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RCII - Q1 2016 Rent-A-Center Inc Earnings Call

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PRESENTATION

Operator

Thank you for holding and welcome to the Rent-A-Center, first-quarter earnings release conference call.

(Operator Instructions)

As a reminder, this conference is being recorded, Thursday, April 28, 2016. Your speakers today are: Mr. Robert Davis, Chief Executive Officer of Rent-A-Center; Guy Constant, Executive Vice President & Chief Financial Officer; and Maureen Short, Senior Vice President of Finance, IR and Treasury. I would like to turn the call over now to Ms. Short. Please go ahead, ma'am.

Maureen Short - *Rent-A-Center - SVP*

Thank you Stephanie. 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 first quarter of 2016.

All related materials are available on our website at investors.rentacenter.com. As a reminder, some of the statements provided 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 takes no obligations to publicly update or revise any forward-looking statements. These facts are described in our earnings release dated yesterday, as well as in the accompanied SEC filing.

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

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

Thank you, Maureen, good morning everyone and thank you for joining us. As part of our multi-year transformational strategy, there were a number of levers that we set out to manage to become more consistent and reduce the amount of risk in the business. Although there is still more work to be done on our top-line results in the core and Acceptance Now, I am happy to say that we now have several of these levers working successfully as demonstrated in our first-quarter performance.

For example, managing the middle of the P&L in the core business has positively contributed to our results for several quarters now. We are seeing increased labor productivity from our store optimization efforts and our flexible labor model which continues to roll out successfully. This quarter we also saw the intended improvements on gross profit margins in both the core business and Acceptance Now. Our work on the supply chain initiative is favorably impacting the core P&L driven by product cost-per-unit savings of 5% to 9% and a more efficient supply chains.

With our strong focus on profitable growth, we have taken a more surgical approach with our promotions in the quarter, which increased gross margins in the quarter. Our work with retail partners and Acceptance Now to improve the economics of the 90-day cash options is also having the desired impact on gross profit margins.

Another positive for the quarter was performance in Mexico. I am very pleased with the progress we have made here. We exited 14 underperforming locations in the first quarter as part of our strategy to focus on the northern part of the country and border markets.

While our goal for this business is to break even in 2016, as of the end of Q1 we are already very close to delivering on that goal. In fact, the entire segment is now profitable on an EBIDTA basis.

Last quarter we presented our capital allocation strategy of using free cash flow to pay down debt, the goal being to reduce our leverage ratio below 2.5 times by the first quarter of 2017.

Because of our more efficient use of working capital, the tax refund and our increased focus on profitable growth, I am happy to say that we ended the first quarter with a leverage ratio of 2.52 times, nearly hitting our goal one year in advance. The increased flexibility that we will gain by meeting our leverage goal will enable us to add share repurchases as another lever to drive shareholder value, at the same time paying down debt helps to reduce the level of risk in the business.

Overall I am very happy with the progress that we have made against our transformational strategy as more of the opportunities that we have been pursuing start to bear fruit. I mentioned earlier that there is more work to be done, most noticeably with top-line performance and Acceptance Now losses.

Our sales results were negatively impacted by the further deterioration in bull-affected markets, including our Texas stores across both core and Acceptance Now. Which were down 10% each as well as the impact of the onset of the new point-of-sale system roll out in the quarter. Additionally we made a deliberate decision to be more disciplined, selective and strategic with our pricing and promotional strategies, which as expected, impacted sales but benefited gross margins. In the core segment furniture continued to perform very well in the quarter for the computer and tablets category continued its negative trends.

As part of our new Smartphone strategy, we have been working on enhancing our assortment by adding new brands. During this transition time, several of the new brands did not have the locking capabilities that we require to insure an efficient use of working capital by decreasing the risk of losses. Again, because we are focused on driving profitable growth, we decided to delay the purchase of these phones until the locking was in place and as a result our top-line performance on Smartphones came in lower than planned. The good news is that we are now able to lock the new phones so the newer brands of phones will start to appear in stores in the second quarter and we anticipate improved performance in this category in the back half of the year.

Last quarter we got into lower core sales in Q1 because of the impact of our new point-of-sale system. During the initial roll out phase, we experienced a greater-than-expected impact of sales so we made the decision to delay the timing of the roll out and address opportunity areas. We have made those changes and have restarted the POS roll out this quarter with the plan to have the system fully implemented by the end of Q3. Today approximately one-third of our core stores are operating this new POS system.

Acceptance Now same-store sales were flat for the quarter. It remains a highly competitive landscape and while we still see pockets of irrational behavior, we are seeing initial signs that the competitive intensity may have peaked. Our flat same-store sales in that quarter were impacted by lacking the 90-day cash pricing changes at the end of the quarter.

In addition, with our enhanced technological capabilities, we have made conscious decisions to improve near- and long-term profitability by making changes to our approval process that moderate approval amounts for higher risk customers. While a top-line headwind in the short term, this should result in lower losses in the future.

Looking forward, I am pleased to say that we are also making significant progress with our new Acceptance Now commercial capabilities team which is already translated into a stronger pipeline of new retail partner opportunities. And as a result I am optimistic about future growth resulting from this enhanced pipeline. While Acceptance Now losses are still at an elevated level, our leading indicators such as past-due metrics are currently trending more favorably.

Additionally we have begun pilot testing of a centralized collections function which we believe will further the positive impact on losses as early as this quarter when combined with the customer decision changes that I mentioned earlier.

Even as we start to achieve the benefits of our transformational strategy, we are simultaneously hard at work on new opportunities and priorities, including e-commerce, and additional cost savings initiatives such as fleet optimization which will generate future benefits. Development of our e-commerce platform, as an example, is going well and we plan to roll out the initial pilot in June and be nationwide before the end of the year. We believe the e-commerce initiative will further benefit top-line results in the core once fully rolled out.

In summary we have made great progress on our profit maximizing initiatives and reducing the level of risk in the business. We intend to build upon that momentum as we move through 2016. I want to thank our teams for focusing and executing against our strategic priorities.

I will now hand the call over to Guy to discuss our financial performance in more detail. Guy?

Guy Constant - *Rent-A-Center - CFO*

Thanks Robert. Good morning, everyone. This morning I will walk you through the highlights of our financial results for the first quarter. I'd also like to mention that as I refer to our first-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 $836 million, which represents a 4.8% decrease versus last year, as single-digit revenue growth in our Acceptance Now segment was offset by a same-store sales decline in the core, as well as the impact of store closures over the past 12 months in both the core and Mexico segments.

Our total US same-store sales, combining the Acceptance Now and core segments decreased 2.5% versus a year ago but on a two-year basis US same-store sales increased 5.5%. We continue to face headwinds in our oil-impacted markets with Texas stores down approximately 10% across both segments, as well as the onset in Q1 of the roll out of our new point-of-sale system. Looking at sales performance in our core segment more closely, total revenues were down 7.1% driven by a same store sales decline of 3.8% and a 5.6% reduction in store count from the prior period.

Furniture performed very well and benefited from improved in-stock positions versus the port-impacted comparison last year. Computers continued to be down sharply as compared to a year ago and Smartphones were down more than planned, although as Robert mentioned, we expect this to be temporary as our recast assortment will start to appear in stores in the second quarter.

In the Acceptance Now segment we saw a 2.7% revenue growth driven primarily by stores open less than 12 months. Flat same-store sales in this segment were driven by the dynamic of having fully lapped the roll out of the 90-day pricing option at the end of Q1 and the focus on driving profitable sales. Consolidated gross profit was $535 million, and gross profit margin was 64%, 30 basis points lower than the prior year with the decline driven by a higher mix of Acceptance Now sales.

In the core US segment gross profit margin was 70.5%, 40 basis points better than a year ago as we begin to see the benefits of our supply chain initiative in the P&L. In addition, we have built capabilities that are executing on a more surgical approach to pricing and promotions as Robert discussed.

In our Acceptance Now segment, first-quarter gross margins were 48.2%, down 50 basis points from Q1 last year. Our year-over-year gap and gross margins, however, showed a meaningful improvement of 350 basis points compared to last quarter driven primarily by the completion of the lack of our 90-day cash option and the increased focus on more profitable sales.

Consolidated store labor, which includes the expenses associated with co-workers at our stores and at the district manager level, improved 10 basis points to 25.3%. Other store expenses, which include expenses related to occupancy, losses, advertising, delivery costs and utilities, also improved 10 basis points to 25.6%.

In our core US segments store labor expense was down over $11 million but worsened by 30 basis points due to sales deleverage. Other store expenses were down almost $10 million but also deleveraged 50 basis points from the prior year. Our core US Rent-to-Own, skip-stolen losses were 3.5% in the quarter, down 30 basis points year over year due to the ongoing improvements we have put in place in the Smartphone category.

In our Acceptance Now segment, labor as a percent of sales was relatively flat, while other store expenses increased 220 basis points versus the prior year driven primarily by higher skip-stolen losses. Acceptance Now skip-stolen losses came in at 9% in the quarter, up 130 basis points to last year.

Earlier Robert reiterated our intentions related to centralized collections and we expect these changes, along with an ongoing focus on the customer approval process, will allow us to narrow the year-over-year gap in future quarters.

On a consolidated basis we delivered operating margins of 6.1% in the first quarter, representing a year-over-year decline of 40 basis points.

Now turning to the balance sheet. We ended the quarter with consolidated inventory on rent down approximately 13.5% or $128 million versus a year ago. In the core US segment, inventory on rent was down $96 million due to our lower mix of Smartphones, lower store count and the improved purchase cost brought about by our supply chain initiative.

In the Acceptance Now segment, the decline in inventory on rent of $27 million was driven primarily by lower ticket in our retail locations resulting from refinements in the customer approval process and the lap of the full impact roll out of the 90-day cash option program.

Consolidated inventory held for rent was down approximately $15.5 million, even with the investment in inventory at our third-party distribution centers. This was predominantly driven by the core US segment in which we saw our one-time increase in working capital for the sourcing initiative offset by a reduction in mobile inventory and lower store count.

We expect to see continued reductions in inventory held for rent in future quarters as we offset initial investments in distribution center inventory and some increases in Smartphone inventory with lower sourcing costs and the ongoing removal of safety stock from our stores.

As of the end of the first quarter we have approximately $46.4 million in cash and cash equivalents and as outlined in the release, we paid down our total net debt by $212.1 million since the end of 2015. We had approximately $20 million drawn on our revolving credit facility as of the end of the first quarter, and as of today we are undrawn on our revolver, leaving approximately $580 million of available capacity.

Again, as Robert noted, we ended the quarter with a leverage ratio of 2.52 times as our more efficient use of working capital and the tax refund resulted in better-than-expected debt reductions. We are encouraged that we are now approaching the 2.5 times threshold that will give us additional flexibility to execute against our capital allocation strategy and provide the additional leverage to deliver on our promise of more reliable and more predictable earnings growth.

With that, I will turn the call over to Stephanie to open the line for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions)

Our first question comes from Budd Bugatch from Raymond James & Associates. Your line is open.

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

Good morning, and thank you for taking my questions. My first question is on the debt paydown, congratulations on that. That is pretty exciting to see that. I just want to know it is sustainable. You said you are undrawn now on the revolver which means you can start, I guess, looking at the notes if that will be where you will go. What is the outlook for the second quarter and the balance of the year? Guy, can you kind of give us a feel for how that cadence might play out?

Guy Constant - *Rent-A-Center - CFO*

As you know, Budd, generally the first quarter of our year tends to be our strongest cash flow quarter because of the amount of payouts we see when our customers receive their income tax payments. And of course that was accelerated somewhat this year by the income tax refund that we received, as well, in the first quarter.

Typically the second quarter we tend to tread water a little bit and our cash flow tends to be somewhat even and then we do a little better in the back half of the year. Although I will say that our working capital and that we are using in order to purchase products is coming in much better than we thought it would and we would expect that to continue.

As for looking at the notes or share purchases, you may recall we have to be under 2.5 times does that. We are obviously very close to that point, so once we get to that point, then all options are available to us to put that cash flow to work.

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

And the feeling of management? I know that it is kind of a board issue, as well. But what is the thought process in terms of the company using its balance sheet pretty aggressively over its long history. What is the thought process today?

Guy Constant - *Rent-A-Center - CFO*

Definitely our plan, Budd, is to stay under 2.5 times. We don't see ourselves ramping up our leverage above that ratio moving forward. Again, given the strong cash flow nature of the business, we believe we have lots of opportunities, whether it be looking at the notes that we have today or looking at a share repurchase option and of course always remaining as the first priority to be investments in the business that we think can generate the kinds of returns better than paying down debt or buying back shares. So, nice that we're in a position very shortly here to be able to look at all of those options.

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

Okay. Just take one more question. It is more of a housekeeping question. Skips and stolen, you gave it to us by segment, can you give it to us overall for the company?

Guy Constant - *Rent-A-Center - CFO*

I don't have it as an overall. We look at it by segment Budd, so I don't have it overall for the company. But since the larger number of those is in the core, my expectation would be that we are probably down overall, but Budd I would have to look at that.

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

Well then, let's get Mexico if we can, and if we have that.

Guy Constant - *Rent-A-Center - CFO*

Yes, Mexico skip stolen losses were better by 250 basis points versus where they were. That was a fairly elevated number but obviously great progress by the team over the last year.

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

And what was that number last year? I don't think that was something we were given?

Guy Constant - *Rent-A-Center - CFO*

It was in the 9%s range and it is down around 7% in Mexico now.

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

Okay. Thank you very much. I will let others have questions. Thank you.

Operator

Our next question comes with J.R. Bizzell of Stephens Inc. Your line is open.

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

Good morning and thank you for taking my questions.

Guy Constant - *Rent-A-Center - CFO*

Good morning, J.R.

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

On the POS system, I know the original plan or the plan we discussed at the end of Q4 was expectation to be done by Q1. Now I know you all said you made tweaks and now it is looking like Q3.

Can you give us an update on the trends you are seeing from the implemented in the one-third of stores that do have that new POS system, and then maybe your expectations. I know it was the main reason you guided first quarter down from an EPS standpoint. Should we kind of thinking about dividing that a little bit of a tail wind -- Sorry, a headwind into the remainder of the next few quarters?

Guy Constant - *Rent-A-Center - CFO*

So, J.R., as we look at rolling out the POS system, we obviously want to a manage the impact we have on the stores and reduce the potential transition period impact over all to results. So, as we roll out stores every week, we are constantly monitoring the results to make sure it is landing well in our stores. Because it is a big change. While it is a system we believe provides better ease of use for our store co-workers and certainly gives us a platform to do a lot of things that we haven't been able do with our older system, there is a transition period, so we have to watch that very closely.

Now that being said, we don't anticipate now that the impact is going t be any more significant than we originally did, but clearly the timing is a little bit different than we originally expected. So, your point that perhaps we didn't see as large an impact as we expected in Q1, we are likely to see a larger impact than we expected in Q2, but our overall guidance for the year has remained the same. So it is really just a shift of in terms of when the impact happened.

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

Perfect, thanks. Kind of switching gears. The direct locations that are up and running now, I was wondering if you can kind of give us an update on the trends you are seeing there, and then further building on that, kind of your expectations for your direct rollout for the remainder of the year?

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

So, I think, J.R., in regards to that question, we have van direct in about 550 locations or so. The trends that we are seeing are improving, but not where we want them to be overall, particularly on the back end from a credit and loss perspective. The commercial capabilities sales team that I referred to earlier is working on both the direct and the high service model or man side. We are seeing a robust pipeline beginning to fill.

So, we will have options with regards to the number of manned locations as well as van direct. I think our primary focus and our preference is obviously to have the demand locations be the ones that we look to open before van direct. Having said that, the pipeline for both is full, but we are going to focus our efforts primarily on manned side as opposed to van direct.

We do expect van direct to have a number of locations open throughout the balance of the year but not the 500 or so that we referred to open last year. The pipeline is strong, the trends are improving, but not where we want them to be but the high service for manned model is where the efforts will be focused on.

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

Robert, building on that, have you pinpointed the issue with the back -- The credit, the loss perspective on the direct and what is causing that? Is there something -- I know you said you are tweaking the underwriting model around. Is that something you got fixed on a go-forward basis?

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

We believe we have the right amount of focus and effort on it now. Frankly, when we were opening them last year, it was at the same time an effort on our part to make sure we had a collections team and a staffing resource requirements that were necessary to address those concerns. We are now fully staffed and fully capable of making sure we are managing the back end appropriately.

And so when we were rolling out last year, we were a little bit behind in terms of having the back end infrastructure to manage that, but today we feel very good about the resources we brought in, the talent that we have on the team to make sure we are addressing those concerns. Going forward we are confident in our efforts to do so, but we were a little bit ahead of ourselves last year with the back end infrastructure. Today we are in much better shape.

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

Perfect, thank you for the detail. Thank you for taking my questions.

Operator

Our next question comes from Brian Hollanden from Sidoti. Your line is open.

Brian Hollanden - *Sidoti & Company - Analyst*

Good morning and thanks for taking my question.

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

Good morning, Brian.

Guy Constant - *Rent-A-Center - CFO*

How are you?

Brian Hollanden - *Sidoti & Company - Analyst*

Good. Can you give us a little bit more -- sorry if I missed this, but what leads you to believe that the competitive pressures have peaked?

Guy Constant - *Rent-A-Center - CFO*

Yes. It is hard to get a good read on that, Brian. I would say they are still elevated. I would not want to suggest that there isn't still a competitive activity going on.

But you do see a couple of things happening in the marketplace. You see, for example, we have made some changes to the economics of the 90 day cash transactions with our retail partners. That program has driven a lot of volume for our retail partners and they have done very well economically on that.

We have not done so well and so we have had some great discussions with our retail partners to try and balance those economics and we have been successful doing that. And you saw that in terms of the trends of what you have seen with our merchandise sales gross profit margin. Obviously if we were in a hyper competitive environment or as a hyper competitive environment as it might have seemed where we were going, it would have been very difficult to make a change like that in such an environment and have it stick, but we have been able to see that happen, which implies to us that the environment may not be as competitive as we thought it was.

In addition, we have seen certainly some competitive pricing actions as well that have stuck. And so I think that if you look at those two factors, those are things that would be inconsistent with an increasing competitive environment and perhaps more consistent with one that might be waning somewhat.

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

We have also seen the number of competitors that are primarily focused on the virtual space who had difficulties. A couple of folks have shut down. A couple of folks have gone out of business. So in addition to Guy's comments, we have seen some competitors exit the space given the fact that their business model is not sustainable for the long term relative to the working capital requirements and the ability to collect and pick up merchandise and re-rent it through the back end infrastructure like we have.

Brian Hollanden - *Sidoti & Company - Analyst*

Thank you for the color, and if I could have just one more and I'll jump back into the queue. How much of the core US sales decline was impacted by the point of sale rollout?

Guy Constant - *Rent-A-Center - CFO*

We didn't talk about that specifically, Brian, but we did talk a little about the specific categories. I think when you look at all the factors, computers still being down sort of to similar levels that we saw last quarter is a big driver. The performance in the oil-affected markets is a big driver.

As you might recall Texas is about 10% of our system in the core business and we saw sales in that market down over 10% which is an acceleration of where it was last quarter. So the math alone on that would tell you 100 basis points of the sales decline was specifically impact by oil affected markets.

And then what is a much more temporary impact, is that we saw a decline in Smartphones simply because we were not as in stock with the phones for the reasons Robert referenced on the call. You probably saw a similar impact related to the fact we were not in stock with Smartphones which we expect to see that rectified over the coming months. Those were the primary drivers of the sales decline in addition to the point of sale rollouts.

Brian Hollanden - *Sidoti & Company - Analyst*

Thank you.

Operator

Our next question comes from Carla Casella of JPMorgan. Your line is open.

Carla Casella - *JPMorgan - Managing Director*

Hi. One thing, did you give core store a skips and stolen rate? I didn't see that.

Guy Constant - *Rent-A-Center - CFO*

We did, Carla. We are 3.5%, which was down 30 basis points from what they were a year ago.

Carla Casella - *JPMorgan - Managing Director*

Okay, great. And then how much of the gross profit margin improvement in that core, you mentioned the 40 basis improvement -- How much of that was a mix away from Smartphones?

Guy Constant - *Rent-A-Center - CFO*

Very little of it. More of it was now just the realization of the cash savings that we already achieved from the reduced sourcing cost. Now actually showing up and becoming a larger and larger component of our portfolio. So as we start to see more of these products that we bought at the 5% to 9% reduction that Robert talked about comprising a larger component of the portfolio, we will see the gross margins improve. We would expect additional gross profit margin improvements throughout the year simply as a result of more and more of that profit getting into the portfolio.

Carla Casella - *JPMorgan - Managing Director*

Okay, great, and I just one -- I have to ask a debt question since I am the debt analyst on the call. When you look at your two different bonds the 20s and 21s, is a there a difference in the restricted payment basket for either of those in terms of how much you can do in the risk basket to due dividends and share repurchases.

Guy Constant - *Rent-A-Center - CFO*

There is, Carla, at least a difference in the way the 2.5 times restriction is calculated. So on the 6-5/8% notes, letters of credit count as debt in the calculation, where in the 4-3/4% notes it does not. So we certainly get under 2.5 times quicker on the 4-3/4% than we do the 6-5/8%.

Carla Casella - *JPMorgan - Managing Director*

But there is not a general basket in the two that you have?

Guy Constant - *Rent-A-Center - CFO*

Well we have the $20 million basket that allows us to pay dividends, but in terms of our ability to repurchase notes, once we get under 2.5 times on the credit facility, we have complete freedom to do that.

Carla Casella - *JPMorgan - Managing Director*

Okay, great. Thank you.

Operator

There are no further questions. I will turn the call back over to Robert Davis for closing remark.

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

Thank you, Stephanie. Thank you everyone for joining us. We appreciate your time this morning.

Obviously a lot going on in the company. We have made significant progress on a number of fronts and a number of initiatives. Still work to be done on others, and we are focused on doing so and we appreciate your support. Look forward to reporting back next quarter. Thank you.