in our inventory to begin with and that's really what we're trying to address here is ensuring we're focusing on the more popular items that customers resonate with them.

Bradley B. Thomas
KeyBanc Capital Markets, Inc.

Q

Got you. All right, I'll turn it over to others. Thank you so much.

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance

A

Thank you, Brad.

Robert Dale Davis
Chief Executive Officer & Director

A

Thanks, Brad.

Operator: Your next question comes from the line of Anthony Chukumba from BB&T Capital Markets. Anthony, your line is open.

Anthony Chinonye Chukumba
BB&T Capital Markets

Q

Thanks for taking my question. Just one follow-up.

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance

A

Hi, Anthony.

Anthony Chinonye Chukumba
BB&T Capital Markets

Q

Hi, just one follow-up question on the smartphone write-down at $35 million, can you give us a sense for what that was as a percentage of your total smartphone inventory?

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance

A

Anthony it's about 35% of our total smartphone inventory.

Anthony Chinonye Chukumba
BB&T Capital Markets

Q

Okay that's helpful. And then just one unrelated question, in terms of comps particular in the Core can you give us any color just in terms of how that worked out over the course of the quarter like on a monthly basis?

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance

A

Well, that can be difficult Anthony because of the mismatch months and how many weekend days fall in a month as opposed to the year previously but I think it's fair to say that you know earlier on in the quarter we felt very good about our portfolio and I think as we got more towards the end of the quarter that declined a little bit which is why now our expectation of flattish for the fourth quarter is now more flat to down 1 because the portfolio is slightly weaker ending the quarter than it was starting the quarter.

Anthony Chinonye Chukumba
BB&T Capital Markets

Q

Okay that's helpful as well. Thank you.

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance

A

All right, thank you Anthony.

Operator: Your next question comes from the line of J.R. Bizzell with Stephens, Inc. J.R. your line is now open.

J. R. Bizzell
Stephens, Inc.

Q

Good morning and thanks for taking my questions.

Robert Dale Davis
Chief Executive Officer & Director

A

Hey, J.R.

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance

A

Good morning J.R.

J. R. Bizzell
Stephens, Inc.

Q

Hi, So Robert kind of building on your commentary I know we're going to beat this phone inventory thing to death but kind of building on your comment about how you – if you had to go back and do it again and kind of thinking about how you wouldn't have as many old phone options thinking about that moving forward I am guessing you all are addressing this inventory moving forward and just if you could I guess my question is kind of walk us through maybe how you are addressing the inventory moving forward and how you are going to handle that moving forward?

Robert Dale Davis
Chief Executive Officer & Director

A

Well I think, as was mentioned in the press release, and as Guy eluded to we are ensuring that all of the learnings that we had were flat going forward. So whether it's from an assortment perspective, a pricing perspective, our depreciation policy perspective, all of that is for things that will be addressed moving forward. So, it's hard from a competitive perspective to give you too much color on that knowing that our competitor is entertaining the notion of getting into this category. So, I hesitate to share too much. But the fact is we do believe that the category has been the popular item, one that really gave us the shot in the arm last year from a top-line perspective and from a profitability perspective has been profitable but improving along the way with some of the locking features and the service cost initiatives that we've undertaken. So, we would expect the category to actually improve going forward as well.

J. R. Bizzell
Stephens, Inc.

Q

Great color. And then, kind of building on that maybe for you Guy, it would be fair to assume that we're not going to expect a big write-down on a go-forward basis now that we've kind of got more color around the inventory levels?

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance

A

No, we don't expect that, J. R., as I said earlier, we've been managing our other product categories for quite some time and have never experienced a write-down and as I mentioned in my earlier comments, this write-down is more associated with standing up a new category that we hadn't done before and getting a read and learning over the year since we've rolled it out about what our customers value most. So, no I wouldn't expect that moving forward.

J. R. Bizzell
Stephens, Inc.

Q

Understood. And then last one from me kind of building on the – switching gears to the 90 day buyout and that continues to be successful and driving nice volume, just wondering Robert, I know you alluded to some changes with your partners kind of in 2016, is that, is it just simply going to be something of a – kind of a discount on the purchase, is there, if you could add some color there, I don't know how much you can but if you could just maybe some more details around may be some margin improvement opportunities moving forward with that?

Robert Dale Davis
Chief Executive Officer & Director

A

Yeah, I think there a variety of ways that we're addressing that J.R., and again I hesitate to share too much with you but I think it's fair to say that we don't want to have top-line growth that's not productive from a bottom-line perspective. And so as we're seeing that feature if you will or that proposition to the customer gaining popularity, we believe it was necessary to address the overall profitability of that option. So, we have been in conversation with some of our top partners from a retailer perspective and those have been very productive. So, we would expect that to enhance as we move into 2016 and beyond.

J. R. Bizzell
Stephens, Inc.

Q

And what percentage of transactions were that [ph] 90 day (36:40) buyout this quarter?

Robert Dale Davis
Chief Executive Officer & Director

A

Yeah, about 33%, a third of our overall transactions customers took that option and we expected that to actually go down from Q2 I think it was in the mid 30s in Q2 and while it came down just a couple of points not as much as we would have otherwise expected coming out of tax season. So it does appear that customers will continue to choose that offer going forward. And so we felt it necessary to go back to our partners and have some productive discussions.

J. R. Bizzell
Stephens, Inc.

Q

Thanks for taking my questions.

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance

A

Thank you.

Robert Dale Davis
Chief Executive Officer & Director

A

Thank you.

Operator: Your next question comes from the line of Laura Champine with Cantor Fitzgerald. Laura, your line is open.

Laura Champine
Cantor Fitzgerald Securities

Q

Good morning. Guy, my question is about the guidance for Q4, the implied range when we spoke in July was $0.10 higher than it is today. Are the differences solely the increased loses versus your prior expectations in Acceptance Now and the accelerated sell through at lower margins of older generation smartphones or is there something else happening impacting the guidance?

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance

A

No, it's really those three factors I mentioned in my remarks Laura, it's the Core comp expectations being just a little bit lower than we might have thought related to the portfolio question I got earlier. A little clarification on where we're going to be with Acceptance Now comps as we get more color into the lap of the 90 day option and then the losses related to Acceptance Now.

Laura Champine
Cantor Fitzgerald Securities **Q**

Got it. And, on the losses on Acceptance Now, that's an issue that obviously you've been facing for a while, what are the specific steps that you're taking to try to improve that?

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance **A**

Well, today, Laura the collections process occurs largely in the stores and so, as we look at opportunities to improve our collections approach, we think there are some other resources we can use to supply that or to at least support that and provide additional ways for us to manage that number down. So, we'll talk more about that as we get into 2016, but I think in Acceptance Now, we have historically managed the losses similarly to how we've done it in the Core business. And I think, what we recognize now is that there is perhaps some opportunities for us to manage it a little differently than we do in the Core business and do it a little more effectively, related to the unique characteristics of that business.

Laura Champine
Cantor Fitzgerald Securities **Q**

Because collections is such a key part of the Core, it is tough for me to understand why those same processes wouldn't be even better when applied to the higher FICOs in Acceptance Now. So, I am just wondering, if I can get more specifics on how it might change and also, whether this will impact growth in Acceptance Now as perhaps you limit approvals?

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance **A**

Yeah, so, Laura, may be the biggest difference I can draw for you is in the Core because of the weekly payment model and where the customer sits on the demographic spectrum versus Acceptance Now we tend to see those customers much more regularly as they come into the stores to make payments. And so managing the collections process largely from the store where the relationship is much deeper and more established works very well in the Core.

As you can see we've made great progress on managing losses in the Core. We don't have that same sort of relationship in Acceptance Now where it's a monthly model and more people are perhaps paying electronically than you might see in the Core or we don't see them as frequently. And so the ability to leverage the in store co-worker in Acceptance Now is not as effective as it is in the Core. And so we see some other opportunities to perhaps manage that or support it more centrally than we do today and become more effective in managing the losses that way.

Laura Champine
Cantor Fitzgerald Securities **Q**

Got it, thanks. And then just one more follow-up and then I will yield. On the Core same-store sales you're now looking to be lower than your prior expectations, I wasn't clear on what that impact is, is it just Texas or are there other things impacting the Core comp?

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance
A

As I think I mentioned earlier Laura, I think the portfolio is not quite as good as it was at the start of the quarter I don't want that to sound alarming it's not in bad shape but it's not as quite good as it was at the start of the quarter. And so that's why we've made what I call more of an adjustment down from expecting flat comps to remain flat to down 1. It's not a dramatic reduction in our expectation but it is more in line with what we expect now.

Laura Champine
Cantor Fitzgerald Securities
Q

Thank you.

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance
A

Thank you Laura.

Operator: Your next question comes from the line of John Baugh with Stifel. John, your line is open.

John Baugh
Stifel, Nicolaus & Co., Inc.
Q

Thank you for taking my questions this morning. I was wondering on the Acceptance Now losses. So, you mentioned looking at collections but frequently if you have sub-prime go bad, it's not so much collections but an underwriting decision problem, is this something you're going to be looking at there to maybe tighten approvals or change the way you approve?

Robert Dale Davis
Chief Executive Officer & Director
A

Yeah, John that's a good question. Certainly, one thing that we believe is an opportunity for us particularly given the technology that we've deployed into Acceptance Now is our ability to mind data and understand the different profiles of consumers given their employment record, the reference checks and so forth. We believe that the underwriting process can be enhanced going forward as it relates to using that technology. So, they're part and parcel of one another as you know, having followed this for so long so not only the back-end process that Guy alluded to but also the front end approval process are both areas that we have opportunities.

John Baugh
Stifel, Nicolaus & Co., Inc.
Q

Robert, do you think that would resolve and maybe a slightly lower of approval rate to improve the profitability or you're not sure yet?

Robert Dale Davis
Chief Executive Officer & Director
A

We're not sure yet.

John Baugh
Stifel, Nicolaus & Co., Inc.
Q

Okay.

Robert Dale Davis
Chief Executive Officer & Director

A

We're in the early innings, if you will, in terms of mining that data but certainly our ability to have those insights are going to just enrich our process and opportunity going forward.

John Baugh
Stifel, Nicolaus & Co., Inc.

Q

Okay. And I'm just curious, you and your competitor throw out this $20 billion industry opportunity numbers relate to this transaction, could you just maybe give us the two or three key assumptions that go into that? And also staying on Acceptance Now, you mentioned the 30% I believe the staffed locations have seamless technology, I guess that's referring to the one application sort of process, do I understand that correctly, one would be we have it in all of the staffed stores and is that technology available to your unstaffed models? Thank you.

Robert Dale Davis
Chief Executive Officer & Director

A

Yeah, I will take the first one John. The market sizing work that we did really took a top down approach and a bottoms-up approach in both of those sort of triangulated around the $20 billion to $25 billion addressable market. When you look at retailers more broadly that are in our categories, our traditional face categories, furniture, plans, computer, electronics and then you look through the process of how many of those sales in the market on an annual basis are cash sales, how many go through non-cash be it prime or non-prime factors, and then you sort of go through this process of shrinking the market until you ultimately get to a market sizing of around $20 billion. So we can walk through that in more detail with you on a later date but we did take a top down and bottoms-up approach and so it came to a similar number in terms of the opportunities that our competitor did as well.

On your second question...

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance

A

Yeah, John I can answer your second question. So, when we talk about the technology opportunities both the seamless application you talk about which ours will work across multiple primary partners and multiple secondary partners which we think is a unique proposition in the space and we believe we are the only one that will allow for that open platform that will allow everyone to participate. So, we believe that much more inclusive approach will drive bigger volumes. And as well it relates to the ability to be on our partner websites which we know already is contributing to comp store performance in Acceptance Now. In terms of the seamless application being available on our [ph] WAN (45:45) direct system, we've been focusing more on the larger partners now and trying to affect the larger pool of revenue opportunity as Robert talked about working with some of our largest partners first. We will have it as part of WAN direct but right now we're focusing on our largest partners first.

John Baugh
Stifel, Nicolaus & Co., Inc.

Q

Okay. And my last question just quickly if I could, core inventory on rent I believe was down 6.5% year-over-year, I understand there was timing of smartphones or the write-down of inventory, whole lot of moving parts but your comp guidance is flat to slightly down and yet inventory on rent going into the quarter is materially down, so could you connect those dots please? Thank you.

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance

A

Well, there is a few things going on, you pointed to one of them John is that last year it was a bit of an anomaly because we're standing up to smartphone category. So, we generated a lot of volume of bringing on new deliveries of smartphones last year putting product on rent but very early in the revenue cycle because they were brand new agreements. If you go back and obviously John, you follow the business for a long time, 2013, 2012, 2011 you typically see this sort of inventory on rent performance like we're seeing this year. So, I think we're back to more of a normal seasonality for the business. So, no, we're not looking at that percentage and making assumption of what that drives in the comp. The other piece I would say is as we enter into this busier volume season, this is probably the quarter where much more of the volume that contributes to comps comes from what we drive in this busier season as opposed to what the portfolio drives. So, while it is important to look at the portfolio, this particular quarter will be driven more so by the volume we generate as part of the busier holiday season than perhaps other quarters.

John Baugh
Stifel, Nicolaus & Co., Inc.

Q

Great, thank you and good luck.

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance

A

Thank you, John.

Robert Dale Davis
Chief Executive Officer & Director

A

Thanks, John.

Operator: Your next question comes from the line of Budd Bugatch with Raymond James. Budd, your line is open.

David Joseph Vargas
Raymond James & Associates, Inc.

Q

Good morning, everyone. This is David on for Budd.

Robert Dale Davis
Chief Executive Officer & Director

A

Hi, David.

David Joseph Vargas
Raymond James & Associates, Inc.

Q

So I was hoping you can just shed a little bit more light on the smartphone issue, I hate to beat it to death but when did you – I guess when did you see this becoming an issue, I mean you've had – the category has been stood up for a while when you bought in, you bought across a spectrum, so when did you I guess realize that the lower or the older generation models weren't renting as well and the inventory may have had to been written down?

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance

A

See David probably over the last couple of quarters the issue has been building a little bit and so what happened particularly in this quarter though was a couple of events that really brought us to where we are today. The first was, we completed a sale of phones in the secondary market at a value that was less than what we had on the books for those phones. And so that as the fist trigger that caused us to realize that we have been looking to take a step like this. The second one was that our belief was we would be able to use some clearance events and some bundling approaches a couple of which occurred in this third quarter. And while we had a little bit of success in that we didn't see as much as we would have liked.

And so those two particular events brought us to the point where we realized the excess inventory was going to cause us to have to make this correction that we did this quarter. So while we knew we had excess phones in the inventory I think our belief was that we rather be able to monetize them in a secondary market or clear them but the third quarter we had a couple of events that told us while that would be somewhat successful or wouldn't be as successful as we thought.

David Joseph Vargas
Raymond James & Associates, Inc.

Q

Got it. And when in the quarter did the sale in the secondary market happen and I am guessing that that triggered a lower cost or lower cost of market event where you had to evaluate the rest of your inventory?

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance

A

Yeah, we probably started talking about in August, I think we completed the sale in early September and the clearance events where we had one sort of early in the quarter and one later in the quarter, so a combination of those three factors.

David Joseph Vargas
Raymond James & Associates, Inc.

Q

Got it. And then my last question on the issue, does this change, will this have an effect on the rental terms of some of the newer, the newer model phones, because the newer, a newer phone becomes an old phone in about 12 months. So I'm guessing that's around the cycle, so we see a – are you going to look at shortening the rental term, adjusting pricing, can we have little color there.

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance

A

I think as Robert said, David, I think we are in a – the changes we'll make will cover a lot of fret in that area. So, I think we now have, we now have a better understanding after a year of being in the category of what works for customers and what won't. So, it'll be pricing, it'll be our depreciation schedule, it'll be terms, it'll be assortment, it'll be inventory levels, it'll – the changes we are making will be across the board.

David Joseph Vargas
Raymond James & Associates, Inc.

Q

Great, all right, thank you, very much.

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance
A

Thank you, David.

Operator: Your next question comes from the line of Carla Casella from J.P. Morgan. Carla, your line is open.

Carla M. Casella
JPMorgan Securities LLC
Q

Hi, sorry about that, I was on mute. On the 90 day option, can you just talk about how does the economics of that differ, I mean, you did mention that it's not a lower margin product but can you just explain in a little more detail?

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance
A

Yeah. So, the 90 day option Acceptance Now, Carla, what it, it looks like a normal agreement when the customer signs up for it so, but the difference is that they have the ability to elect, to pay a cash option prior to the end of the 90 days from the start of the agreement. And so, what we – previously we had not offered that in our Acceptance Now business more than a year ago, we've always offered it in our core business but clearly with that stronger customer that we see in the Acceptance Now business they perhaps have a little more ability to take advantage of that than our Core customer would.

And so what you're seeing is with us buying the product at retail that the margin we earn on the product comes in the form of a discount for the product that we can tap into or with the ability to mark up the cash price in the store. Either way though that is a lower margin transaction than what we would see in our normal rentals and fees business. So I think I said in my prepared comments something more like a 10% to 15% margin when we typically earn a margin that's more like in the 60s for our rentals and fees business.

Now we don't think it's a highly cannibalistic business. I mean, clearly, it wouldn't take a lot of transactions to cannibalize our normal business for it to not be a good idea for us to be in 90-day cash option, but what we think is happening is that we're bringing people in that perhaps wouldn't have considered a longer term rental agreement, but are those that are predisposed to take advantage of the 90-day cash option that only other option would have been to save the money for longer and try and purchase it a few months from now.

Carla M. Casella
JPMorgan Securities LLC
Q

Okay. And then when you talked about moving from direct to staffed are you the one initiating that typically or is it the retailer and how is the labor market, are you having any problems finding staff or you pull from your existing staff?

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance
A

It depends on the volume that we generate in the particular location Carla. So it does cost us to put staffing in a location. And so we want to make sure that certain amount of volume that could be driven in order to justify the cost of the staffing. And generally when we start off with the retailer we're staffed in all of their locations but as we gain some experience in terms of what volumes are driven often will historically we would have closed the location that wasn't doing enough volume.

Now, we have the ability to convert that location to a direct location where the transaction would simply be an electronic one and not supported by an actual staff member in the store. So usually retailers would like us to be staffed because the staffed model is so much better than the online model in terms of driving volume but there are just some locations that can't support the staffed model. So the direct option is a good one for those locations.

Carla M. Casella
JPMorgan Securities LLC Q

Okay. It sounds like that you are moving the other direction [ph] and so (54:18) moving from direct back to staffed?

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance A

Yeah in some, I think what – in Robert's comments what he said was in some locations, we've started with direct that are smaller locations, we have been really pleased by the volumes that we've been generating. These locations may actually reach the point where it does make sense for us to be staffed but those are typically smaller locations starting out not larger retailers but yes if we can generate the volume necessary to do the staffed model, we prefer to do that because it is better for the retailer and it is certainly better for our business too.

Carla M. Casella
JPMorgan Securities LLC Q

Okay. And then just one comment on the labor market, are you still having any trouble staffing either those or your stores given all your changes in the labor model?

Robert Dale Davis
Chief Executive Officer & Director A

We haven't seen that. In fact, we've been very pleased with the rate at which our flexible labor model has ramped up and our ability to source, recruit and hire, as I mentioned, 5,500 plus part time co-workers in a short span of time. So at this point in time, the labor market seems to be sufficient to allow us to make this transition haven't seen any challenges.

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance A

Yeah we'll say Carla on – the thing about the labor market as wage rates push up, that's a good thing for our business because our customers are those minimum wage earners for close to minimum wage earners that are all going to be seeing salary increase as which will allow them to shop in our stores. Our hourly wages are typically up above $10 an hour anyway, so we are not at minimum wage levels today. Certainly in some micro markets where the wages are higher than that we will have to pay a little bit more but on balance rising minimum wages is a good thing for our business not a bad thing.

Carla M. Casella
JPMorgan Securities LLC Q

Okay, great. Thank you.

Guy J. Constant
Chief Financial Officer, Treasurer & EVP-Finance A

Thank you.

Robert Dale Davis
Chief Executive Officer & Director

A

Thanks Carla.

Operator: This concludes our question-and-answer session. I would now like to turn the call back over to Robert Davis for closing remark.

Robert Dale Davis
Chief Executive Officer & Director

Thank you, Amy and thank you everyone for joining us. We appreciate your time and interest in Rent-A-Center, in our company. We certainly look forward to reporting back to your next quarter as we come out of our seasonally strongest period, our fourth quarter selling season. And look forward to the opportunity for all of our initiatives to continue to add value and create opportunities for all of us going forward. Thank you for the time and attention.

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