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# Rent-A-Center, Inc. (RCII)

Q2 2016 Earnings Call

# CORPORATE PARTICIPANTS

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# MANAGEMENT DISCUSSION SECTION

**Operator**: Good morning and thank you for holding. Welcome to Rent-A-Center's Second 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, Thursday July 28, 2016.

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

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

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

Thank you, Regina. 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 second quarter of 2016. All related materials are available on our website at investor.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 undertakes no obligation to publicly update or revise any forward-looking statements. These factors are described in our earnings release stated yesterday, as well as, the company's SEC filings.

I would 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. As you know, we have been very focused on our multiyear transformational strategy and I am pleased with the progress that we are making in several areas as we focus on profitable growth. However, I am extremely disappointed in our topline performance in the short-term revised outlook. Our operational execution needs to improve and we're going to capitalize on opportunity areas to rebuild the topline, while continuing to capture the revenue and productivity benefits from our key initiatives.

First, let me touch on a few of the items that impacted our topline performance this quarter, and the steps we are taking to improve the business. After our initial delay, in Q2 we completed the roll out of our new POS system in the Core business. Last quarter, we had said that the new system would be installed in all stores by Q3. However, given the dependencies of other critical initiatives, and future anticipated benefits from those initiatives, on completing the implementation we decided to accelerate the roll out, which was completed in its entirety in Q2.

Despite our team's efforts to mitigate the negative impact of accelerating the implementation of the new system, the decline in Core top-line results was more significant than we expected, making up over half of the second quarter decline in Core same-store sales. Although the system performance and usability issues identified in the first quarter were fixed, the distraction of the new system impacted our Core portfolio and took time away from collections efforts, which resulted in a hit to revenue. Given the impact to the portfolio, we expect it to be a few quarters before we fully recover.

That said, the distraction of the major system rollout is now behind us, and we believe the longer term benefits of our new system will outweigh the short term costs. The new POS enables us to move forward with several growth opportunities to address the broader challenges in the Core business. One example is our eCommerce initiative, which we began to pilot in the second quarter. The initial pilot is intended to make sure our customers have the ability to fully transact online. Both online activity and in-store traffic will be monitored to understand the benefits of the new channel, and we are excited to offer a better customer experience to those that prefer to shop online. We are optimistic that eCommerce will play an important role in helping reinvigorate Core revenue once rolled out nationally by the fourth quarter.

The new POS system also enables us to be more prescriptive on pricing, so that we can customize pricing elements by region and by product category to ensure our value proposition continues to be relevant to our customers. Although, we are not happy with the negative impact from the distraction related to the rollout of the new POS system, we are excited about the opportunities that it will continue to bring well into the future.

We believe top-line performances also continuing to be impacted by the loose credit environment. Subprime customers have more access to credit than ever before, increasing their options, which we believe impacts their decision whether they enter into a rent-to-own transaction. Although, we believe if subprime loss rates increase beyond acceptable levels or if interest rates increase, that this impact should diminish, recent economic data would suggest this is unlikely to occur any time soon. As a result, it is imperative that our value proposition, our coworker talent, our customer experience, and our operational execution are all solid enough to allow us to thrive in an environment where more alternatives are available.

Now that the fundamental work is completed, our sourcing and distribution, and flexible labor initiatives, as well as the POS roll-out distraction, we can shift more of our focus to these top-line opportunities. From a product line standpoint, smartphones, computers and tablets were down in the second quarter. I'm pleased to say that we've added new smartphone devices that have the appropriate locking capabilities we were missing in the first quarter. However, it will take some time for the new assortment to ramp up. Computers and tablets are down within the broader retail environment, but down less than higher quality brand names. So, we are shifting our assortment to elevate our product offering, so that it more closely mirrors customers' brand preferences. And finally, the furniture category continues to perform well, and has been up mid single-digits for the past several quarters.

Also impacting both our Core and our Acceptance Now businesses in the quarter was the further deceleration in our Texas stores. In the Core business, Texas sales were down 13% and down 9% in Acceptance Now. Beginning in the third quarter, we should start to anniversary the Texas slowdown from Q3 last year and would expect to see improvement in the coming quarters, as the oil affected markets stabilize. We'll continue to monitor our Texas performance, given that it makes up about 10% of our overall business.

As I've discussed, we know there's much work to be done in our Core business and I'm pleased to announce that Jim York has been promoted to Executive Vice President, leading the domestic operations, and now will lead the charge for our core rent-to-own business. Jim has been with the company since 1994, and during his time as Division Vice President, he has distinguished himself as an outstanding performer. Jim brings a breadth of operational experience, a track record of delivering outstanding results and a fresh, driven perspective to this critical role. We believe his fierce commitment to delivering exceptional customer experiences and ability to develop strong coworker talent will help revitalize sales in our Core U.S. segment. Jim inspires teams to think differently and work in new ways and we're excited to have him step into this increased leadership position.

With regards to our Acceptance Now business, our top-line continues to be negatively impacted by some of the same items I spoke to you about on our last call, which we have factored into our revised outlook. It remains a highly competitive marketplace, often with multiple companies competing head-to-head for new business. At times we see irrational behavior even among our largest competitors. We continue to make deliberate decisions that may have short-term revenue impacts, but will have more meaningful contributions to long-term profitable growth, such as reducing approval amounts for higher risk customers.

Similarly, in June, we made the decision to exit our partnership with a second tier national retail partner, since the relationship was no longer economical for our business. We believe this is another clear example of our discipline and increased focus on profitability. I noted last quarter how confident I am in our new Acceptance Now commercial team and the work that they have done to build a stronger pipeline of new retail partner opportunities. And today, I'm even more optimistic. Though the impact of their efforts is not yet visible in our results, the pipeline continues to progress nicely, with several national retail partner prospects interested in our Acceptance Now model.

We recently promoted Doug Guziec to Senior Vice President and General Manager of National Accounts for Acceptance Now. I believe Doug will help to drive our initiatives in developing relationships with these new national accounts that continue to build upon the pipeline that our team is working hard to grow. While there will be initial start-up costs associated with any national account pilots that may occur, our revised outlook does not predict the timing or size of any potential future national account pilots. However, there is significant upside potential to the business as a result.

Although we continue to see challenges in top-line performance, there are a number of areas that are working well, and I'd like to share the progress that we've made during the quarter.

Last year, we told you we would improve gross margins by implementing a more efficient supply chain and by improving the economics of our Acceptance Now 90-day cash option transaction. For the past three quarters, we've shown progress against this goal. And I'm happy to say that in the second quarter, we again delivered on that promise, with gross margins up over 100 basis points over prior year in all three major businesses. Second, we are delivering on the core middle of the P&L initiatives by improving labor productivity through our flexible labor model and have seen significant savings materialize, as expected.

Our store optimization efforts also continued in the second quarter. This was a more aggressive pace of closures than originally planned, but it is another important step to take as we move to optimize the store base and improve the profitability of the business. Approximately 175 locations were closed in Q2 and the customer accounts were merged into nearby locations, increasing the economics of the remaining locations and improving the overall return profile of the business. Looking ahead, however, we must improve top-line performance in order to capture the full value of these productivity gains.

During Q2, we also made further progress on our goal to break even for the full year in our Mexico business. The operational improvements implemented over the last several months have delivered positive operating profit and EBITDA in Q2 that was well ahead of our planned timeline. I'm even more confident today in our ability to successfully and profitably grow the Mexico business.

Finally, turning to the balance sheet, we were pleased to end the second quarter with a leverage ratio of 2.37 times, with our year-to-date free cash flow of $275 million. With our reduced leverage, we are inching closer to having a full set of options in returning capital to shareholders. Given the top-line challenges I spoke about and our outlook for the rest of the year, we are revising our full year guidance, which Guy will explain in more detail. While I'm not happy with the lower near-term expected performance, I believe that we have the right team and strategies in place to improve the business and we are keenly focused on delivering in the back half of the year.

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

## Guy J. Constant

*Executive Vice President – Finance, Chief Financial Officer and Treasurer*

Thanks, Robert. Good morning, everyone. This morning I'll walk you through the highlights of our financial results for the second quarter. I'd also like to mention that as I refer to our second quarter performance, either this year or last, all numbers will be presented on a recurring basis, excluding special items.

As outlined in the release, consolidated total revenues were $749.6 million, which represents an 8.1% decrease versus last year. The decrease was driven by a 0.5% decline in our Acceptance Now segment, a Core same-store sales decline of 6.7% and the impact of the continued rationalization of our U.S. retail store base.

In June, we completed the most recent round of store closures in our Core system, closing 174 stores. As has been the case in previous rounds of store closures, we expect a positive P&L impact as a result of our ability to retain a significant percentage of the accounts that are merged into nearby stores, while saving the costs of operating in these poor performing locations.

Our total U.S. same-store sales, combining the Acceptance Now and Core U.S. segments, decreased 5.1% versus a year ago. And on a two-year basis, U.S. same-store sales increased 2.4%. As Robert already mentioned, our Texas market continues to be negatively impacted by the macro environment in that region.

Looking at sales performance in our Core U.S. segment more closely, total revenues were down 10.6%, driven by a same-store sales decline of 6.7% and an 11.5% reduction in store count from the prior year. The same-store sales decline was primarily due to the accelerated rollout of our point of sale system as Robert described earlier and the topline impact associated with the recast of our smartphone category.

In the Acceptance Now segment, we saw a 0.5% revenue decline as our same-store sales decline of 1.5% was offset by results from stores open less than 12 months, as well as our direct locations. Monthly comp sales in Acceptance Now improved throughout the quarter, driven by improvements in our rentals and fees revenue. Merchandise sales were down for the quarter as we saw a slightly lower incidence of 90-day transactions as compared to a year ago. Consolidated gross profit was $500.2 million, and gross profit margin was 66.7%, 70 basis points higher than the prior year, with the increase driven by meaningful improvements across all three major segments.

In the Core segment, gross profit margin was 72.2%, 120 basis points better than a year ago. The gross profit margin was positively impacted by the continued growth in the mix of more efficiently sourced product in the Core portfolio, improved merchandise sales margin as a result of fewer smartphone sales, as well as a reduction in the smartphone loss reserve. In our Acceptance Now segment, second quarter gross margin was 52.8%, up 100 basis points from Q2 last year. This increase was driven by our focus on driving profitable sales, particularly related to improved profitability of the 90-day program. In addition, as of the beginning of Q2, we had officially lapped the roll out of our 90-day program and saw slight declines in the program's usage.

Consolidated store labor, which includes the expenses associated with coworkers at our stores and at the district manager level increased 70 basis points to 26.9%. Other store expenses, which include expenses related to occupancy, losses, advertising, delivery costs and utilities, increased 50 basis points, to 25.9%.

In the Core, store labor expense was down approximately $10.5 million, but worsened by 140 basis points due to sales deleverage. Other store expenses were down $13.7 million, but also deleveraged 70 basis points from the prior year. Our Core skip/stolen losses were 2.9% in the quarter compared to 2.6% last year, consistent with historical norms even post the addition of smartphones. In our Acceptance Now segment, labor as a percent of sales improved by 30 basis points due to increases in productivity and less overtime. However, other store expenses increased 350 basis points versus last year, driven by a 240-basis-point increase in losses to 10.1%. We're extremely disappointed in our Acceptance Now losses and continue to see opportunities for improvement.

Some areas of improvement will be more near-term given the changes to the approval engine that were put in place in December of last year, while a more transformational effort is underway as we'll begin testing centralized collections with a third-party in the back half of this year. On a consolidated basis, we delivered operating margins of 6.2% in the second quarter, representing a year-over-year decline of 50 basis points, while consolidated EBITDA was at 9%, or down 20 basis points from a year ago.

We ended the quarter with consolidated inventory on rent down approximately 13.4%, or $125 million versus a year ago. The decline was due primarily to a drop in inventory on rent in the Core, which was down 19% or $104 million. The key drivers to this reduction were an 11.5% reduction in store count, a $43 million reduction in smartphone inventory, and the lower purchase cost brought about by our supply chain initiative. In the Acceptance Now segment, inventory on rent declined $20 million, or 5.7%, which represents a smaller decline than seen a quarter ago by approximately 190 basis points. This 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 of the 90-day cash option program.

Consolidated inventory held for rent was down approximately $47 million or 17.3% even with the investment in inventory at our third-party distribution centers. This was predominantly driven by the Core U.S. segment which was down $44 million or 17.4%, driven primarily by tighter controls on idle inventory, the benefits of our sourcing changes, reductions in mobile inventory, and lower store count.

As of the end of the second quarter, we have approximately $88 million in cash and cash equivalents and we've paid down our total debt by approximately $230 million this year. As Robert noted, we ended the quarter with a leverage ratio of 2.37 times as our more efficient use of working capital and the tax refund allowed us to accelerate our debt reduction. This leaves us undrawn on our revolver with approximately $580 million of available liquidity. This leaves us with significantly more available liquidity than any other player to fund future working capital needs to grow our Acceptance Now business. We're now materially below the 2.5 times leverage threshold in our credit agreement, and as Robert mentioned, this moves us closer to having full flexibility to pursue the optimal capital allocation strategy for the enterprise.

As we look forward to the balance of 2016, we now expect full year Core revenue to be down 8.5% to 11.5%. And Core same-store sales to be down between 5% and 8%. This is due to the ongoing impact of the lower Core segment portfolio balance at the end of the second quarter, impacted primarily by the point-of-sale system rollout and the continued rationalization of the store base. We also expect full year Acceptance Now revenue between $805 million and $835 million and consolidated non-GAAP earnings per share between $1.65 and $1.85.

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

# QUESTION AND ANSWER SECTION

**Operator**: [Operator Instruction] Our first question will come from the line of Budd Bugatch with Raymond James. Please go ahead.

David Joseph Vargas
*Raymond James & Associates, Inc.* Q

Good morning everyone. This is David Vargas on for Budd. I hope you're all doing well.

Robert Dale Davis
*Chief Executive Officer & Director* A

Good morning David.

David Joseph Vargas
*Raymond James & Associates, Inc.* Q

I'll start off, you've done a pretty good job driving costs out of the Core business, but I'm wondering if this quarter, lower levels of labor in the store and the staffing had an adverse impact on the ability to convert sales and do the collections?

Robert Dale Davis
*Chief Executive Officer & Director* A

I think I understood your question. You're wondering if we believe that our flexible labor model is having an impact on driving top-line sales. We don't think that's the case. Obviously, as we've been going through the process of implementing the flexible labor model, we actually have more coworkers available; instead of having five full-time coworkers, now you have seven to cover off hours and peak times and things of that nature.

 

Certainly there is some transition period that occurs as coworkers are coming into the new role; it requires some additional training and things of that nature. However, it was evident to us as we moved through the second quarter, as we were rolling out the POS system, our deliveries were down as compared to prior periods during the rollout phase as well as our collection efforts. So, we believe that primarily – the portfolio and the revenue is primarily impacted by the POS acceleration of the rollout.

David Joseph Vargas
*Raymond James & Associates, Inc.*

Q

Okay. That's what I was trying to get at is, did the pendulum swing too far and have an adverse impact on the topline. And then could you walk through your thought process on driving revenue growth, especially in the Core business, and to the same extent, Acceptance Now going forward?

Robert Dale Davis
*Chief Executive Officer & Director*

A

Well, I think, as we indicated, the smartphone category that's been recast is now making its way into the portfolio. We do believe that it will have some benefit in the back half of the year. However, just, not having that product category throughout the first quarter did have an impact, so it's going to take some time to rebuild the portfolio. We do believe the eCommerce initiative is going to play a large role in helping drive incremental sales to the Core business in the back half of the year.

And then as I mentioned in my prepared comments, just making sure from an operational execution standpoint, ensuring that the coworker talent, the customer experience, the value proposition, all resonates for our consumer in this competitive marketplace, that was a big portion and rationale as to why we moved Jim York into this role. His experience and background and areas of focus, we believe, are a right fit to address the weakness in our Core business. And so from our perspective, the Core business, we've got the right ideas, strategies and programs in place now to rebuild the portfolio.

From an Acceptance Now standpoint, the national accounts is certainly something that's provided a lot of optimism around the office here. We've got great conversations and opportunities with a number of large retail partners. As I mentioned, none of that is taken into consideration in our forward outlook, and so to the extent those pilots prove successful and we win those accounts, there's significant upside potential.

So from the Mexico side, obviously revenues are down just given the lower store count from a year ago, but the same-store sales growth has been very impressive, mid-teens, over mid-teens last year. And we're optimistic and excited about the future for growth in Mexico as well.

David Joseph Vargas
*Raymond James & Associates, Inc.*

Q

Okay. And in Acceptance Now on the national accounts, how many accounts are you piloting with now versus last quarter? How does the pipeline look, and are they skewing more towards a staffed model or to the Acceptance Now direct model?

Robert Dale Davis
*Chief Executive Officer & Director*

A

Good questions. We have not quantified that, and I'm not going to do that here today either. However, I will just mention that the number of folks that we are talking to and the progress that we have made throughout this quarter is larger than it was last quarter. We are not piloting with anyone currently, but we are in final negotiations with a few of the folks that I'm referring to, and so we're obviously very optimistic about what the outcome can be from that.

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David Joseph Vargas
*Raymond James & Associates, Inc.*
Q

Okay. Then...

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Robert Dale Davis
*Chief Executive Officer & Director*
A

[ph] The optimizations (25:38) are largely centered around the manned model. However, there's some consideration for the virtual as well. It's obviously not our preferred option, just given the significant upside from a manned presence to drive incremental sales for our retail partners and the value we can deliver to them, as well as just the revenue associated with that for our own business. So largely centered around manned, some consideration for virtual but our preference, I think you know, David, would be the manned.

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David Joseph Vargas
*Raymond James & Associates, Inc.*
Q

Sure. And then two more for me and then I'll get back in the queue. You mentioned you lost or you stopped doing business with a large national partner this quarter. Was that in Acceptance Now selling partner or is it a partner that you buy from in the core business?

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Robert Dale Davis
*Chief Executive Officer & Director*
A

It was an Acceptance Now partner that asked us and we agreed to have a manned presence, but the volumes were just too low to allow for us to be profitable, so we decided to exit.

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David Joseph Vargas
*Raymond James & Associates, Inc.*
Q

Got it. And what category was it? Furniture, electronics?

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Robert Dale Davis
*Chief Executive Officer & Director*
A

Multi-line.

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David Joseph Vargas
*Raymond James & Associates, Inc.*
Q

Multi-line. Okay. And then, Guy, one for you, and I'm sorry if I missed it. Skips and stolens in the Acceptance Now quarter, what were they this quarter?

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Guy J. Constant
*Executive Vice President – Finance, Chief Financial Officer and Treasurer*
A

They were up 240 basis points. They were 10.1% this quarter. They did, however, improve sequentially throughout the quarter, if I'm not mistaken. I think June may have been higher, but through April to May, it did improve.

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David Joseph Vargas
*Raymond James & Associates, Inc.*

Q

Okay. All right. Great. Thanks a lot for taking my questions.

Robert Dale Davis
*Chief Executive Officer & Director*

A

Thanks, David.

**Operator**: Your next question will come from the line of John Baugh with Stifel. Please go ahead.

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

Q

Thank you for taking my question. I apologize if you've addressed this already, but I was just curious around the store or staff closings in Acceptance Now. You've I think called out 100-plus closures. Could you maybe tell us what types of stores those were and maybe elaborate a little bit on the rationale or strategy going forward there? Thank you.

Robert Dale Davis
*Chief Executive Officer & Director*

A

Yes. John, it was primarily one relationship that volumes were too low to justify the operating costs that we had invested in to drive sales. And so it was a manned presence primarily at one large partner. Obviously, the outlook going forward from a national account perspective is where our focus is. We're investing in people and talent to drive those relationships and we're optimistic about the future and what that can mean for the business.

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

Q

So, Robert, would that be mean we shouldn't expect more or if this particular retailer maybe has more to come or how do we think about that number moving forward?

Robert Dale Davis
*Chief Executive Officer & Director*

A

No, we're completely out of that relationship, so there's no more to come from that.

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

Q

Okay. That's helpful. And then what are you doing, if anything, with term and pricing within Acceptance Now? I know you've been a little more focused on margin there than revenue. What would the changes be either sequentially or year-over-year in pricing and turn?

Robert Dale Davis
*Chief Executive Officer & Director*

A

Nothing extraordinary. Obviously, we always continue to look at opportunities to tweak the value proposition to ensure we're capturing sales. As you know, we have been working on economics related to the 90-day cash option, and so that largely has made its way into the portfolio, and you see the resulting positive impact on the margin, but there's nothing of an extraordinary nature going forward that we're considering or tweaking currently.

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

Q

Okay. And then, again, I apologize if you've addressed this already. But I was curious on the core business, in terms of store count there and potential further consolidation, as you look out, do you feel like you have the right number of stores now and you just need Texas to come back or would there be plans to further reduce footprint and maybe reduce cost in the core business? Thank you.

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**Robert Dale Davis**
*Chief Executive Officer & Director*

A

Yes. John, as you know, to predict that precisely or with precision is very, very difficult. Obviously, the changing marketplace and the dynamics that occur into the future obviously play a large role in those outcomes. Having said that, we felt like this quarter that a larger number of closures than we originally anticipated was necessary to return to improve the return profile of the business.

We believe that the recast of the smartphone category obviously as well as the e-commerce initiative are going to play a large role in helping improve the sales for the core business, and the leadership change that we made, we believe, obviously, will be a positive step in that direction as well. We'll continue to evaluate the fleet of stores as we move through, the balance of this year, next year, and into the future, but to predict with any precision around what the ultimate final store count would look like is just not quite possible.

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

Q

And, Robert, has there been any change in the comp, if you will, to existing stores that stay open in a nearby location to a core store that was closed? In other words, how much the account business is transferring down the street over, say, the next 12 months? Have you seen any change, improvement, deterioration in that number as you close stores?

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**Robert Dale Davis**
*Chief Executive Officer & Director*

A

As it relates to the overall portfolio when stores merge into nearby locations, the curve, if you will, has not materially changed from our historical performance. Having said that, John, you may know that the way in which we report our same-store sales comps does have a negative drag as a result of mergers. In fact, this quarter, six tenths of an impact on our same-store sales is a result of stores that merged in existing locations a year ago coming back into our comp. So we actually hurt ourselves given the way that we report comps with merged accounts, and we do anticipate and expect as we move into 2017 to modify our reporting around same-store sales so that we're not reporting a negative number, when in fact it's a positive outcome by improving the revenue and return profile of the surviving location.

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

Q

Yes. Yes. I'm aware of that, and in my mind, you're really comping an existing store fairly dramatically when you transfer those accounts, but...

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**Robert Dale Davis**
*Chief Executive Officer & Director*

A

That's right.

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

...I guess the comp calculation. Is there finally – and if you don't want to answer this, that's fine. But is there a rough revenue per month that these stores that you're closing, what kind of – is that hurdle the same or is that actually coming down as well?

Robert Dale Davis
*Chief Executive Officer & Director*
A

I'm not sure I understand your question, John. Can you clarify what you mean?

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

Yes, I mean, obviously, you're closing your weaker stores in the core business, and I'm just curious whether the revenue per store closed is, say, different from what you were doing two, three, four years ago when you were closing stores?

Guy J. Constant
*Executive Vice President – Finance, Chief Financial Officer and Treasurer*
A

Yes, I understand your question now, John. Clearly, we try to address the weakest performers first. So on balance, as we've gone through this process, closures that happened some time ago were probably on balance, on average weaker than ones we're closing now. But we're also trying to manage against when leases are expiring, too. So we're trying to manage the potential ongoing [ph] dead red (34:02) expense that we would manage.

So as the approximately 20% of our system comes due for lease renewal every year, that does gives us an opportunity to look at stores. But, as we've gone through the process, I think now the stores that we're closing are probably less core performers than the ones we closed a couple years ago.

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

Understood. Thanks for answering my questions and good luck.

Robert Dale Davis
*Chief Executive Officer & Director*
A

Yes. Thanks, John.

**Operator**: Your next question will come from the line of Bradley Thomas with KeyBanc Capital Markets. Please go ahead.

Bradley B. Thomas
*KeyBanc Capital Markets, Inc.*
Q

Yes, hi, good morning, guys.

Robert Dale Davis
*Chief Executive Officer & Director*
A

Hi, Brad.

**Bradley B. Thomas**
*KeyBanc Capital Markets, Inc.*

Q

I wanted to ask a couple of questions on the outlook for sales, first of all. Maybe first starting with the core segments and thinking about maybe same-store sales. Obviously, you end quarter with a lower level of agreements, partly given the accelerated POS rollout. As we think through the second half, can you talk a little bit more about your expectations for same-store sales, and the major initiatives that may be able to help you, and any risks that we should consider as we look out for the balance of the year?

**Guy J. Constant**
*Executive Vice President – Finance, Chief Financial Officer and Treasurer*

A

Yeah. Brad, as you saw in the revised guidance for the full year comps, you can easily back into the math of what that means for an expectation for the balance of year. You're right, the primary impact that we're expecting for the balance of the year comes from the deterioration of the portfolio that you experience as you go through the transitions of this new point of sale system.

So that is the primary driver as we look forward, not to mention some of the broader macro issues that are impacting the business like credit availability that don't appear to be lessening in any way.

But as you look forward to some of the things that we can do to address the business, Robert touched on a couple of them. The recap of the smartphone category that we believe will be complete here in this quarter, so we should get back to more normalized run rate on smartphones.

The year-over-year decline in smartphone revenues will lessen pretty dramatically here in the back half of the year. We have the e-commerce initiative that's coming on. We're piloting right now more from an operational point of view, just to make sure that it works and it functions properly when a customer does a transaction online, we expect to be able to roll that out fully to the system in the fourth quarter.

And then I think the one that perhaps is not as obvious, but could be very meaningful is Robert's point about how we are now past some of the major change that we've asked our operators to undergo in the last year or so. We've asked them to do a lot and to absorb a lot to put the business in a better situation, and now that we're through that distraction, once we start to pour some sales into this model, the resulting profitability of it will be much better.

We now believe our store co-workers will be able to focus much more so on the customer experience than they ever could before now that we're through the supply chain, labor, point-of-sale rollout, store closure changes that we've made over the last 6 months to 12 months.

**Bradley B. Thomas**
*KeyBanc Capital Markets, Inc.*

Q

Great. And to that point, is there a cohort of stores that you could look at that maybe was earlier in the rollout of flexible labor, earlier in the rollout of the POS, that may be trending a bit better as of late? And any evidence out there that you could cite for better performance as the level of change starts to moderate at the store level?

**Robert Dale Davis**
*Chief Executive Officer & Director*

A

Yes. Certainly we think that the second quarter and where we are now in the third quarter, certainly it's a trough; in fact, the one data point I can point to is, our first region that went through the POS implementation is ahead of the company performance and actually up on his portfolio on the year, and so that provides us some level of expectation that as we get through this distraction, the POS is now fully implemented, that there is a bounce back, so that's one data point I could share with you, Brad.

Bradley B. Thomas
*KeyBanc Capital Markets, Inc.*

Q

That's great. And then just one last maybe higher-level question: You've pushed for a lot of change over the last – over the last year, year-and-a-half, and it's clearly yielded great benefits on the cost side and will continue to do so. I guess, Robert and Guy, I mean, as you think about the next 12 months, 24 months, what's your appetite to take on other cost opportunities versus perhaps letting the chain digest some of the changes and trying to see what a more normalized run rate looks like?

Robert Dale Davis
*Chief Executive Officer & Director*

A

Yeah, I think, it's a fair question, and a great one, actually, and no doubt a lot of the productivity gains that we have implemented over the last 12 months, 18 months have started to bear fruit. But your point is a valid one, and one which the organization is keenly focused on and that's allowing us to just really focus on operational execution and delivering on sales. While there's still opportunities out there that we'll continue to evaluate and pursue, our near term and immediate focus is certainly on the topline.

Bradley B. Thomas
*KeyBanc Capital Markets, Inc.*

Q

Great. Thank you so much. Good luck.

Robert Dale Davis
*Chief Executive Officer & Director*

A

Thanks, Brad.

**Operator**: Your next question comes from the line of [ph] Laura Champine (39:43) with Roe Equity Research. Please go ahead.

Q

Good morning. I wanted to talk a little bit about what drove the decision to accelerate the POS rollout, and then as you think about the disruption there, what exactly is causing it? Because I know this is something that Rent-A-Center has been working on for years now, this rollout and trying to make sure it went smoothly. So what went wrong, and why did you make the decision to step it up in Q2?

Robert Dale Davis
*Chief Executive Officer & Director*

A

Yeah, I think you've sort of alluded to it a little bit, as to part of the rationale. We've been working on this system for a number of years, and as I mentioned in my prepared comments, there's a number of capabilities that we are unlocking by getting the POS system fully implemented and in place. And so it's really a two-part answer, one is just getting it behind us and eliminating the distraction and not allowing it to drag on throughout the balance of the year. So that's part of the answer.

The second part is, unlocking the pricing capabilities and opportunities that we have around tweaking our value proposition, by market, by category, by region, by store, that we've never been able to do before, as well as the e-commerce initiative, the fact that we're up in pilot in Q2 as a result of getting the POS system implemented allows us to learn sooner rather than later. And with e-commerce being a long-term benefit and revenue driver and providing the right experience for consumers who like to shop online, we wanted to get the distraction behind us and get going sooner on these new capabilities. Those are the two reasons.

Q

And then, what has led to this, because when we talked about it in the past, we thought there'd be a few days, hey maybe a week of sales disruption. It looks like it's lot worse than that, so what has led to the significant sales drop off associated with the POS?

**Robert Dale Davis**
*Chief Executive Officer & Director*

A

Yeah, I think, [ph] Laura (41:40), good question. I think with any large major system implementation, these things happen from time-to-time. But I think from our perspective, obviously, with the benefit of 20/20 hindsight, the early on pilots and the approach that we took to learn in the early stages had a lot more care and feeding, if you will, and handholding and oversight from multi-levels of management. And as we accelerated the pilot, that opportunity to have that kind of care and feeding dissipated.

And so just the distraction at the store level, our multiunit managers were not able to focus on their entire portfolio of stores and really focused on the conversions of the store that was transitioning to the new system, it really was a big burden, and that resulted in the result that we're reporting, and the outlook that we have for the balance of the year.

Having said all that, that distraction is behind us, and the opportunities that we have moving forward, we're optimistic about it, and excited for. So it's unfortunate, but we're looking into the future and making sure that we're addressing the needs of the business and learning from these new capabilities.

Q

Got it. Thank you.

**Robert Dale Davis**
*Chief Executive Officer & Director*

A

Thank you [ph] Laura (43:09).

**Operator**: [Operator Instruction] Our next question will come from the line of Carla Casella with JPMorgan. Please go ahead.

Carla M. Casella
*JPMorgan Securities LLC*

Q

Hi, I had a few cash flow questions. First, I'm wondering what you expect to spend in cash taxes this year?

Guy J. Constant
*Executive Vice President – Finance, Chief Financial Officer and Treasurer*

A

So I don't have that number at my fingertips, Carla.

Carla M. Casella
*JPMorgan Securities LLC*

Q

Okay. I can always follow-up later, but it looks like you're running well below last year, [indiscernible] (43:42) the deferred tax payments?

Guy J. Constant
*Executive Vice President – Finance, Chief Financial Officer and Treasurer*

A

Yeah, again, I'll have to get back to you on that, I don't have that on my fingertips.

Carla M. Casella
*JPMorgan Securities LLC*

Q

Okay. And then for the CapEx side, are you still targeting $75 million, which makes it looks like it's a big ramp up in the back half, or you think that could be lower this year?

Guy J. Constant
*Executive Vice President – Finance, Chief Financial Officer and Treasurer*

A

Yeah, I mean, we've been projecting $70 million to $80 million. I still think that's our range, if there is a bias, it's maybe to the lower end of the range, Carla, but we still think it's in that $70 million to $80 million range.

Carla M. Casella
*JPMorgan Securities LLC*

Q

Okay. The $20 million debt pay down in the quarter, I'm assuming that was all the revolver?

Guy J. Constant
*Executive Vice President – Finance, Chief Financial Officer and Treasurer*

A

Yes.

Carla M. Casella
*JPMorgan Securities LLC*

Q

Okay. How aggressive, I mean, now that the revolver is fully paid down, will you still continue to go and pre-pay term loan or potentially look to buyback bonds. I'm wondering how aggressive you'd be with your debt pay down now that you've taken out the easy pay down?

Guy J. Constant
*Executive Vice President – Finance, Chief Financial Officer and Treasurer*

A

Yeah, I mean, obviously now we have much more flexibility that were under the 2.5 times as you know, Carla, we couldn't really do anything other than pay down the revolver of the term loan until we were in that position. Now, we're in that position, so that does give us a little more flexibility. We're not yet at the position where we can start share purchase, but you know, we're not far away from that. So as both Robert and I commented, the opportunities are starting to open up for us now to use our capital.

Carla M. Casella
*JPMorgan Securities LLC*

Q

Okay. And your cash flow is a lot better than we expected in the quarter, can you give us just some insight in terms of any of the key items that drove it? I'm guessing a lot of it was the purchase of rental merchandise, given how much you brought down your inventory levels, is that a safe assumption?

Guy J. Constant
*Executive Vice President – Finance, Chief Financial Officer and Treasurer*

A

Yes, that's a safe assumption. We've really been managing our working capital much more tightly. Some of it is every item we're purchasing we're purchasing at a lower cost because of our sourcing initiatives. So it's not entirely a reduction in the actual units on inventory some of the average cost per unit, but there's no question we're doing a much better job of managing our inventory more tightly.

Carla M. Casella
*JPMorgan Securities LLC*

Q

Okay. And then just two quick business questions. Did you, I may have missed it, you gave the percentage of sales that are cell phones at this point?

Guy J. Constant
*Executive Vice President – Finance, Chief Financial Officer and Treasurer*

A

We didn't give that, Carla, but you know with the category being recapped, it's probably not an ongoing run rate what we've seen in the last couple of quarters. I think our expectation was that once fully recasted that the mix of smartphones would probably be down a little bit from where it was before. I think we peaked out at almost 9%. But, no, it's at a much lower level than that right now, but that's partly because we have not got the category fully recasted yet.

Carla M. Casella
*JPMorgan Securities LLC*

Q

Okay. That's very helpful. And then one business question on the Acceptance Now side, can you talk a little bit about the new terms of reimbursement and what percentage of the retailers are taking the new terms for reimbursement?

Guy J. Constant
*Executive Vice President – Finance, Chief Financial Officer and Treasurer*

A

Are you speaking directly to the 90-day transaction?

Carla M. Casella
*JPMorgan Securities LLC*

Q

Yeah.

Guy J. Constant
*Executive Vice President – Finance, Chief Financial Officer and Treasurer*

A

Yeah. We're probably about half – about half the retailers are we've gone back to and spoken with and have a new economic arrangement as it pertains to the 90-day transaction.

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**Carla M. Casella**
*JPMorgan Securities LLC* Q

And you expect to get them all over to that, or there's some that just doesn't – it doesn't fit the model?

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**Guy J. Constant**
*Executive Vice President – Finance, Chief Financial Officer and Treasurer* A

No, I think it fits the model for all the retailers, but we're working closely with all of them. And our discussion is centered more on just the 90-day transaction. Obviously, that's one piece that's got a lot of attention because of the impact it had on the business, but no, when you think about, whether it's a hybrid model or the virtual model or what we're trying to do with the staff model, the discussions with the retailers are more broad than that, so we would expect to continue to talk to all of our retailers about how we can make the business better for them and for us.

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**Carla M. Casella**
*JPMorgan Securities LLC* Q

Okay. Great. Thanks for taking all the questions.

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**Operator**: At this time, I will turn the conference over to Mr. Robert Davis for any closing remarks.

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**Robert Dale Davis**
*Chief Executive Officer & Director*

Thank you, Regina, and thank you everyone for joining us. We appreciate your time and your support. We look forward to reporting back next quarter, and we'll talk to you then. Thank you.

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**Operator**: Ladies and gentlemen, this concludes today's conference. Thank you all for joining. You may now disconnect.