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Rent-A-Center, Inc. (RCII)

Q2 2019 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning, and thank you for holding. Welcome to Rent-A-Center's Second Quarter Earnings Conference Call. As a reminder, this conference is being recorded, Thursday, August 8, 2019. Your speakers today are Mr. Mitch Fadel, Chief Executive Officer of Rent-A-Center; Maureen Short, Chief Financial Officer; and Daniel O'Rourke, Vice President of Finance and Real Estate.

I will now turn the conference over to Mr. O'Rourke. Please go ahead, sir.

Daniel O'Rourke
Vice President - Finance, Investor Relations & Treasury, Rent-A-Center, Inc.

Thank you, Jessa. 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 2019. All related materials, including a link to the live webcast, 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 in 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 call over to Mitch.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

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Thank you, Daniel, and good morning, everyone. Thank you for joining us. We will be providing a voice over to the presentation shown on the webcast. If are unable to view the webcast presentation, it can also be found in investor.rentacenter.com.

Now moving on to the first page within our company highlights and strategic update. The strategic plan we laid out last year focused on cost optimization, enhancing the value proposition and refranchising. The successful execution of our strategy has been instrumental in driving same store sales and EBITDA. Over the last 18 months, we've taken over $140 million of annualized cost out of the business. And with the refinancing now completed, that number goes up to approximately $160 million moving forward, due to the expected interest expense savings of between $15 million and $20 million annually. This new capital structure has also enabled our board to approve the initiation of a quarterly dividend of $0.25 per share, starting in the third quarter.

Maureen will fill in additional details regarding capital allocation, but certainly a big step forward. The value proposition enhancements we've made are having a positive impact as reflected in our continued same store sales growth. One of the key initiatives we focus on this year is driving online traffic, which is up almost 30% for the quarter. We also focus on improving the conversion rate of those orders, which we've also done and that's improved by about 400 basis points. I'm going to hit a few more web and e-commerce steps in a minute as it's really become a really key growth driver for us.

On July 15, we announced our intention to acquire Merchants Preferred, a nationwide virtual rent-to-own provider which fast tracks our existing virtual rent-to-own strategy. The virtual business is now becoming a top priority and we intend to leverage the experience of the Merchants Preferred team to take full advantage of the growth potential. More on that in a moment as well.

Finally, Franchising has been our third pillar, which we have selectively executed. During the second quarter, we refranchised 20 locations. Given the strength of our corporate-owned locations, refranchising will be utilized as a means of improving operating results in underperforming markets and stabilizing our brick-and-mortar footprint.

As a result of the strategic plan, we continue to see significant progress in both, our top and bottom line results. Highlighting the second quarter, our consolidate same store sales increased 5.8%, a considerable achievement for any retailer. As shown on the same store sales graph, our two-year stacked consolidated same store sales were 9.5%, which is a testament to how our top line has stabilized over the last 18 months.

The bottom line results are shown on the trailing 12-month EBITDA basis. And since early last year, our trailing 12-month EBITDA has improved sequentially each quarter as a result of our performance to-date and the recent refinancing, we are raising our annual guidance. The revised guidance as shown in the lighter color bar on the far right speaks to what we expect will be a strong second half of the year as our cost savings are fully reflected in the bottom line.

Now moving on to more specifically to the Core segment, driven by the execution of the value proposition changes, the Core produced a better than expected same store sales increase of 5.6% in the second quarter. While our overall revenues are down year-over-year due to refranchising and our store rationalization efforts the comp increases reflect the pulse of our business.

The same store sales increase is primarily driven by higher customer traffic year-over-year, especially the online increases I mentioned a moment ago. Our portfolio on a same store basis finished the quarter approximately 4% higher than the comparable quarter last year, because most of you know those metrics a good leading indicator for future same store sales expectations in the Core business.

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So, as I mentioned earlier, we continue to focus on converting our online traffic, which was up almost 30% over last year in the quarter. With the conversion rate that traffic – the conversion rate is also being up. You think about a 30% increase in the traffic, but we're converting more of that traffic, so we get a 38% increase in orders being closed off the web and that now represents about 12.5% of all of our rent-to-own agreements written and about 15% of our revenue.

So this significant increase in online or e-com agreement gives us confidence in the sustainability and the continued growth of our platform. Couple of other comments on the Core business. Our skip/stolen losses remained very consistent year-over-year and they actually came down 50 basis points from the first quarter of this year as the team is executing very well. These days we get asked a lot about any tariff impact on our product purchases. And I'm pleased to report based on who and where we get our products from, to-date, we've seen virtually no impact from tariffs nor do we foresee any future impact coming from tariffs. As a result of this positive momentum adjusted EBITDA improved $12 million in the Core and 280 basis points versus last year.

Now moving onto Acceptance NOW our changes to value proposition drove our same store sales increase of 6% for the quarter and invoice volume was $113 million for the quarter, 7.5% higher than last year. Our skip/stolen losses in Acceptance NOW improved by 40 basis points versus the first quarter of this year and the year-over-year increase driven – and thus have a year-over-year increase driven by abnormally low losses in the second quarter of 2018 related to the impact of recoveries. But, sequentially, it's the third quarter in a row they're down.

So we feel good about where we're going there and they're in line with expectations, the sequential improvements in skip/stolen losses versus the first quarter despite the lack of tax refund money in our customer base in the second quarter as compared to the first is a further indication of our team's ability to execute in both of our key business segments.

Now looking forward, we expect to integrate the Merchants Preferred business model into the Acceptance NOW segment over the back half of 2019, and slide 5 expands on the Merchants Preferred opportunity, the transaction and what this mean to Acceptance NOW and to our retail partners.

As we announced in July, the pending acquisition of Merchants Preferred was unanimously approved by Rent-A-Center's board of directors for a total value of approximately $45.5 million and it is expected to close this month. As noted on our earnings call after the first quarter, we were in the early stages of standing up our own virtual rent-to-own expansion. In parallel, we're also looking at acquisition opportunities in the space to speed up our timeline. And after looking at numerous companies, we believe Merchants Preferred it's the right match for us to fill the holes we had in our startup initiative. Acquiring the Merchants Preferred technology and their infrastructure and their 2,500 locations is expected to enable us to accelerate our expansion plan by at least 18 months.

Merchants Preferred was founded in 2012. It's a nationwide provider as I think you know virtual rent-to-own services for non-prime customers. They've generated approximately $80 million in revenue on a trailing 12-month basis as of June 30 of this year. The retail partners include independent furniture bedding, appliance tires and other retail partners. They're led by President and Chief Executive Officer Joe Corona. And over the past seven years of [indiscernible] (00:08:49), we believe, its leading edge technology and scalable infrastructure for virtual rent-to-own that will complement our existing Acceptance Now Staffed business model.

Looking ahead in the next two slides, we see how Merchants Preferred enhances our capabilities and where we think we can take the business over the next three years. Strategically, this acquisition is very appealing due to the advancement across several key capabilities. It also gets us past the infrastructure building phase which can

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be costly when setting up a new business. They've already established the infrastructure, we're just starting to stand up, and they've made the necessary start-up investments and now we buy them at a time when they're now profitable. And as I said, they should accelerate our virtual rent-to-own growth by at least 18 months.

They bring a management team experienced in virtual rent-to-own and a nationwide sales team of over 40 people. With access to lower cost of capital, we believe this team can capture significant share in the over $20 billion virtual rent-to-own market.

Next up the risk decision engine. Well, Acceptance NOW utilizes an automated decision engine in our staff locations. Merchants Preferred been able to do this in the virtual space, which does present different challenges. And this is a significant step forward from where we are today as Acceptance NOW on a standalone basis is in the early innings of fine-tuning a virtual decision engine.

Merchants Preferred also bring to the table of scalable, technology-enabled call center that provides what we believe is industry-leading service to both, customers and retailers. Utilizing artificial intelligence as a means to efficiently track compliance and improve upon best practices.

Merchants Preferred also as a retailer facing portal that provides capabilities such as real time reporting, ability to build marking lists and live chat with a call center, just to name a few. The retailer partner portal is also integrated with a Core technology platform and it's very intuitive. They utilize a tutorial built right into the platform for retail partners to reference and quickly get up to speed, much farther along than where we were.

Similarly, our ability to integrate with e-commerce platforms and convert online traffic will continue to be a focus. Merchants Preferred, currently generates approximately 20% of its business via online applications [ph] for filled-in (00:11:07) store versus Acceptance NOW, it's about half of that. And this acquisition accelerates the advancement with integration of online only retail providers.

Consumer-facing technology is an area that will evolve. Generally, this platform is the means for us to interact with the customers from originations through servicing. And the Merchants Preferred technology foundation accelerates our ability to build consumer-facing functionality. Both Acceptance NOW and Merchants, Preferred have a waterfall technology integration capabilities that retailers rely upon to ensure a seamless customer experience.

As a matter of fact, Acceptance NOW generates approximately 80% of its revenue in partners, where we are fully integrated in waterfall technology. We're committed in to providing a convenient seamless application process with any platform or retailer partners, the retail partners [ph] choose (00:11:59) and we'll have the capability to do so both Acceptance NOW and Merchants Preferred.

Looking forward, we believe the combined offering will be the most comprehensive in the industry as we will offer stack model, a virtual model or a hybrid model for use during peak selling seasons to our retail partners. Our retail partners will be able to assess and select which model best fits their needs to maximize revenues and save the sale. With this added flexibility, we will now be in a much better position [ph] and add (00:12:29) more large national retailers.

So what are our growth expectations over the next three years. By 2022, we expect to grow revenues over $1.2 billion in annual growth rate of approximately 15% and an increase of approximately $400 million versus the pro forma combined businesses. We believe, our goals will be achievable out of the gate with the improved capital position and ability to aggressively sell to our respective pipeline.

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As we move forward, we'll introduce that hybrid model expand into new product verticals. And as I mentioned earlier, put ourselves in position [ph] and add (00:13:05) more national partnerships. And although, we'll see a slight dip in Acceptance NOW's overall margin percentage when we initially combine these two businesses, we'll be at a higher margins once virtual is a meaningful part of our business. Really excited about the opportunities with Merchants Preferred.

And I'll now turn the call over to Maureen for additional highlights on our financial results.

Maureen B. Short

Executive Vice President – Chief Financial Officer, Rent-A-Center, Inc.

Thanks, Mitch. Good morning, everyone. I'll cover some financial highlight for the second quarter, provide an overview of the refinancing we recently completed and close with our increased guidance for 2019 before opening up the call for questions.

During the second quarter, consolidated total revenues were approximately $656 million, flat versus the same period of last year, primarily driven by a consolidated same store sales increase of 5.8%, offset by refranchising and rationalization of our store base. Adjusted EBITDA was $67.4 million in the quarter and EBITDA margin was 10.3%, up 100 basis points over the same period last year.

Net diluted profit per share, excluding special items, was $0.60. In our Core U.S. segment, total revenues in the second quarter decreased 1% versus the same period last year, primarily due to refranchising and rationalization of our store base, partially offset by a same-store sales increase of 5.6%.

Store labor and other store expenses decreased by $23.8 million, primarily driven by lower store count and cost savings initiatives. Adjusted EBITDA in the Core was approximately $73 million and EBITDA margin was 16.2%, up 280 basis points versus the prior year.

Now turning to the Acceptance NOW business. Total revenues in the second quarter decreased 1.5% primarily due to the run-off of certain with certain Acceptance NOW partners partially offset by a same-store sales increase of 6%. Store labor and other store expenses increased by $3.8 million, primarily due to higher year-over-year skip/stolen losses, due to recovery credits in the second quarter of 2018.

Adjusted EBITDA in the Acceptance NOW segment was $23.1 million and EBITDA margin was 13.1%, lower than last year, but up 180 basis points from 11.3% in the first quarter 2019. Remember, if you look at last year, the Acceptance NOW business benefited from the runoffs of accounts from Conn's and HH Gregg and skip/stolen recoveries I just mentioned as well.

Mexico grew revenue by 10.1% in the second quarter and generated $1.6 million in adjusted EBITDA. In the Franchise segment, revenue was $14.9 million and adjusted EBITDA was $1.8 million. Corporate operating expenses in the second quarter decreased by approximately $1.4 million, compared to the prior year, primarily due to the realization of our cost-savings initiatives, partially offset in the quarter by executive severance and higher incentive compensation.

Moving on to the balance sheet and cash flow highlights. For the second quarter of 2019, cash generated from operating activities was $110 million, $51 million higher than the prior year, driven by merger termination settlement and stronger operating performance, partially offset by one-time working capital benefits in the prior year.

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We ended the quarter with $353 million in cash on the balance sheet and the net debt to adjusted EBITDA ratio of 0.8 times. The liquidity and net debt to EBITDA metrics shown in the graph highlight our strong liquidity position and the improvement of our net debt to EBITDA ratio over the past 18 months.

Moving to page 11, as Mitch mentioned, we recently completed the refinancing of our credit facility and the redemption of our outstanding senior notes. With the refinancing, the company entered into new credit agreement for five-year $300 million asset-based revolving credit facility and the seven-year $200 million Term Loan B. The initial draw on the revolver was $80 million and the full $200 million was borrowed under the Term Loan B.

The proceeds from the refinancing, plus $260 million of cash on hand was used to prepay in full the $543 million senior notes. Following the completion of the refinancing, outstanding debt was $280 million Given the significantly lower debt balance, net interest expense is expected to decrease by approximately $15 million to $20 million on an annualized run rate basis. Cash on the balance sheet at the time of closing was $102 million and total availability on our revolver was $128 million taking into account our letters of credit.

Now, I'll talk a little bit about our capital allocation framework. Our first priority will be investing to grow the business with the focus on the 20-plus-billion-dollar virtual rent-to-own opportunity. We're also committed to maintaining a conservative balance sheet going forward. Our net debt to EBITDA ratio is currently at 0.8 times and we have a long range target to not exceed 1.5 times. Through the refinancing and our improved financial performance, we're also now able to return value to our shareholders through a $0.25 per share quarterly dividend starting in the third quarter of 2019.

Also, as a reminder, the board of directors previously authorized the share repurchase program. And as of June 30, 2019, we had $255 million remaining under the program. With the new flexibility of the refinancing, the company now has the option to repurchase shares.

Moving to Slide 12, it lays out our revised guidance for 2019. Please note these ranges do not include the Merchants Preferred acquisition, but do include the refinancing transaction. Total consolidated revenue increased by $10 million and is now expected to be in the range of $2.595 billion to $2.640 billion, the revenue increase was due to the strength of our Core portfolio and Acceptance NOW revenue remains flat to prior guidance.

Same store sales is now expected to be mid-single digits, up from low-to-mid-single digits. Adjusted EBITDA was increased to be between $240 million and $265 million, non-GAAP diluted earnings per share are expected to be between $2.05 and $2.40. An increase of $0.20 on the low end and $0.15 on the high end of the guidance range. The adjusted EBITDA and EPS increases versus the previous guidance are due to the performance in the second quarter and the interest savings in the back half the year due to the refinancing. Free cash flow is expected to be between $200 million and $225 million and I also wanted to note that the net debt has been adjusted to include the dividend payments.

The guidance does not include any new refranchise transactions after the second quarter of 2019. Due to the seasonality, most of the guidance increases are expected to materialize in the fourth quarter. As always, detailed pro forma income statement by segment are posted on our company website and the 10-Q for the second quarter will be filed later today.

Thank you for your time. Now I open up the call for your questions.

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QUESTION AND ANSWER SECTION

Operator: Thank you. [Operator Instructions] Your first question comes from the line of Budd Bugatch from Raymond James. Please go ahead.

Beryl Bugatch
Analyst, Raymond James & Associates, Inc.

Q

Good morning, and thank you for taking the questions. Just a couple of questions. [ph] Certainly, I guess, (00:21:42) start with the Merchants Preferred since that's the newest initiative. Mitch, can you give us kind of a read of what your first steps will be on Merchants Preferred? How are you going to plan to integrate and maybe give us a little bit more flavor of what [ph] their current (00:21:58) is in terms of doors and growth of doors year-over-year and that kind of historical?

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Yeah. I'll give you some of that, Budd, good morning. Probably won't get into too much of their historical results, we haven't even closed yet. So, you know, we can talk quite a bit about it, but I won't get into too much depth with it. Like I said, we haven't even closed yet.

But, generally speaking going forward, we're going to have integrated the businesses. We're going to have at least initially the people here running the staff model will continue on that staff model and Joe Corona and his team out of Atlanta with Merchants Preferred will run the virtual model. So, we're going to – you'll see the numbers integrated, we're getting the experts on each side work together kind of co-leads, if you will, the person that runs Acceptance NOW for us. And then Joe who leads – who is their CEO, running the virtual.

So, co-leads, still working on the branding, doing some customer research on whether we keep both brands long-term. Initially, we will. Whether we keep both brand names long-term or not. We're doing consumer research on. They've got about 2,500 doors, I mentioned their LTM in revenue is about $80 million. They have started to turn a profit in the last year or two. As I mentioned, what we like a lot is they've already built the infrastructure, already taken those startup losses that we're about to embark on from an Acceptance NOW standpoint to dive into the virtual world. They've got a lot of pipeline. They've been capital constrained, so we can unleash that pipeline with their 40-plus sales person team.

We've got a large pipeline for virtual. We went over the numbers how we think we can grow the $700 million of Acceptance NOW becomes $800 million with Merchants Preferred, initially and we think we can go to $1.2 million over the next three years, very confident we can do that based on the business that's out there, the offering we'll have, new verticals. And when I say the offering manned or virtual or a combination of the two which will be – we're the only ones out there that will have that combination. And sort of new verticals. They're in tires, we're not in tires, so that's a new vertical and there's other new verticals to talk about, so we're excited should close this month and get working on integrating the two businesses.

Beryl Bugatch
Analyst, Raymond James & Associates, Inc.

Q

Okay. Let me just turn quickly to the Core. One of the issues we talked about last quarter was the 180 days. It looks like it showed up maybe a little bit in gross margin performance this quarter – in the quarter year-over-year.

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Can you talk a little bit about what's affecting gross margins? I saw it in the cost of merchandise sales was up significantly year-over-year. Talk a little bit about how that works and maybe if you can give us a flavor on what investors should expect.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Yeah. I don't think it just showed up this quarter. When you go year-over-year, those were – the last year in the second quarter is when we're making the value proposition changes. If you look sequentially the last four quarters, it's the highest gross margin in the Core business in the last four quarters. So, it's fair to show up. As soon as we put it in at the beginning of 2018, by the third quarter it was showing up and our gross margin percentages, they have only gone up from there slightly. They've been about 69.5% every quarter. So, it's been pretty consistent. I'd expect them to stay at least with that range.

Sequentially, they've improved actually since the third quarter of last year and quite a bit of improvement over the first quarter. So I think that's already baked in. It's not like they're dropping, they're only dropping year-over-year, because we made a lot of changes last year or at the beginning of the year. And I just pointed EBITDA margins. The 16.2% EBITDA margin in the Core is the highest in forever. And it's almost 300 basis points higher than it was a year ago. So, if the gross profit's down marginally from a year ago, the EBITDA margin's up almost 300 basis points, so which I think is the important number.

And like I said, just look at the gross margin in the last four quarters, and it's not like it's dropping, it's only dropping if you go all the way back to the second quarter last year before we made the value proposition. And it is more than it was before we made the value proposition. But, again, the EBITDA margin is the highest in forever. So, we've got a better value proposition, but we've taken cost out. So, we're making a lot more money than we used to overall and the gross margins are pretty, pretty – it's already baked in. It's not like they're dropping anymore now, they're only dropping when you go back to early last year. So, overall, really happy with gross margins – with the EBITDA margin.

Beryl Bugatch
Analyst, Raymond James & Associates, Inc.

Q

Agreed, I see that. What's the average contracts per – number of contracts now per Core door? Can you kind of give us what that looks like kind of the customer account is?

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

I don't have that in front of me. I know one of the slide shows the customer count per store. Back on page 3, the customer count is right on top of where it was per store back in 2016. The blue line on page 3 compared to the red line, so we're right on top of our high point forever finishing a second quarter – I say ever – in the last four years what our high point customer count wise, [ph] back on (00:27:38) page 3 of the presentation, I don't have the counts in front of me, but that's the customer count, which is going to be about the same. I mean the accounts were higher than the customer count, but on a relative basis and comparables they will be pretty close.

Beryl Bugatch
Analyst, Raymond James & Associates, Inc.

Q

Great. And the last for me just, Maureen, can you talk a little bit about the rates in the Term Loan B and revolver how does that look, I know we get $10 million to $15 million of annual interest savings. So, when will the

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document be filed on those agreements and can you talk – maybe give us a little flavor of inside what those look like.

Maureen B. Short
Executive Vice President – Chief Financial Officer, Rent-A-Center, Inc.
A

Sure. Sure, Budd, within the 10-Q that's filed later today, it will include all the information about the credit agreements and the rates on the ABL are initially 150 basis points, plus LIBOR, is dependent on leverage that can range from 150 to 200 basis points and the Term Loan B is 450 basis points plus LIBOR.

Beryl Bugatch
Analyst, Raymond James & Associates, Inc.
Q

450 basis points above LIBOR?

Maureen B. Short
Executive Vice President – Chief Financial Officer, Rent-A-Center, Inc.
A

Yes.

Beryl Bugatch
Analyst, Raymond James & Associates, Inc.
Q

Okay. And is that FILO loan, is that how that's working?

Maureen B. Short
Executive Vice President – Chief Financial Officer, Rent-A-Center, Inc.
A

No. It's a traditional Term Loan B not a FILO. It's not based on the borrowing base.

Beryl Bugatch
Analyst, Raymond James & Associates, Inc.
Q

And repayment capability, if you want to, what kind of flexibility do you have?

Maureen B. Short
Executive Vice President – Chief Financial Officer, Rent-A-Center, Inc.
A

Yes. We have full flexibility. There is six months before we'll be able to prepay the debt with no penalties.

Beryl Bugatch
Analyst, Raymond James & Associates, Inc.
Q

Okay. And lastly are there any charges that will show up for the bank refinancing in the third quarter?

Maureen B. Short
Executive Vice President – Chief Financial Officer, Rent-A-Center, Inc.
A

Yes. Within the third quarter, there is refinancing fees of between $7 million and $8 million.

Beryl Bugatch
Analyst, Raymond James & Associates, Inc.
Q

Terrific. Thank you very much. Good luck and congratulations. It's really lovely to see the complete turnaround. Thanks.

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Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Thanks, Budd.

Operator: Your next question comes from the line of John Rowan from Janney. Please go ahead.

John Rowan
Analyst, Janney Montgomery Scott LLC

Q

Good morning, everyone.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Good morning, John.

Maureen B. Short
Executive Vice President – Chief Financial Officer, Rent-A-Center, Inc.

A

Good morning.

John Rowan
Analyst, Janney Montgomery Scott LLC

Q

Maureen, I appreciate the information on the cost of the B in the ABL, but I was just wondering what – just maybe back-up, making a little bit simpler. What's the blended rate of debt cost you have now, including any commitment fees that you might have, just trying to get a sense of what the overall cost of the facility is to you today?

Maureen B. Short
Executive Vice President – Chief Financial Officer, Rent-A-Center, Inc.

A

The blended rate is I believe it's around 6%, a little under 6%. It would be the $200 million at the 450 basis point plus LIBOR. And then the $80 million on the ABL at 150 basis points plus LIBOR.

John Rowan
Analyst, Janney Montgomery Scott LLC

Q

And the 6%, does that include commitment fees as well?

Maureen B. Short
Executive Vice President – Chief Financial Officer, Rent-A-Center, Inc.

A

Yes. There are commitment fees on the letters of credit and that ranges from 25 to 37.5 basis points.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Yeah. I think...

John Rowan
Analyst, Janney Montgomery Scott LLC

Q

Okay. And then...

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Maureen B. Short
Executive Vice President – Chief Financial Officer, Rent-A-Center, Inc.
A

Yeah.

John Rowan
Analyst, Janney Montgomery Scott LLC
Q

The guidance that you gave – you guys gave for the net at the end of the period, does that include an assumption for repurchases? I mean, I'm basically asking if your guidance includes assumption of repurchases.

Maureen B. Short
Executive Vice President – Chief Financial Officer, Rent-A-Center, Inc.
A

It does not include share repurchases in our guidance.

John Rowan
Analyst, Janney Montgomery Scott LLC
Q

Is there a limiter in the covenants to how much you can return whether it'd be through dividends, acquisitions or repurchase?

Maureen B. Short
Executive Vice President – Chief Financial Officer, Rent-A-Center, Inc.
A

As long as we meet certain liquidity thresholds, the restricted payment basket is unlimited, within those facilities.

John Rowan
Analyst, Janney Montgomery Scott LLC
Q

Okay. Any tax rate guidance going forward?

Maureen B. Short
Executive Vice President – Chief Financial Officer, Rent-A-Center, Inc.
A

Any tax rate guidance?

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.
A

Yeah.

Maureen B. Short
Executive Vice President – Chief Financial Officer, Rent-A-Center, Inc.
A

Yes. It's between 23.5% and 24.5%.

John Rowan
Analyst, Janney Montgomery Scott LLC
Q

Okay. And then just one question on the acquisition now you did. What is their strategy for dealing with returned merchandise?

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Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Well, they have a few different ways they do it. I think the key point there, when I say few different ways when they recovered merchandise. Of course, they don't have brick-and-mortar stores to [indiscernible] (00:31:53) and so they have to use other things online sales things like that to discard the merchandise, whether it's off or up or those kinds of things, which is what most of the virtual providers do is have to find another liquidators and things like that.

The key point there though, John, is that in our – I said in the brick-and-mortar stores, we can monetize them at a higher level than what they've been able to do without. It's not like they have a level of returns that's going to hurt the Core based on the way their value proposition works with shorter term agreements 12 to 18 month agreements. They don't get a loss, but the [indiscernible] (00:32:28), we can monetize. We can improve the monetization with our Core brick-and-mortar stores.

John Rowan
Analyst, Janney Montgomery Scott LLC

Q

Yeah. Would you be willing to tell us what were their target is relative to the Rent-A-Center. Well, relative to Rent-A-Center Core and Acceptance NOW?

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

No. There are two ways. One, we haven't closed yet. So I wouldn't give any data and with their current situations. And they don't have it in front of me, but we'll get into that later, it's not really high. It's really high.

John Rowan
Analyst, Janney Montgomery Scott LLC

Q

Yeah, okay.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

But there are returns of course it's a rental business, but the few they have, we'll be able to monetize in a much better way.

John Rowan
Analyst, Janney Montgomery Scott LLC

Q

And do you think, you'll be able to plug them into your brick-and-mortar stores and improve the gross margin that they are getting on returned merchandise?

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Correct.

John Rowan
Analyst, Janney Montgomery Scott LLC

Q

To be clear.

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Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Correct.

John Rowan
Analyst, Janney Montgomery Scott LLC

Q

All right. Thank you very much.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Thanks, John.

Operator: Your next question comes from the line of Kyle Joseph from Jefferies. Please go ahead.

Kyle Joseph
Analyst, Jefferies LLC

Q

Hey, good morning guys. Thanks for taking my questions and congratulations on a busy good quarter.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Thanks, Kyle.

Kyle Joseph
Analyst, Jefferies LLC

Q

Just following up. I know you guys talked about one-time costs from the credit facility. Should we expect any one-time costs related to the acquisition in the third quarter as well for modeling perspective.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

A little bit – from a banker standpoint investment banking fees are – it's not a whole lot.

Kyle Joseph
Analyst, Jefferies LLC

Q

Okay.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

But there'll be small, small amount of investment banking fees.

Kyle Joseph
Analyst, Jefferies LLC

Q

Got it. And then thinking about Merchants Preferred, how quickly do you anticipate being able to consolidate the two businesses and go out and pitch the platform to new potential retail partners. What sort of timeline you have there?

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Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Well, kind of – will come in phases, Kyle. They've got a large pipeline right now for virtual. They've been capital constrained, so some of that we can unleash immediately based on the current offerings. As far as the hybrid offering, where it's a combination of virtual or manned within the same within the same store. In different stores, we'd be able to do that pretty quickly in the same store from a technology standpoint, we're probably looking at early next year. So, it's six-month kind of time window on the full offering. But as far as the current offering and unleashing their sales team based on that being capital constrained that starts day-one.

Kyle Joseph
Analyst, Jefferies LLC

Q

Got it. And then just thinking about EBITDA margins of the consol – sorry not the consolidated business, but the combination of Acceptance NOW and Merchants Preferred over time. I know you said, from a near-term perspective there may be a little bit of margin compression. That's understandable given you highlighted, they're a little bit profitable. But over time combination of the business, how do you think about the EBITDA margin versus where Acceptance NOW has been trending given it is virtual and fully understand that there is some puts and takes in terms of EBITDA margin obviously less employee costs, but some offsets there as well?

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Yeah. There's some gross – certainly gross profit is a little lower in the virtual world, but then you make up forward from a labor standpoint. I think initially, it will drop the margins. But as it becomes more meaningful, the margins will be higher than where Acceptance NOW is today.

Kyle Joseph
Analyst, Jefferies LLC

Q

Got it. Thanks very much for answering my questions.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Thanks, Kyle.

Operator: Your next question comes from the line of Bradley Thomas from KeyBanc Capital Markets. Please go ahead.

Q

Good morning. This is [ph] Andrew (00:36:14) on for Brad. I just had a question on Merchants Preferred, it seems like the acquisition will compliment Acceptance NOW well. A question that we've been getting from investors is whether or not you're keeping an eye out for an additional acquisitions like this one going forward?

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Well, we looked at numerous companies and decided Merchants Preferred, we believe Merchants Preferred is the best fit for us for what we needed. Certainly, with our capital structure, we have the opportunity to do more

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and we won't need to buy the infrastructure and so forth that we're buying, so we'd have to look at it a little differently. But I would never say never, we're always going to look at opportunities, but right now we're focused on just integrating and growing rapidly with the one we've just bought.

But to answer your question, [ph] Andrew (00:37:11), of course, we look at things but it would be under a different look, right? Because, again, this is a lot about buying infrastructure and so forth. But, sure, we look at it, there's an awful lot of virtual companies out there. And if the economics are right for us, we'd look at it.

Q

Right. That makes sense. And my last question is on the Core business. I was wondering if you could talk more about some of the merchandising transit initiatives that you guys are doing that will drive comp in the second half?

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Well. It's really the e-com side of the business the web orders that are growing at 30%, our conversion rate's growing. We grew about 400 basis points in the second quarter, so our online agreements, they are up 38% when you combine those two. It's already 15% of our revenue and it's growing every quarter. So, the value proposition changes we've made are really attractive to the customer and we're getting a lot more online traffic and we're very confident that that's very sustainable.

Q

Okay. Great. Thanks. That's all for me.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Thanks, [ph] Andrew. (00:38:31)

Operator: Your next question comes from the line of John Baugh from Stifel. Please go ahead.

John Allen Baugh
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Thank you. Good morning and congrats on particularly the progress with the balance sheet. I was wondering first, could we just get a clarification on your comp calculations, Maureen. That hasn't changed at all. We're still like taking out the benefit, right, of a closed door when it folds into an existing store for what, 12 months, and then it comes back in the comp.

Maureen B. Short
Executive Vice President – Chief Financial Officer, Rent-A-Center, Inc.

A

It's fold out for a full 24 months.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

24, yeah.

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Maureen B. Short
Executive Vice President – Chief Financial Officer, Rent-A-Center, Inc.

A

If the store receive the certain percentage of counts from a closed location and there were quite a bit of changes this quarter with new stores coming into the comps whether that'd be from hurricanes that had occurred previously or the closures, particularly on the Acceptance NOW side.

John Allen Baugh
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay. Great. Thanks. And, Mitch, I know you've mentioned the Merchants Preferred has been capital constrained, but is there any kind of a rough invoice volume growth number for the last 12, 24 months [ph] GP, you're (00:39:41) willing to offer.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

I don't have the invoice volume growth. Their revenue has grown. I know their – the 2018 revenue was about $75 million and the last 12 months revenue was $80 million. So, that's a nice trend from a percentage standpoint, especially being capital constrained having to pick their spots where they can grow.

So, I don't have invoice volume in front of me, but their revenue is growing and their profit has been growing. And even though they're only slightly profitable now with synergies, we're going to be in the – we said it's an immaterial effect this year. Of course, it's only going to be about four months left in this year and we take it over.

But on a run rate basis, once we get the synergies by the end of the year, even their current profit we're looking in the $5 million range. So, besides buying the infrastructure and speeding up our process from a virtual standpoint, it's not like we didn't get any revenue or profit. Like I said with synergies we're going to be in the $5 million range, we said immaterial to this year, because of the timing and obviously we had to get those synergies over the next couple of months.

John Allen Baugh
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay. And then, Maureen, is there any if you hit this goal for Merchants Preferred or A NOW growth. How does that impact cash flow? Is it self-funding to generate cash, is it use cash?

Maureen B. Short
Executive Vice President – Chief Financial Officer, Rent-A-Center, Inc.

A

There will be a working capital outflow as we grow the Merchants Preferred business. But clearly we believe that's profitable growth from an EBITDA standpoint over time and definitely believe in the potential of growth of that business. So yeah, it will generate free cash flow as an ongoing business, as we put the inventory investment out to work and we'll generate cash flow over time, but initially there will be a working capital investment.

John Allen Baugh
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Great. And jumping back to Core and write-offs, you mentioned online is growing. My understanding is that that has a little higher risk to it. Are you seeing that or is it too early to see that you mentioned it's up 30%, I'm wondering what you're experiencing and/or anticipating on write-offs in Core?

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Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Yeah. Our skip/stolens were 3.2% in the quarter in the Core. Second quarter. And a year ago when online business was probably less than, well, as I said the online agreements were up 38%, it was 3.1%. So we're right on top of last year, even with all the new customers coming from the web. So, we're not seeing that kind of risk from that customer coming in. So we're not anticipating it to happen going forward. We haven't seen it yet. Like I said, we're right on top of last year, sequentially, down significantly from the mid-3s and we're executing very well on that. So, we're not seeing a problem with the web customers driving on losses though.

John Allen Baugh
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay. And then my last question, Mitch, is here around, obviously the balance sheet is great. And you announced a dividend and just curious the debate internally around the opportunity to grow with the virtual business and how important it is to have a capital structure balance sheet that can support that and when pitching the business. Can you give me the puts and takes on how you thought about the capital allocation as it relates to the total addressable market being so large.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Sure. Good, simply put our first priority is to grow their business. And to grow into that $20 billion business and [indiscernible] (00:43:34) comes from a place where we think we do both. We're at 28 times debt right now. As Maureen said, we want to stay conservative from a balance standpoint and keep it at 1.5 times or less. But that's an awful lot of cash flow on a monthly basis today anyhow, so the short answer John is we can do both

John Allen Baugh
Analyst, Stifel, Nicolaus & Co., Inc.

Q

Okay. All right. Terrific. Thank you and good luck.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Thanks, John.

Maureen B. Short
Executive Vice President – Chief Financial Officer, Rent-A-Center, Inc.

A

Thanks.

Operator: Your next question comes from the line of Vincent Caintic from Stephens. Please go ahead.

Vincent Caintic
Analyst, Stephens, Inc.

Q

Hey, thanks. Good morning, guys. So questions on the virtual rent-to-own. So, I appreciate the revenue guidance you gave for the three year outlook of to $1.2 billion kind of wondering if you can give us a flavor of kind of what confidence and what kind of insight you have in there. And I guess the reason I ask is it seems like for virtual rent-to-own you have a typical three-year sales cycle with a retailer. So, are there any pilot programs that you have already running. Is there any progress you can share.

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Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.
A

Well, our confidence Vincent comes from the pipelines that are out there, the opportunity that's out there, how much whitespace is still out there. We've been able to grow the manned model Merchants Preferred, actually been able to grow the virtual model even being capital constrained.

We've got a great sales team. We don't have any pilots, not that we're going to speak to today on the as far as large national partners [ph] or anything (00:45:12). We do already have some large financial partners and we believe this will accelerate our opportunity to do that, but it's not – but I guess the short answer here is, the $1.2 billion is not based on going and getting one of the largest retailers in the country. That would actually improve that $1.2 billion. We believe, we're going to be able to do that, but it's not, our number is more conservative than that when it comes to just getting regional players, some other verticals like I mentioned earlier. So it's not based on, we got to get that one big retailer that were going to do $200 million a year on or $300 million a year on.

Vincent Caintic
Analyst, Stephens, Inc.
Q

Okay. Got it. That's helpful. And I guess maybe taking a step back and kind of your view of a virtual rent-to-own and your expansion plan. So, you've got your existing Acceptance NOW, manned offering. Now you have the virtual offering with Merchants Preferred. And then another one we haven't talked about I think before is your partnership with Vyze by Mastercard, where I think you've already got a couple of retail partnerships there like with Home Depot. So I wonder if can talk about that. But then, so once you get Merchants Preferred integrated this year, how do you – did you give us a broad overview, how you see Rent-A-Center their virtual tent-to-own offering competing beginning in 2020?

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.
A

Well, we do have relationships with a few of these different waterfall companies like Vyze and integrators like Vyze Versatile and some of those other ones [indiscernible] (00:46:38) – some of those other companies. We also integrate right into POS systems directly with the retail partners. As I mentioned earlier, about 80% of our business comes through a waterfall, a partner that has a waterfall, whether it's their own that we – that our IT department went into and built into with the retail partners', IT department or it's a third-party like Vyze or Versatile. So we are doing business with all those companies, great relationships with all those companies and that will be – as we grow, a lot of times you're talking not just the retail partners, but you're also using those waterfall integrators as a growth vehicle.

We just recently did a deal, where we're in something called [ph] TD Complete the TD Bank (00:47:24) is the primary and we're the only tertiary in there that just started being offered last month. So, yeah, there's a lot of activity around not just retail partners, but also online partners in these waterfall integrators and the direct online business is going to be a big play there in the virtual world too, not just necessarily direct with the retailer.

Vincent Caintic
Analyst, Stephens, Inc.
Q

Okay. Perfect. And, yeah, I think [ph] TD (00:47:47) has a couple of private label credit cards with big retailers, so that's really exciting. Just one last quick one. So I know we talked about the value proposition driving some of the gross profit margin decline, but has there been any recent changes to the value proposition since second quarter last year or should we now be expecting the comp, the virtual proposition – value proposition in the third quarter? Thanks.

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Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.
A

Yeah. Not sure I totally understood that, Vincent, but no there hasn't been any major value proposition changes since last year in the second quarter. And it's a good point it's kind of what I was talking about when Budd asked the question about the Core. The second quarter last year from a margin standpoint, if you start with the third quarter you see a much more consistent gross profit margin, because EBITDA goes up. And then on the [ph] e-mail side (00:48:43) you see a more consistent as you get into the latter part of last year and there's not more that's going to drop and except for virtual. Virtual as you know, Vincent drops gross profit level, but grows EBITDA level and that's what we expect to see.

And one other point on what we were talking about earlier when you followed up and said, yeah, [ph] TD Bank (00:49:03) has some of these – some exclusive offerings...

Vincent Caintic
Analyst, Stephens, Inc.
Q

Yeah. Private label, yeah.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.
A

We're exclusive in there – in with their online program is it's called [ph] TD Complete (00:49:15) and we're the exclusive rent-to-own provider in there.

Vincent Caintic
Analyst, Stephens, Inc.
Q

Yeah. That's great. Really helpful. Thanks so much, guys.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.
A

Thanks, Vincent.

Operator: [Operator Instructions] Your next question comes from the line of Anthony Chukumba from Loop Capital Markets. Please go ahead.

Anthony Chukumba
Analyst, Loop Capital Markets LLC
Q

Good morning, and let me add my congratulations, particularly in terms of all the work, which you guys got done this quarter with the refinancing and the Merchants Preferred deal, so executing the turnaround. So, hopefully, you're off for a long vacation sometime soon, particularly Maureen.

So, I had a question, you know kind of related to the last question. You talked about in the Core business, I guess, in both in Core business and Acceptance NOW, gross margin has been coming down, that's because of that better value proposition. In the Core business at least this quarter [indiscernible] (00:50:11) more than offset that through essentially expense leverage right?

So you [ph] had that (00:50:16) and came up with higher operating margin. That wasn't the case in Acceptance NOW, and I was just sort of looking through my model. This is the first time in five quarters that Acceptance NOW

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operating margin [indiscernible] (00:50:26) one-time items actually declined year-over-year. So, I guess I'm just trying to sort of reconcile that, why that's sort of working in the Core business, but it's not working now in Acceptance NOW, is something I'm kind of missing there?

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Well, couple of comments that I'd make. First of all, I want to reiterate in the Core business margins are not coming down. They're lower, the gross profit margin is lower than a year ago. But if you look at the last four quarters, it's been very stable and it's actually higher than the third quarter of last year, so they're not continuing to drop. They're only lower than the second quarter of last year as a value propositions were being implemented.

And, overall, the EBITDA margin's up 300 basis points. And against the third quarter of last year, it's up 500 basis points. So, they're not coming down, they're only coming down if you compare it to five quarters ago. On the Acceptance NOW side, as Maureen mentioned and if you look at skip/stolens, now this is the third quarter in a row, where they're down. We've gone from the mid-11s, which was out of our range of 8% to 10% and then they were 10% in last quarter and now they're 9.6%. So, they've dropped significantly in the last three quarters, we performed well there.

But a year ago, when you go back five quarters to the second quarter of 2018, we had some recoveries, Maureen mentioned it. We, in 2017, left Conn's and HH Gregg declared bankruptcy. So those two large partners with up to 36-month agreements, the revenue from those accounts was running off in 2018, especially in the early part. So we had the runoff of those accounts, which was driving revenue with very little cost, because we closed those kiosks and put the revenue stream into other kiosks. So we had the accretion of those closed stores helping us early last year, the recoveries, where we put the [ph] certain (00:52:26) recovery amount at the end of 2017, and the losses associated with closing those stores, we had some large recovery as we look at what their real losses were in the second quarter is from recoveries, so we had a low and abnormally low skip/stolen number.

So, even though skip/stolen number this past quarter is in line with our expectations, it's 200 basis points higher than a year ago. So, when you take out those 200 basis points, the margin is right on top of – or pretty close or right on top of where you had expected it to be – or what it was last year, excuse me in that 15% 16% range. We're not disappointed with the 13.1% EBITDA margin this quarter. It's just last year was abnormally high, because that run off and then the recoveries.

Anthony Chukumba
Analyst, Loop Capital Markets LLC

Q

Okay. No. It's very helpful clarification. And then just one thing. Just wanted make sure I heard correctly when you're talking about the increase in your EBITDA guidance and you said part of that was the debt refinancing and I was did I hear that correctly, because I mean that's interest expense right so that that wouldn't be factored that wouldn't affect our EBITDA right?

Maureen B. Short
Executive Vice President – Chief Financial Officer, Rent-A-Center, Inc.

A

No

Anthony Chukumba
Analyst, Loop Capital Markets LLC

Q

Did I hear something incorrectly?

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Maureen B. Short
Executive Vice President – Chief Financial Officer, Rent-A-Center, Inc.

A

So EPS was impacted by the refinancing.

Anthony Chukumba
Analyst, Loop Capital Markets LLC

Q

Okay.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

EBITDA

[indiscernible] (00:53:41)

Anthony Chukumba
Analyst, Loop Capital Markets LLC

Q

Okay

Maureen B. Short
Executive Vice President – Chief Financial Officer, Rent-A-Center, Inc.

A

...performance

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Yeah

Maureen B. Short
Executive Vice President – Chief Financial Officer, Rent-A-Center, Inc.

A

Yeah

Anthony Chukumba
Analyst, Loop Capital Markets LLC

Q

Okay. Got it, got it , got it, okay. Okay. No. Thanks. Thanks for clearing that up. Okay. Thanks so much guys.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Thanks, Anthony.

Maureen B. Short
Executive Vice President – Chief Financial Officer, Rent-A-Center, Inc.

A

Thank you, Anthony

Operator: There are no further questions at this time. I turn the call back over to Mr. Fadel for closing remarks.

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Mitchell E. Fadel

Chief Executive Officer & Director, Rent-A-Center, Inc.

Well, thank you everyone, thanks for your time. We are pleased to report these really solid numbers and getting the refinancing done and now we'll go back to work on getting the Merchants Preferred acquisition closed and maintaining these kind of this kind of revenue growth same store sales numbers and go out there and put another good quarter on and the board, so we're working hard for our shareholders, working hard to grow the business and we're really excited about getting our refinancing done and Merchants Preferred acquisition. So with that, thank you for your time.

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

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