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Rent-A-Center, Inc. (RCII)

Q4 2015 Earnings Call

CORPORATE PARTICIPANTS

Maureen B. Short
SVP-Finance, Investor Relations & Treasury

Robert Dale Davis
Chief Executive Officer & Director

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

OTHER PARTICIPANTS

David Joseph Vargas
Raymond James & Associates, Inc.

J.R. Bizzell
Stephens, Inc.

Bradley B. Thomas
KeyBanc Capital Markets, Inc.

John Baugh
Stifel, Nicolaus & Co., Inc.

Anthony Chinonye Chukumba
BB&T Capital Markets

Carla M. Casella
JPMorgan Securities LLC

William Reuter
Bank of America Merrill Lynch

MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and thank you for holding. Welcome to Rent-A-Center's Fourth 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, February 2, 2016.

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 – Finance, Investor Relations and Treasury.

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

Maureen B. Short
SVP-Finance, Investor Relations & Treasury

Thank you, Sally. 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 fourth quarter and year-end 2015. 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. Rent-A-Center undertakes no obligation to publicly update or revise any forward-looking statements. These factors are described in our earnings release issued yesterday, as well as, in the company's SEC filings.

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

Robert Dale Davis

Chief Executive Officer & Director

Actually, we're going to have Guy just make a couple of comments first.

Guy J. Constant

Chief Financial Officer, Treasurer & EVP-Finance

Thank you, Robert, and good morning, everybody. Before Robert joins to walk you through our key areas of focus, I'd like to touch on the goodwill impairment that was taken in the quarter. As a result of our annual testing processes, we recognized a $1.17 billion impairment of our goodwill in the fourth quarter, due primarily to the recent decline in the company's market capitalization. As we had previously disclosed, a non-cash charge of this size, while having no negative effect on our liquidity or our debt covenants, does limit our ability to pay dividends at our current levels.

However, due to a recent amendment to our credit agreement, the company is permitted to make up to $20 million in annual dividend payments at current leverage ratios. Accordingly, the board of directors will reduce the quarterly dividend from $0.24 to $0.08 starting with our next quarterly payment in April. I'll discuss the detailed financials later on the call, but first let me turn over to Robert to discuss the key areas of focus for the company.

Robert Dale Davis

Chief Executive Officer & Director

Thanks, Guy, and thank you, everyone for joining us. First, let me say that despite progress on many fronts, our leadership is not satisfied with the current performance in business results. As many of you are aware, we are in a time of significant transition in our industry, with the maturation of the Core business and the increasing competitive intensity of our Acceptance Now business. We do believe that we are making the necessary changes to address this changing environment and improve our overall profitability for the future success of Rent-A-Center. We are now two years into our multiyear transformation strategy with a plan to deliver improved profitability in our Core rent-to-own business, maximize the Acceptance Now revenue growth and profit opportunity and optimize our Mexico business.

As we look at our overall 2015 performance excluding special items, we grew operating profit by 8%, we grew EBITDA by 4.8%, and we significantly improved Core same-store sales and stabilizing Core profitability. We grew the Acceptance Now business double-digits in both revenue and units. And in Q4, we grew Acceptance Now gross margins sequentially, demonstrating our focus on profitable growth.

In the fourth quarter, we fully lapped the introduction of smartphones in the Core business, a dynamic that helped drive same-store sales in the Core for the first three quarters of 2015. So while our comp performance is impacted by lapping smartphones, we are pleased with the improved profitability that we are now delivering from this category as improved product service capabilities and loss mitigation features like phone locking are having the desired impact.

Our skip/stolen losses in the quarter were 2.6%, which is near historical bests, even with the rollout of smartphones. The introduction of the smartphone category demonstrates our commitment to remain relevant to our customer and evolve our offering in response to their needs and changes in the marketplace. We know we drew new customers to Rent-A-Center with this product. We helped mitigate the declines in the computers and tablets category that are seen throughout the industry and the net profit impact was clearly incremental. As we move forward with the smartphone category, the go-forward strategy will include an assortment primarily made up of latest generation phones. And in order to meet the needs of our more price-sensitive customers, we will introduce well-known brand name alternatives.

Inventory will be managed to tighter levels and depreciation terms will be shortened, reducing the likelihood of future write-downs. This new strategy will be implemented over the next several months. In our other product categories, we have seen the expected improvement continue as it has throughout the year, culminating in Q4 with positive same-store sales in our furniture, consumer electronics, and appliances categories. That's the first time in the Core business in many quarters. However, the industry-wide decline in the performance of computers and tablets also affected our Core businesses at Rent-A-Center, negatively impacting overall comp store sales along with the declines that we saw in store performance in oil affected markets.

On the cost front, we continue to roll out our flexible labor model and the savings are starting to materialize on the P&L, adding to the significant progress we have made on reducing labor expenses in our Core stores. Our updated supply chain and the logistics strategy is also poised to deliver significant benefits for 2016. On the sourcing front, we continue to make strides with expanding our vendor base and offering better quality product and selection to our customers. New, higher quality appliance brands are now being offered in stores. The customers are responding positively to and our product cost per unit have gone down.

Our pricing efforts are also helping us to make better decisions aligning customer needs with the right pricing to maximize gross margin dollars. In Q4, we started to see the impact of these changes, with gross margin declines narrowing significantly from what was seen earlier in 2015. We have continued to optimize our store footprint in order to focus on improving the return of our asset base and optimizing our store fleet. This rationalization has been highly accretive to our business as we have been able to transfer agreements easily to nearby stores. We will continue to carefully analyze our markets and identify opportunities to further right size our store fleet if needed.

Our Core rent-to-own business has benefited from a number of transformational actions over the past two years. As a mature business, we intend to continue focusing on maximizing cash flow and operating profits in the quarter through operational efficiencies. This has allowed our team to reduce our run-rate operating expenses by over $50 million in 2015.

In our Acceptance Now business, we saw a same-store sales increase of 25.8% for the year. And as you know, the 90-day cash option pricing was rolled out as a competitive response that was not fully anticipated at the beginning of last year, but allowed us to significantly accelerate our revenue growth. As we lap the 90-day option rollout in Q2 of 2016, our comp store sales growth will not be as high, but we will see additional unit expansion as well as growth from the Acceptance Now Direct locations opened in 2015.

We accomplished our goal of opening 500 direct locations in 2015 and we expect to add additional locations in 2016, most likely in the back half of the year. Unfortunately, with the sales growth from the 90-day option [ph] also came pressure (8:47) on gross margins. However in Q4, Acceptance Now began to slow the declining year-over-year trends by showing meaningful sequential gross margin improvement as the number of cash options being exercised was lower in Q4. And we're also starting to see higher margins from the improved economics in place with a number of our best retail partners.

Now, let me touch on our Mexico business. As you know, we stopped unit growth at our Mexico business to allow our new in-country leadership team and our operators to digest some of the changes that we are making to improve the overall health of that business and to demonstrate progress with results and results have certainly improved with [ph] mini markets and mini stores (9:32) that are very profitable generating positive cash flow.

However, there are markets and aspects of the business that still have opportunity for improvement. We recently completed our year-end review of the business, and following this evaluation, we have made a decision to continue to operate in the region, but we will be exiting underperforming markets and focusing on the northern part of the country and border markets where we have been more successful. We will continue the transformation of our Mexico business, and we do expect to be breakeven in 2016 with the path to future profitable growth.

Moving forward, despite some important achievements, there is still more work to be done. Meeting our customers' needs has always been a driver of our business decisions, and that will continue in 2016 as we rollout e-commerce capabilities. We believe that offering our RTO transaction online will allow us to access new customers who might not otherwise consider rent-to-own, as well as enable our existing customers to interact with Rent-A-Center more easily and conveniently. By pairing e-commerce together with our traditional brick-and-mortar stores, we believe we will offer our customers an even more compelling value proposition and will help support our longer-term goal of flat same-store sales in the quarter. So, as we reap the benefits of our major 2015 initiatives in 2016, we are also aligning the ground work for additional benefits to be realized in 2017 and beyond as we maximize operating profits and cash flow in our Core business.

In Acceptance Now, we believe there is a material amount of market opportunity in the non-traditional RTO market. To ensure that we capitalize on an addressable market we think exceeds $20 billion, we've recently established a dedicated commercial sales organization charge with growing Acceptance Now's national footprint, while continuing to deliver industry-leading service. This organization will allow Acceptance Now to bring a more targeted focus to the way we prospect, sell and manage retail relationships. It will enable us to enhance the operational support to our existing retailers and boost the recruitment of national business partners.

For us to successfully execute on the strategies and strategic priorities for both Core RTO and Acceptance Now, technology must play a central role in the modernization of our business. In Core RTO, this means providing our customers the ability to not only obtain an online approval but also fully transact without ever having to come into a store. In Acceptance Now, this means further expanding our product offering of staffed, direct and point-of-sale based models, ensuring that our program platform allows us partner with best-in-class primary and secondary financing companies and deepening our risk management and decision analytics capabilities.

In summary, we feel strongly about the opportunities available for us to create value for our shareholders, customers and co-workers. The Core RTO business has numerous opportunities available to further increase its efficiency and generate higher operating profits, while Acceptance Now will be pursuing revenue growth with their compelling margins through a focus on sales and technology.

As I reflect back on the past two years, there is something that we could have done better and there have been some changes we could not have anticipated. But with increases in operating profit, EBITDA and free cash flow, we are headed in the right direction. We're asking our team to execute on significant changes as part of this multiyear transformation that we are undergoing and I'd like to thank all of our co-workers, who're working very hard to drive results and improve our performance.

With that, I'll turn it over to Guy, to provide more details on the results and our outlook for 2016.

Guy J. Constant

Chief Financial Officer, Treasurer & EVP-Finance

Thanks Robert, and good morning, everyone. This morning I will walk you through the highlights of our financial results for the fourth quarter, as well as our outlook for 2016. I'd also like to mention that as I refer to our fourth quarter performance, either this year or versus a year ago, all numbers will be presented on a recurring basis, excluding special items.

As outlined in the press release, consolidated total revenues were $794 million, which represents a 0.4% decrease versus last year, as double-digit sales growth in our Acceptance Now business was offset by the continued rationalization of the store base and lower same-store sales in our Core U.S. segment and foreign currency headwinds of approximately $3 million in our Mexico business. Our total U.S. same-store sales combining the Acceptance Now and Core performance increased 1.7% versus a year ago, marking our seventh consecutive quarter of domestic same-store sales growth.

Looking at sales performance in our Core business more closely, total revenues were down 4.5%, driven by a 5% reduction in store count and a same-store sales decline of 2.2%. Comp sales were negatively impacted by the continued economic slowdown in oil-producing markets, including our Texas stores, which were down over 8%. The fourth quarter also saw the stores that received merged accounts during our store closures in June of 2014 enter back into the comp base. This also negatively impacted comp store sales in the fourth quarter, as these stores were down almost 9% as they lapped the benefit of the merged accounts a year ago.

On the positive side, the fourth quarter benefited from comp sales increases in our furniture, consumer electronics, and appliance categories. Flat comps in our smartphone category as we have now fully lapped the rollout, offset only by the industry-wide comp declines in the computer and tablets category. On a two-year basis, same-store sales in the quarter remained strong, up 1,200 basis points since the first quarter of 2014.

In the Acceptance Now segment, we saw 16% revenue growth driven primarily by same-store sales increase of 13.7%, as well as 38 more staffed locations than a year ago and 532 direct locations versus none in the fourth quarter last year. Sequentially, our comp has slowed as we close-in on the full lap of the rollout of 90-day cash options set to occur in the second quarter of 2016.

Consolidated gross profit was $526 million and gross profit margin decreased 220 basis points versus prior-year to 66.3%. However, gross margin did improve sequentially. Gross profit as a percent of total revenue was negatively impacted by the lower gross profit margin on merchandise sales. In the Core segment, gross profit margin was 71.1%, 90 basis points worse than a year ago, but stable over the past three quarters. We expect the year-over-year trend to improve over the coming quarters, turning positive during the year, as we realize the benefits of lower product costs from our sourcing and distribution initiative.

In our Acceptance Now business, fourth quarter gross margins were 53.7% in Q4, up sharply from 51.9% in Q3. Gross margins are still down 400 basis points versus a year ago, as we're still a couple of quarters away from lapping the same-as-cash roll out, but the year-over-year gap has narrowed dramatically. As we fully lap the introduction of the same-as-cash option pricing by the second quarter of 2016, we also expect to realize the benefits of the new economics we are putting in place with our retail partners.

Consolidated store labor, which includes the expenses associated with co-workers at our stores and at the district manager level improved 120 basis points to 26.9% of store revenues. Other store expenses, which include expenses related to occupancy, losses, advertising, delivery cost, and utilities, also improved 120 basis points to 25.8% of store revenues. In our Core segment, store labor was down $12.1 million, an improvement of 70 basis points and was positively impacted by better labor productivity, the continued rollout of the flexible labor model and lower incentive payouts. In our Core segment, other store expenses were down $1.3 million or 110 basis points higher driven by higher advertising expense, partially offset by reduced losses and lower gas prices.

In our Acceptance Now segment, we continue to see improved leverage in the business with labor better by 130 basis points versus a year ago. Other store expenses also benefited from improved leverage, a 120 basis points better than a year ago. Our Core U.S. rent-to-own skip/stolen losses were near historical lows coming in at 2.6% in the quarter, down 90 basis points to last year, even with the rollout of the higher loss profile smartphone category.

Acceptance Now skips/stolen losses came in at 10.5% in the quarter, up 70 basis points to last year, higher than we would like, but in line with our expectations. On a consolidated basis, we delivered improved operating margins with a 40-basis-point year-over-year improvement to 6.7% in the fourth quarter as gross margin headwinds were more than offset by lower year-over-year operating expenses. We are pleased to be building on the momentum in operating margin improvement that started earlier this year, and we expect to deliver improvement in overall operating margins for the full year 2016.

Now to the balance sheet. We ended the quarter with inventory on rent down approximately $53 million versus a year ago. This was driven by lower store count, lower product cost as a result of our sourcing and distribution initiatives, the write-down of smartphones that occurred in Q3, and lower comp sales in Q4. Inventory held for rent was also down, approximately $49 million even with the investment in inventory at our third-party distribution centers. This was also driven by lower store count, lower product cost as a result of our sourcing initiatives and the write-down of smartphones in Q3, and also a reduction in store-based idle inventory, due to the tighter inventory management enabled by our sourcing and distribution initiative. Our inventory held for rent in the Core is 28.5% of total inventory, the lowest level since Q1 of 2014.

As of the end of the fourth quarter, we had approximately $60 million in cash and cash equivalents, our quarter-ending leverage ratio was about 3.1 times, down approximately half a turn as compared to the end of 2014. In fact, our total debt is down $74 million since the end of 2014. This includes $190 million drawn on our revolving credit facility as of the end of the fourth quarter, leaving approximately $390 million of available capacity.

We remain committed to bringing our leverage ratio down below 2.5 times and to remaining below that level going forward and we expect to see our leverage ratio approach 2.7 times by the end of the first quarter of 2016. This was driven by the tax refund of approximately $80 million that we expect to receive in mid-February related to the passage of tax extender legislation late in 2015, as well as the strong cash flow that we typically generate in our first quarter. We hope to accomplish our goal of reaching 2.5 times by the end of the first quarter of 2017 at the latest.

For 2016, we expect to deliver growth in earnings per share versus a year ago, assuming a decline in Core revenues of approximately 4% to 6%, driven by a projected same-store sales decline of 1% to 3% and the impact of store rationalization efforts, along with projected Acceptance Now revenues of between $850 million and $900 million. We expect the year-over-year declines in Core revenues to be weakest in the first quarter, coming in at approximately $575 million to $590 million, as we absorbed the short-term impact as seen in tests of the rollout of our new point-of-sales system to our Core store network. This will result in a projected first quarter year-over-year earnings per share decrease of over 20%.

We also expect to deliver year-over-year improvements in operating profit margin and EBITDA in each of the Core U.S., Acceptance Now and Mexico business, while improving free cash flow as well. In addition, we expect interest expense in the range of $45 million to $50 million, our tax rate to be approximately 37.5% and between $70 million to $80 million in capital expenditures. The flexible labor and sourcing and distribution initiatives are expected to drive incremental benefits in 2016 and both our operations and senior leadership teams remain committed to improving operational execution and performance. We're taking additional steps to improve performance and results within and beyond the current year. Our pursuit of flat Core U.S. same-store sales will be assisted in part by the introduction of e-commerce as previously mentioned by Robert and refined pricing actions.

Through the investment in a dedicated commercial sales and support organization, we expect to reinvigorate Acceptance Now staffed location growth. We are also targeting flat and improving gross margins in both our Core U.S. and Acceptance Now businesses due to capturing the sourcing and distribution benefits, continuing to improve the economics of the cash option offering in our Acceptance Now business and pursuing profitable sales growth by improving execution at the store level.

We are focused on continuing operating margin improvement driven by cost efficiencies from our flexible labor model, new sourcing and distribution model, pursuing profitable sales growth, and implementing new procedures and structures to improve losses in our Acceptance Now business. Free cash flow will be used to invest in standing up e-commerce, rolling out our new point-of-sales system, further technology investments in Acceptance Now related to our approval decision engine, and the pursuit of additional cost savings across our Core U.S. and Acceptance Now businesses, with the remaining cash flow used to reduce debt in support of our commitment to lower the leverage ratio below 2.5 times.

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

QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Your first question comes from the line of Budd Bugatch with Raymond James. Your line is open.

David Joseph Vargas
Raymond James & Associates, Inc.
Q

Good morning and thank you for taking my question. This is David on for Budd.

Robert Dale Davis
Chief Executive Officer & Director
A

Hey, David.

David Joseph Vargas
Raymond James & Associates, Inc.
Q

Just wondering if you could quantify what you think the impact of rolling out e-commerce next year is going to be and how much of an impact it will have on comp?

Robert Dale Davis
Chief Executive Officer & Director
A

The impact that we expect from e-commerce in 2016 is de minimis, it's minimal. Our expected rollout of that will be primarily a cash utilization for CapEx, as Guy mentioned, but in terms of top line impact, very minimal, but supporting our longer-term goal of flat same-store sales in the quarter.

David Joseph Vargas
Raymond James & Associates, Inc.
Q

Okay, great. And second, you've been doing a good job of taking down labor expense year-over-year and I'm just wondering can you provide a little detail on how you expect to continue to leverage labor going forward? And also where you are in the transition to a flexible labor model and what are the next steps there?

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

A

Look, David, about 85% of our Core stores have now triggered the flexible labor model, which means that the introduction of part-time labor has occurred in those stores. Although we're still in the early innings of realizing the full extent of the savings, because in addition to getting the part-time labor in place, we need to also transition through attrition from full-time coworkers that have overtime today to those who will be working 40-hour shifts in the future, thereby getting at the rest of the overtime premium that we pay.

So I would say we're still very early in the process of realizing that $20 million to $25 million of savings. However, we would expect that to materialize as we go through the balance of the year. After that the ability to then flex our labor and flex the hours depending on the particular demand patterns and activity levels in stores gives us an additional leg up on future savings once the initial roll out is complete.

David Joseph Vargas
Raymond James & Associates, Inc.

Q

Okay. And then one more and I'll get back in the queue. In Acceptance Now, can you give me a little bit of comments on what progress you're making on negotiating better economics with your retail partners?

Robert Dale Davis
Chief Executive Officer & Director

A

Yes. So as alluded to in our prepared scripts, we've obviously been impacted on the margin side from the popularity in consumer demand related to the cash option pricing. However, our ability to work with our retail partners in negotiating better economics has been successful to-date. We are focusing on our larger retail partners at this point in time, but that negotiation will be expected to continue with the rest of our retail partners for the balance of the year. We are seeing some benefits with those negations, but specifically how we're going about those conversations, I'd prefer not to get into the detail of that.

David Joseph Vargas
Raymond James & Associates, Inc.

Q

Okay, all right. Thanks very much and good luck going forward.

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

A

Thank you, David.

Robert Dale Davis
Chief Executive Officer & Director

A

Thank you.

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

J.R. Bizzell
Stephens, Inc.

Q

Yes, good morning, and thanks for taking my questions.

Robert Dale Davis
Chief Executive Officer & Director

A

Good morning, J.R.

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

A

Good morning, J.R.

J.R. Bizzell
Stephens, Inc.

Q

Building on kind of the A Now here, the Acceptance Now, just wondering, if you could give us a kind of a 30,000-foot view of what you're seeing in the competitive environment, because I think you alluded to that in the prepared remarks. And just wondering, how you're thinking about competition on a go-forward basis? I know you've implemented the new team to go out and extend that pipeline. So just give us an idea what you're seeing, how you're thinking about the pipeline on a go-forward basis?

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

A

So, J.R., as Robert mentioned in his comments, there's a lot of opportunity we believe still in the marketplace to bring on new retailers that don't have the rent-to-own option in their stores today. And so that's a big part of why we're stepping up our capabilities around trying to bring on new retailers and growing our staff location model. But at the end of the day, we still think we have the best model in the space by a long shot in order to help retailers save sales. I think the data is definitive in that regard. We save more sales for our retailers than any other competitor by some significant number of multiple. So we think once we can make that case to those retailers that don't have the option in their stores today, we will be able to get some pretty significant traction in that regard.

In terms of the competitive landscape, I think you're really seeing the onset of technology introduction into the space, not just by us but by other competitors as well. Retailers are seeking it, whether those are the credit cascades or waterfalls, so to speak, that make the customer experience better in store to the progress we've made on being on the e-commerce sites of our particular competitors as an additional way to save sales for the retailers and to drive traffic into their stores. That's probably the area where we've seen the biggest amount of change and we would expect that to continue. So the work we've done around, as I said, e-commerce, our associated web portal inside the stores, having the cascades, improve the customer experience, the decision engine work that we've done, we've made a lot of progress on the technology front in the last year-and-a-half and expect to do so in the future.

J.R. Bizzell
Stephens, Inc.

Q

So, Guy, kind of building on that, maybe even for Robert as well, with that technology build and the direct model, how are you all thinking about the pipeline for 2016 when it comes to the Acceptance Now platform?

Robert Dale Davis
Chief Executive Officer & Director

A

Well, as I alluded to in my opening comments, we have over 500 direct locations now, so unstaffed, and opened those in the back half of 2015. We would expect to open a similar number but more likely in the back half of this year in 2016. Our focus with the increased capabilities of the commercial organization that we're standing up, is going to shift our focus back into the manned locations and so the pipeline, we believe, remains strong. Last year we opened fewer staffed locations than we anticipate opening this year. So, as Guy alluded to, the model, the high-service model of the manned locations we believe is really where we operate and execute the best from a retail partner relationship perspective and the results that are forthcoming from that. So there will be a combination of both manned and direct, but with a bigger emphasis on manned this year than we had last year.

J.R. Bizzell
Stephens, Inc.

Q

Great. And I promise last one for me. What was the percent of sales that was made up by the 90-day buyout option and the Acceptance Now platform?

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

A

It had been tracking in the mid-30%s or so, J.R., and it dropped into the low-30%s in the fourth quarter, if you looked at it on a year-over-year basis. So that as well as some of the work we've done on improving the economics of the transaction resulted in a pretty sharp increase in gross margins that you saw in the fourth quarter.

J.R. Bizzell
Stephens, Inc.

Q

And if I can, building on that, you saw a decrease in that percentage. Was that a result of the underwriting model that you all kind of put into place to kind of reduce it? So was that in a positive way self-inflicted or was it that you saw the customer not opting for that option in the quarter?

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

A

I think it's probably a combination of both. We obviously want to make sure that our sales are profitable. I think we've certainly heard the feedback not only just internally but the investment community about driving sales growth, but at very low profit levels. So we want to make sure that our focus in our business is going to be on profitable sales. But at the same time, I think you probably saw a little bit of seasonality of how people utilize the cash options within the store as well. In addition to the fact that we're now starting to get to the point and will be by the end of this quarter where we've fully lapped that rollout.

J.R. Bizzell
Stephens, Inc.

Q

Great. Thanks for taking my questions.

Robert Dale Davis
Chief Executive Officer & Director

A

Thanks, J.R.

Operator: Your next question comes from the line of Brad Thomas with KeyBanc Capital Markets. Your line is open.

Bradley B. Thomas
KeyBanc Capital Markets, Inc.

Q

Yes, hi. Good morning, Robert, Guy and Maureen, how are you?

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

A

Good, Brad.

Robert Dale Davis
Chief Executive Officer & Director

A

Good, Brad.

Bradley B. Thomas
KeyBanc Capital Markets, Inc.

Q

Good. A couple of questions, if I could. Just as we think about 2016 as a whole and you think about the different cost savings opportunities, could you maybe quantify for us how much you're expecting from labor and sourcing specifically?

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

A

Well, we've laid out previously, Brad, what we think those overall savings could be. The sourcing project, as you know, we've already banked the cash savings and you started to see a little bit of that improvement in gross margins in the fourth quarter we had been tracking in the, call it, down 150 basis points to down 200 basis points range and now we're down less than 100 basis points in gross margin in the fourth quarter, and we would expect as I said in my comments over the coming months to see that turn flat and then even positive in the Core business. And that simply will be the materialization of the savings that we've already got on a cash basis as the products enter into the portfolio. On the labor side, we still think the opportunity from limiting the overtime premiums between $20 million and $25 million and then we think there can be even more after that fact through our ability to flex the labor. But beyond that, no we wouldn't want to quantify what that will be for 2016.

Bradley B. Thomas
KeyBanc Capital Markets, Inc.

Q

Okay, great. And then on smartphones, I apologize if I missed it, but could you give us the percentage of sales in the fourth quarter from smartphones and then just as we think about phones in 2016, given some of the changes in the assortment that you've made, what does that mean for the impact to revenues and profitability?

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

A

Well, we've now essentially fully lapped the rollout of smartphones. So it was about 8.5% in the fourth quarter of this year and it was a little over 8%, if you incorporate all the rentals and fees associated with smartphones a year ago. So we shouldn't see any further lapping going forward of smartphones as a result. I think in terms of the changes we've made to the product category, for competitive reasons, we wouldn't want to get into specifics about what we think that means for percent of revenues or what we think it will do with margins.

Bradley B. Thomas
KeyBanc Capital Markets, Inc.

Q

Got you. Okay. And then just a couple of questions about this current quarter, if I heard you right I think you said that you're expecting the first quarter earnings to be down 20% year over year. I just want to make sure I heard you right and any more color that you might be able to provide on why that's the expectation for the first quarter?

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

A

Yes, that's correct, we expect the EPS to be down more than 20%. It's basically related to revenues in the Core business that we think will come in between $575 million and $590 million. What we've seen, as we have tested the rollout of our new point-of-sales system, as we see a pretty short-term impact, just given the activity associated with putting a new point-of-sales system in the stores, very quickly the stores get up to speed and we end up with a better point-of-sales system that allows them to be more efficient to process transactions quicker and to deal with customers better. But as with any change of that significance in the store, you do get a little bit of a short-term impact. So as we roll that out in full force here in the first quarter, we would expect to see a little bit of impact to revenue which would go away then in the back half of the year.

Bradley B. Thomas
KeyBanc Capital Markets, Inc.

Q

Got you. And at what point will the POS be in all stores?

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

A

It should be done near the end of the first quarter, start of the second quarter.

Bradley B. Thomas
KeyBanc Capital Markets, Inc.

Q

Got you, got you. And then just a last near-term question, I know it's pretty early. But as you think about tax refund season, how are you forecasting that and any impact in particular that you might be modeling from changes in the Affordable Care Act?

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

A

We're not modeling any differences right now. We would expect to see, as we do typically in this first quarter, a higher level of merchandise sales than we do in other quarters. It will be interesting to see what that impact will have. It may result in not quite as many dollars in our customers' pockets as might have existed previously, which in our business would typically mean items would stay on rent longer which actually at the end of the day is a more profitable transaction for us. But without knowing exactly what that impact could be, we haven't modeled anything different than what we've seen in past years.

Bradley B. Thomas
KeyBanc Capital Markets, Inc.

Q

All right, great. Thank you so much. I appreciate it.

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

A

All right. Thanks, Brad.

Robert Dale Davis
Chief Executive Officer & Director

A

Thanks, Brad.

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

John Baugh
Stifel, Nicolaus & Co., Inc.

Q

Thank you for taking my questions, and also thank you for all the clarity and color you give both in the Q and on the call. Could you touch on two comments I think that were made during the call. One was maybe a little deeper dive on the depreciation schedule change. I think you mentioned that in relation to smartphones, describe that and is there a term change or any change on the pricing as well or is there just depreciation?

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

A

Hey, John, this is Guy. Yeah, on the depreciation schedule, we're going to have shorter depreciation schedules, schedules that are more in line with what we think the true effective life of the phone is. As you know that's changed a lot over the last year to just given what's happened in the marketplace with phones, and the fact, that they tend to be traded in sooner for newer models and for a lot of reasons that had an impact on re-rental of older phones in our business or the sale of older phones in the third-party marketplace. And so, the best way for us to deal with that is to run shorter depreciation schedules on those phones to lessen the likelihood that we're in a position with a write-down. As for pricing in terms, competitively, it doesn't make sense for us to talk about that specifically.

John Baugh
Stifel, Nicolaus & Co., Inc.

Q

Okay. And then also, there was a mention, I believe this was in context of the Core business of "refined" pricing action, any color there?

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

A

Well, as I mentioned, I think in response to one of the earlier questions, I think we certainly got a lot of feedback about the revenue growth we've seen last year in our two major business segments without a lot of gross profit growth associated with that. And so, I think you'll see us be focused on a much better balance of driving revenue growth and the gross profit margin – operating profit margin growth in our business and our pricing actions will reflect that.

John Baugh
Stifel, Nicolaus & Co., Inc.

Q

Okay. And then, lastly, I apologize if this has kind of been addressed, but maybe coming at a slightly different angle, in relation again to the increased competition in the Acceptance Now segment, certainly I believe the 90-day same-as-cash, there's one reference to that, I think you mentioned technology or just that maybe is where it's increasingly competitive. Is there anything else that you would add to that bucket? Thank you.

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

A

No, I don't think so, John. I mean, the technology is competitive in the sense that as new offerings come out, either done by us or done by competitors, retailers are wanting to see those same kinds of innovations happen in their stores as well. I mean, at the end of the day, what we all provide in the space of the retailers is the opportunity to save sales. So as much as we can do that, we would like to, and if technology helps us do that as opposed to having to be more aggressive on the offering, we'd certainly much rather do that with technology. I think that's a better path forward for us than simply competing on what's become a little bit more of a commoditized pricing offering within the space.

So for us, the staff model, which nobody else has that drives more business and the ability to compete on technology that allows us to save more sales without having to be aggressive on pricing, we think is a better path forward.

John Baugh
Stifel, Nicolaus & Co., Inc.

Q

Thank you for that color and good luck.

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

A

Thanks, John.

Robert Dale Davis
Chief Executive Officer & Director

A

Thank you, John.

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

Anthony Chinonye Chukumba
BB&T Capital Markets

Q

Good morning and thanks for taking my question.

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

A

Good morning.

Anthony Chinonye Chukumba
BB&T Capital Markets

Q

Hey. I had a couple of questions. I guess the first question I had and pardon me, if I missed this during your prepared remarks. But could you just give us a sense for what your expectation is, in terms of net new store openings in the Core U.S. business for fiscal year 2016?

Robert Dale Davis
Chief Executive Officer & Director

A

Yeah. So as you are aware, Anthony, we've not been opening stores as of late and we do not anticipate opening any new locations in 2016 in the Core. In fact, our store rationalization that we've gone through the last couple of years, we will continue to ensure that our fleet of stores, our asset base are delivering the right returns and providing the expected results. So no new store growth anticipated in the Core.

Anthony Chinonye Chukumba
BB&T Capital Markets

Q

Okay. Can you give us any sense for, in terms of store rationalization like how many stores we should expect to close in fiscal year 2016?

Robert Dale Davis
Chief Executive Officer & Director

A

No, I mean you've seen us historically as leases come up for renewal, close a dozen or so a quarter or maybe 30 stores or 40 stores a year necessarily. Other than the two larger opportunities that we had the last couple of years, we are still mindful of our need to ensure our asset base is performing optimally. But we're not going to get into specifics in regards to what that looks like for 2016.

Anthony Chinonye Chukumba
BB&T Capital Markets

Q

Okay. Fair enough. And then, I just want to make sure I understood in terms of the dividend cut. So you took the $1.2 billion goodwill impairment, now because you took that goodwill impartment, did you then have to get an amendment to your credit facility to allow you to at least pay the $20 million a year in dividends. In other words like, did the goodwill impairment preclude you from paying dividends, and you had to get the amendment to allow you to continue to pay some level of dividends? I'm just trying to understand how that worked.

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

A

That's correct, Anthony. The goodwill impairment while a non-cash charge and having no impact on our leverage ratios or our debt covenant, it did have an impact on our restricted payments basket and as a result depleted that basket. In our two indenture agreements, we had the ability to do up to $20 million in annual dividends at these leverage ratios, we did not have that same provision in the credit agreement.

And so, with the cooperation of the bank group that have been [indiscernible] (46:11) group of partners for us, and been very supportive of the business, been pleased by the efforts we've made to pay down debt and the commitment to do so and further worked with us cooperatively in order to put that amendment in place for the credit agreement. So, we had the same $20 million ability across all of our facilities.

Anthony Chinonye Chukumba
BB&T Capital Markets

Q

Got it. And then just one last question. To the extent that you get your leverage ratio below 2.5 times, then what does that open up in terms of restricted payments? In other words, can you increase the dividend if you get the leverage ratio below 2.5 times, or do you then have to get some sort of other amendment or come to some new agreement with your banks?

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

A

No, that was somewhat the [indiscernible] (46:58) situation, we are in above 3.75 times leverage. We had $15 million annual ability, below 2.5 times we have an unlimited availability. We just simply have this pocket and the credit agreement between 2.5 times and 3.75 times where we didn't and so that's what we addressed as part of this amendment, but you're correct, if we get below 2.5 times then our flexibility to do those types of restricted payments increases dramatically.

Robert Dale Davis
Chief Executive Officer & Director

A

Yeah. Whether it's dividends or share repurchases...

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

A

...or debt pay-downs.

Robert Dale Davis
Chief Executive Officer & Director

A

Further debt reductions, yes.

Anthony Chinonye Chukumba
BB&T Capital Markets

Q

Got it. That's very helpful. Thank you.

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

A

Thank you, Anthony.

Robert Dale Davis
Chief Executive Officer & Director

A

Thanks.

Operator: Your next question comes from the line of Carla Casella with JPMorgan. Your line is open.

Carla M. Casella
JPMorgan Securities LLC

Q

Hi. I think I just missed the figure on how much of your revolver is drawn. I was also wondering the balance on the bonds as well. Did you pay anymore bonds during the quarter?

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

A

No, Carla. We did not pay down any further bonds in the quarter. And as for the revolver, we're drawn $190 million on the revolver, so about $390 million of availability.

Carla M. Casella
JPMorgan Securities LLC

Q

Okay. So, the bonds are $293 million or so. You bought back $7 million I think in the third quarter?

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

A

Yeah. It's $292 million and change, yes.

Carla M. Casella
JPMorgan Securities LLC

Q

Okay, great. That's all I had. Thanks.

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

A

Thank you.

Robert Dale Davis
Chief Executive Officer & Director

A

Thanks.

Operator: Your next question comes from the line of William Reuter with Bank of America Merrill Lynch. Your line is open.

William Reuter
Bank of America Merrill Lynch

Q

Good morning guys.

Robert Dale Davis
Chief Executive Officer & Director

A

Good morning.

William Reuter
Bank of America Merrill Lynch

Q

My first question is, you guys were talking about the POS rollout and you've kind of talked about that there could be a little bit of disruption. I guess is this due to additional costs or are you assuming that the rollout has challenges such that you actually missed some sales due to that?

Robert Dale Davis
Chief Executive Officer & Director

A

Yeah. We tested in 385 locations now, so pretty substantial test. So, we have a very good knowledge of what we see in terms of the impact for the stores. We've done numerous upgrades and additions to the system through the testing process that's improved any of the areas where we're seeing challenges. Now the commentary is more around just the change that occurs, when you are asking people that are operating the point-of-sales system every day to change what they're doing. Even though it's much more intuitive and much easier to use than the old system one, there will be a period of change and so that distraction that we see for a fairly short period of time is what we've factored into the commentary around first quarter revenue.

William Reuter
Bank of America Merrill Lynch

Q

Okay. And then secondarily, you guys have set up a target for $20 million to $25 million of cost savings. Can you tell me how much you guys achieved in 2015 thus far, thus what would be the difference on a year-over-year basis in 2016?

Robert Dale Davis
Chief Executive Officer & Director

A

So William, I am assuming you are speaking specifically to the labor model because obviously our projected cost savings are much larger than that across multiple lines. But in terms of the labor model savings, I would say we're about 20% of the way there on the savings so far that we expect towards the $20 million to $25 million goal.

William Reuter
Bank of America Merrill Lynch

Q

Okay. And then just lastly for me, I'm curious whether you guys – if you guys – you guys talked about increased competition on the Acceptance Now. Are there customers, meaningful customers you guys have lost and if so when you did lose them, kind of what the reason that they chose to leave you guys and go to another competitor was?

Robert Dale Davis
Chief Executive Officer & Director

A

We have not lost any significant business in terms of our retail relationships as a result of the competitive landscape. So, no, nothing in that regard. However, just the commoditization of the pricing elements that Guy alluded to earlier, does create an heightened intensity around what's being offered today and so retail partners obviously have options for saving sales in their business.

We believe our model is the industry leading model in terms of helping them to save sales, but nevertheless, those conversations do take place when other competitors introduce certain offerings like 90-day cash option, it certainly enters into the conversation with our retail partners, but we have not lost any significant accounts as a result of the competitive landscape.

William Reuter
Bank of America Merrill Lynch

Q

Great. I will turn it over to others. Thank you.

Robert Dale Davis
Chief Executive Officer & Director

A

Thank you.

Operator: This concludes the Q&A portion of today's call. I will now turn the call back over to Mr. Davis.

Robert Dale Davis
Chief Executive Officer & Director

Thank you, Sally. And thank you everyone for joining us. Certainly, as I mentioned in my prepared comments, we are making progress in a number of fronts. But we are not satisfied with our overall results and we look forward to making continued progress in 2016, reporting back to you in the next quarter. So thank you for joining us.

Operator: Thank you for your participation today. This concludes today's conference call. You may now disconnect.