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RCII - Q4 2017 Rent-A-Center Inc Earnings Call

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OVERVIEW:

Co. reported 4Q17 consolidated total revenues $639m and net diluted loss per share, excluding special items, of $0.41.

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PRESENTATION

Operator

Good morning, and thank you for holding. Welcome to Rent-A-Center's Fourth Quarter Earnings Conference Call. As a reminder, this conference is being recorded Wednesday, February 21, 2018.

Your speakers today are Mr. Mitch Fadel, Chief Executive Officer of Rent-A-Center; Maureen Short, Interim Chief Financial Officer; Joel Mussat, Chief Operating Officer; and Daniel O'Rourke, Vice President of Finance, Investor Relations and Treasury.

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

Daniel B. O'Rourke - *Rent-A-Center, Inc. - VP of Finance Analytics & Reporting*

Thank you, Maria. Good morning, everyone, and thank you for joining us. Our earnings release was distributed after market closed yesterday, which outlines our operational and financial results for the fourth quarter of 2017. 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 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 - *Rent-A-Center, Inc. - CEO & Director*

Thank you, Daniel, and good morning, everyone. Thank you for joining us. Before I get into my prepared remarks, I want to provide some clarification regarding certain details from yesterday's press release. I believe there is some confusion as to why the board hired consultants to work on a restructuring plan while the company is in the midst of a strategic and financial alternatives review process. Some have mistakenly taken our announcement of a significant cost savings plan as evidence that this strategic and financial alternatives process has concluded. I'm here to tell you that's not the case. The board made the decision to hire AlixPartners in December because it believed that a major cost savings opportunity existed inside the company. This belief was clearly validated based on the substantial savings targets we've outlined and we'll discuss today. The board also recognized that the completion of this analysis using competent outside experts would benefit our shareholders, whether the company was sold as a result of the strategic and financial alternatives process or remained an independent company. As was stated in the press release, the alternatives process -- strategic and financial alternatives process does remain ongoing, and the board plans to provide an update to investors once this work has concluded. So I hope this helps clarify the situation for those of you who may have been confused. But the strategic and financial alternatives process has not been concluded.

Having said that, I'd like to say how excited I am to be back at Rent-A-Center. Many of you know, I was previously part of Rent-A-Center for over 30 years, and served 15 years as the President and Chief Operating Officer, having left that position in mid-2015. I understand the cash and credit constrained customer and believe strongly in the business. Although the company has gone through challenges over the past 3 years, the rent-to-own customer is still a large segment of the population and is still in need of our products and services.

Some progress was made in 2017, specifically, improving core delinquencies and increasing the average ticket resulted in same-store sales improving throughout most of the year. Even though progress was made, performance in the fourth quarter was much lower than the company expected. Revenue performance was behind where it should have been, primarily due to an overuse of low payment trial offers, the lingering impact of the revenue loss due to the hurricanes last fall, especially in Puerto Rico as well as higher-than-expected expenses. This performance is not acceptable to me. Therefore, several changes to our strategy are needed to improve the profitability of the business and to position Rent-A-Center for a successful future.

My strategy is built around aggressively addressing a number of controllable items rather than counting on revenue growth to drive near-term profitability and cash flow. My plan should drive bottom line results without a top line turnaround. Now that being said, we are laser-focused on achieving sustainable revenue growth, which would be additive to our internal plans. This conservative top line plan, combined with controllable expense reductions should provide more certainty around our forecast. As I alluded to earlier, in December, the Board of Directors engaged with AlixPartners, a well-known business consulting firm, to assist the company in identifying financial cost savings and efficiencies. We've identified $65 million to $85 million of annualized EBITDA-enhancing opportunities. Company plans to implement improvements in the areas of supply chain, overhead expenses and other store expenses such as procurement costs. We have also identified working capital improvements we can realize in 2018 in the $20 million to $25 million range. These initiatives are not expected to disrupt the business since the opportunities are primarily outside the store operations. But they will allow us to be much more efficient as an organization. I strongly believe there is a significant amount of opportunity available to improve the profitability of the company.

Cash flow will be one of the key metrics we use in measuring progress against our turnaround plan, and investments will be monitored very closely to ensure the actions we take result in bottom line profit and improved cash flow.

Now even though my turnaround plan is not dependent on customer growth, we will continue to work diligently to drive transaction volume and revenue growth. The key point is this represents upside to the plan. I will outline a number of initiatives I've put in place to drive a return to revenue growth. First, we need to strike a better balance between pricing and volume in our Core business. Last year the company focused on increasing rates and shortening terms. The expectation was deliveries would likely decline modestly but would be more than offset by reduced returns and increased average ticket. This offset did, in fact, occur but the drop in deliveries needs to be reversed in order to continue sustainable growth.

As we turn to this year, we see the opportunity to continue building the portfolio in a more balanced and sustainable way by being more surgical around our pricing metrics and our product assortment. For example, our pricing must be more category-specific rather than a blanket markup approach. Today our furniture margins and our electronics margins are nearly equal. And that is simply not the retail world we live in. We can drive additional margin in some categories in order to pave the way for more competitive positioning in other categories.

The same is true with our mix of product in the stores. While our better and best product strategy is fine, there are certain categories that require traffic drivers. And the margin investment required to carry these traffic driving products will be covered by increased pricing in more inelastic categories.

More product-specific pricing will also allow us to reduce the amount of promotional free time compared to last year. As I mentioned earlier, in the fourth quarter, we excessively used free time offers to drive traffic. While these promotions were largely successful in growing the portfolio, the delayed payments negatively impacted revenue and profit in the quarter. Now the good news is these promotions proved the customer still believes our value proposition is relevant. And my belief is we can drive customer growth without nearly as much free time by tweaking our pricing strategy and ensuring we have a compelling everyday offer for our customers, which will drive a more even pattern of demand. This means, as I mentioned, certain product categories that are more price-elastic, things like TVs need to be priced more competitively while in other product categories things like furniture, there are opportunities to increase prices or be less promotional. We need to strike a better balance between our pricing and promotions and our ability to drive traffic without giving too much away.

I did this for many years as the COO of the company and I will do it again. In addition, I've also asked Ann Davids, who led our marketing function at Rent-A-Center for over 15 years but left in 2012 -- I've asked her to come back. I'm excited to have her back to help drive more traffic and an increased customer focus throughout the company. And her first day back is actually today.

Another big opportunity for the company I plan to pursue is refranchising. Being a relationship business and with the success of the owner/operator model within rent to own, we have the opportunity to franchise certain markets, grow the brand in a less competitive -- I'm sorry, in a less capital intensive way and use proceeds to deleverage our balance sheet. The company has started preparing for the expansion of the franchise business and will be upgrading certain systems in 2018 to better support our franchisees. At our franchise convention held last month, we had record attendance and believe demand will be strong once we start heavily marketing our brand of potential franchisees. Now just to be clear, expanding our franchising footprint is not built into our 2018 plan. Our cost savings are not related to franchising. In fact, there is a small investment being made this year to prepare to expand our franchising footprint.

In addition, our store optimization evaluation is also taking place to determine if any and which stores to close or merge with other stores in 2018, which typically results in better profitability within those markets. And of course, which markets to franchise.

Turning to Acceptance Now, a new value proposition was rolled out in January with lower terms, improving the path to ownership for our customers and providing a quicker cash payback to the company on our product investment. We believe it will drive more ownership for our customers, better cash flow for the company and less returns to be handled by our Core business. The model consists of a lower number of months to get to ownership as well as a lower overall cost for the customer, with a monthly rate more in line with the market. It's still early for us to assess results of this change but we believe it will benefit our customers, our partners and the company. The customer approval decision engine continues to be enhanced and is showing signs of driving a higher quality portfolio based on recent transaction activity.

However, there's more to do to improve the profitability of the Acceptance Now business. We need a better unmanned solution to be able to profitably run lower volume locations and to scale large national accounts by reducing expenses in our existing manned locations. More to come on this as I continue to evaluate the best path forward on building that unmanned capability and improving profitably and cash flow of the Acceptance Now segment.

As I said earlier, my plan is driven by conservative expectations on top line performance, improving our competitive position with a more targeted approach to pricing and reducing risk by lowering costs and expanding our franchise store footprint.

As I mentioned earlier, the company is currently going through a strategic and financial alternatives review process and that -- as I said, this process remains ongoing and we appreciate your patience as our board continues their work. Now the job for me and my team is to execute a successful turnaround of the business in parallel to the board's process. That's exactly what we intend to do. So lastly, I'd like to thank all of our coworkers and our franchisees for the warm welcome back to the company, and for all they do to serve our great customers.

And with that, I'd now like to turn the call over to Joel Mussat.

Joel M. Mussat - *Rent-A-Center, Inc. - COO & Executive VP*

Thanks, Mitch. I'll first start with the Core business. In the fourth quarter, we were able to grow the overall portfolio as we continue to trend 5 consecutive months of portfolio growth. This was mainly due to tickets in the third quarter, while in the fourth quarter we were able to drive customer growth as well. This enabled our portfolio size to be essentially flat year-over-year on a per-store basis compared to where we began in 2017, and retention trends are positive with these agreements. Our quarterly comps improved sequentially throughout 2017 and we saw a 150 basis point improvement in the fourth quarter. However, our goal of positive same-store sales in the fourth quarter was not met and came in at negative 3.6%. As Mitch mentioned, we were promotional in the fourth quarter, with low initial payment offers to drive customer growth. However, we did not collect sufficient revenue on these new agreements to hit our goal.

We have adjusted our promotions accordingly, and so far in 2018, we see the business back in the right trajectory and we're seeing sequential revenue improvements as we would expect. For example, January same-store sales were approximately flat in the Core. Our ownership rates improved year-over-year by about 18%, our delinquency rates in the quarter were in line with our estimates and 160 basis points better than fourth quarter of 2016, with a similar improvement in our loss rate.

Going forward in the Core, we'll be focusing on a balanced approach to both customer and ticket growth. Mitch touched on our plans around pricing, and we'll get much more surgical when it comes to how we price by category and different pricing levels within each category. We believe there are specific categories we can expand margin within and some where we need to be more price competitive to drive volume.

In the first quarter, we are focused on capitalizing on the upcoming tax season to drive customer conversions, as we historically see heightened payouts from our current customers in the back half of the first quarter. We'll also leverage our heightened web traffic by driving our conversion rates higher for our web leads as we saw significant growth in web activity in 2017 as a lead generation channel.

Additionally, our new mystery shop initiative, which outlined in our last call, is a solid training tool for our store teams to use to improve their point-of-purchase success and in-store close rates to deliver a great customer experience. As you can see, we believe we can capture a larger amount of the sales opportunities that come to us via multiple channels to help us grow our customer base in the Core.

Regarding the hurricane impact, we made tremendous efforts to get the Core operations back up and running as quickly as possible after the series of hurricanes in the third quarter. Overall, in the quarter, we saw a revenue impact of about $8 million in the Core due to the hurricane, including the impacts in South Texas, Florida and Puerto Rico. For our Acceptance Now brand, we saw positive same-store sales of 6.7% in the fourth quarter. This number is a 500 basis point improvement versus 2016. As a reminder, our comp store count has dropped to about 400 stores, since the exit of the Conn's and HHGregg brands in the spring of 2017. We added 26 stores in the quarter, which gets us to a total of about 220 new stores added last year. Revenue, gross profit and store income were each down in the quarter as expected due to the Conn's and HHGregg closures and the reduction to revenue as these agreements began to leave the system. Overall, losses increased by 520 basis points year-over-year. And the losses peaked in October, in both dollars and as a percent of revenue and then declined in both November and December.

We did see in the fourth quarter, an improvement in our forward-looking collection metrics for Acceptance Now, as we continue to move toward a higher quality portfolio in this business. We saw a 185 basis point improvement in our delinquency rate at the end of Q4 versus the end of Q3 and are seeing these improvements continue in 2018. Additionally, we have seen continued improvement in our first payment default rates since the back half of 2017.

As outlined in our third quarter call, we made a number of operational improvements to bring our delinquency numbers back down to historical levels. Enhancements to our decision engine, a much higher take rate on our AutoPay feature, enhancing verification for approvals, exiting partners who cater fundamentally to an RTO customer base and implementing a new collection routing software tool, are examples of tactics we are using to improve our collection results and return our operations to a balanced focus on both sales and collections.

With these improvements, we ended December with our best collection number since the summer, and our forward-looking loss numbers are trending more in line with our historical averages for this business.

Regarding the hurricanes in the fourth quarter, our revenue was impacted by about $2 million across all of the affected Acceptance Now allocations. And from a consolidated view, the company estimates lost revenues from hurricanes at about $10 million and a non-GAAP EPS loss of $0.08 in the quarter, with approximately 80% coming from the Core business and 20% coming from Acceptance Now.

In Mexico, we have been refocusing our efforts on building a quality portfolio. We had a year-over-year comp decline of about 90 basis points, with a sequential improvement of 390 basis points in the fourth quarter. We saw a nice gain in the overall agreement levels in the fourth quarter, against both last year and last quarter, and our delivery ticket was up 7% year-over-year. Delinquencies improved by 110 basis points versus 2016 and operating profit improved both year-over-year and for the entirety of 2017.

Overall, debt levels improved by 15% year-over-year as we continued our focus on cash flow management.

With that, I'd like to thank our 18,000 coworkers for their dedication and efforts during the fourth quarter, with a special thanks to those affected by the hurricanes.

Now I will turn it over to Maureen to discuss the financial performance of the company. Maureen?

Maureen B. Short - *Rent-A-Center, Inc. - Interim CFO*

Thanks, Joel. Good morning, everyone. I'll cover our fourth quarter financial results in more detail, provide an overview of our balance sheet and walk through the company benefits from tax reform. I will then close with our financial target for 2018, before turning it back to Mitch.

During the fourth quarter of 2017, consolidated total revenues were $639 million, down 6.6% versus prior year, primarily due to store closures and same-store sales decline of 2% and the impact of the 2017 hurricanes.

Adjusted EBITDA was negative $8.5 million and EBITDA margin was down 280 basis points versus prior year. Net diluted earnings per share on a GAAP basis were $0.65 and net diluted loss per share, excluding special items, was $0.41. GAAP earnings were positively impacted by $1.45 per share related to the Tax Cuts and Jobs Act passed in December of 2017.

In our Core U.S. segment, total revenues in the fourth quarter were down 6% driven by same-store sales decline of 3.6%, the impacts from the hurricanes and store closures. Same-store sales improved sequentially by 150 basis points driven by higher growth in customers and agreements and the higher average ticket, partially offset by higher promotional free time. Rental merchandise on rent increased $44 million from Q3 to Q4 compared to an increase of $13 million in the same period of the prior year, highlighting the portfolio growth in the fourth quarter. Store labor expense was down $4.2 million driven by lower store count and other store expenses were down $2.7 million driven by lower losses and lower store count. Skip/stolen losses in the Core were 2.7% in the quarter compared to 3.7% in the prior year due to lower delinquencies and a higher quality portfolio. Core U.S. EBITDA was $18.9 million in the fourth quarter and EBITDA margin was down 210 basis points from the prior year driven primarily by top line deleverage.

Now turning to the Acceptance Now business. Total revenues decreased by 9.1% primarily due to store closures and the impacts from the hurricane, offset by higher same-store sales of 6.7%. Gross margin in Acceptance Now was 50.9%, down 220 basis points from the prior year, driven by lower gross profit on merchandise sales from discounting the buyout amount to encourage customer ownership and reduce returned products. Other store expenses were up $9.3 million, and included an $8.4 million onetime noncash charge to write off unreconciled invoices in the Acceptance Now segment, which is nonrecurring. Skip/stolen losses were 13.7% of revenue. And Acceptance Now adjusted EBITDA was $5.1 million in the fourth quarter.

Beginning in 2018, the company will start adjusting down the book value of returned Acceptance Now products, so that Core business is not burdened with the excess cost of inventory purchased at retail instead of wholesale rates. This is expected to result in a 100 basis point improvement in Core gross profit margin, a 200 basis point decline in Acceptance Now gross profit margin and no impact to the consolidated financials.

Corporate operating expenses decreased $6.6 million compared to prior year primarily driven by lower executive and incentive compensation expense. As Mitch mentioned, the company will have significant benefits from the Tax Cuts and Jobs Act that was passed in December of 2017. Rent-A-Center will see a lower federal statutory tax rate of 21% beginning in Q1 of 2018, which will lower our 2018 estimated tax rate to between 22.5% and 23%.

Our deferred tax liability of $162 million was revalued in Q4 of 2017 to adjust for the new lower tax rate, which was a onetime benefit of $77.5 million to GAAP earnings. In additional to the lower federal tax rate, the company will also benefit from lower cash taxes due to the 100% bonus depreciation rule, which allows us to immediately expense merchandise that we lease to our customers. The company expects to receive a tax refund of between $30 million and $40 million in 2018 primarily due to the temporary timing differences of accelerated depreciation on merchandise purchases.

The estimated cash tax benefit of the new tax reform is approximately $200 million over the next 3 years, which will help improve the company's capital position by deleveraging our balance sheet. At the end of the fourth quarter, cash and cash equivalents were $73 million. We drew $30 million against our revolver during the quarter and ended the quarter with $672.9 million in total outstanding debt, including a total of $85 million drawn on the revolver. Total available capacity on our $350 million revolver was approximately $110 million, taking into account the $50 million reserve necessary given the fixed charge coverage ratio and approximately $100 million in letters of credit.

Total liquidity, including the $73 million of cash on hand, was $183 million at the end of the quarter. Through the end of 2017, the company generated $110.5 million of cash from operations and reduced its outstanding debt balance by $52.5 million. Since the end of the fourth quarter, we have paid down the revolver by $10 million. The company plans to strengthen the balance sheet by using excess cash flow to pay down debt, reducing our leverage.

Now turning to 2018 targets. As Mitch mentioned earlier, the company has identified annualized cost savings opportunities of $65 million to $85 million and we expect about 2/3 to be realized in 2018. This includes $30 million to $40 million in overhead, $25 million to $30 million in supply chain savings and $10 million to $15 million in other store expense savings.

Working capital benefits are expected to be $20 million to $25 million in 2018. Capital expenditures for 2018 are expected to be between $40 million and $50 million, lower than recent years and free cash flows for 2018 is estimated to be at least $130 million.

With that, let me turn the call back over to Mitch for some closing comments before we open the lines for your questions. Mitch?

Mitchell E. Fadel - *Rent-A-Center, Inc. - CEO & Director*

Thanks, Maureen. Thanks, Joel. We're going to open it up to questions now. As we mentioned in the strategic review process a couple of times and as we said it's ongoing, we'll have a complete update when it is concluded. But we don't have any other further updates. So I appreciate the questions being -- avoiding questions on that because we don't have anything more to say, other than it is ongoing. And we're running our turnaround plan in parallel with that, with the board working on the strategic review process.

So with that, let's open it up to questions and...

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Kyle Joseph of Jefferies.

Kyle M. Joseph - *Jefferies LLC, Research Division - Equity Analyst*

Maureen, just wanted to get into the onetime other store expense in Acceptance Now. I believe that was credit related. Is it fair to assume that, that was primarily Conn's and HHGregg related? And any more color you could give us there.

Maureen B. Short - *Rent-A-Center, Inc. - Interim CFO*

Sure. The onetime noncash charge was to write off unreconciled invoices. With certain of our Acceptance Now vendors, we will pay an invoice before the product is delivered. And then we had difficulty after the fact matching up the invoice to a rental agreement. And so the write-off was a result of a special reconciliation project over our inventory payables process for certain of our Acceptance Now partners. It's not credit related, Kyle. So it's basically a manual process to reconcile the items. We've been making a number of improvements and believe that we've resolved these issues with this write-off. There is no concern of a restatement of our financial statements, but the write-off is on invoices that occurred within 2015 and 2016. But it's not related to credit and it's a nonrecurring onetime item.

Kyle M. Joseph - *Jefferies LLC, Research Division - Equity Analyst*

Got it. Sorry, go ahead.

Mitchell E. Fadel - *Rent-A-Center, Inc. - CEO & Director*

Kyle, I was just going to add, an overall -- as Maureen said that was -- it's 2015 and 2016 invoices. It was less than 1% of all the invoicing that was done over those 2 years, well under 1%. So it's unfortunate we had to take that charge. But I think the key point is, it's not cash, it's nonrecurring. We believe the problem is fixed going forward. And just to give you the size of it, the practicality of it, it was under 1%. Still unfortunate, but like I said, the key points are it's not cash and nonrecurring.

Kyle M. Joseph - *Jefferies LLC, Research Division - Equity Analyst*

Got it. And just a little more color on Conn's and HHGregg, if you could give us any sense of the remaining size of that portfolio as a percentage of Acceptance Now and how much of that has wound down?

Joel M. Mussat - *Rent-A-Center, Inc. - COO & Executive VP*

Yes. I think, in general, it's become a much smaller portion of the portfolio as time has gone by. I think now we're somewhere south of 10%, overall, as a percent of the overall agreements for the -- for right now.

Kyle M. Joseph - *Jefferies LLC, Research Division - Equity Analyst*

Okay. And then just one last so I'll follow on there. In terms of the timing of the loss of Conn's and HHGregg, could you refresh us on that to give us a sense of when we should anticipate sort of lapping those difficult comps?

Joel M. Mussat - *Rent-A-Center, Inc. - COO & Executive VP*

Well we exited those brands in the spring of 2017. We probably wrote our last agreements in April. Yes.

Mitchell E. Fadel - *Rent-A-Center, Inc. - CEO & Director*

I think -- and the same-store sales in Acceptance Now, I'd say, it's going to put a stress on same-store sales in Acceptance Now for the majority of the year, probably at least till the fourth quarter because it will be comping over the revenue that's been diluted. Because as Joel said, we're down to under 10% of our agreements now so. Now the good news there, Kyle, is the agreements that are left aren't adversely affecting our past due numbers as was the case most of last year. So that part of the story is over, which is the good news on that.

Kyle M. Joseph - *Jefferies LLC, Research Division - Equity Analyst*

Yes. That make sense. And then Mitch, just sort of stepping back, wanted to get your view on the industry and sort of what's driving the headwinds at the Core? Is it more secular, cyclical, competitive pressures and just get your sort of thoughts on the industry?

Mitchell E. Fadel - *Rent-A-Center, Inc. - CEO & Director*

Sure, Kyle. I think it's a combination of things. I think there is -- the customer does have more options that I think, we can't kid ourselves from that standpoint. They do have more options. And I think when you combine that with the self-inflicted wounds that the company has been talking about for the -- for over a year now, it's a bad combination. So there's a little less traffic because they have more options. And then we've got a lot of things to fix in our organization. Not only on the cost side, as I talked about, to put the -- our overhead in line with the company that exists today from a revenue standpoint, but also to drive traffic. I mentioned bringing back our Chief Marketing Officer that was -- that left almost 6 years ago, to help us as well as the pricing enhancements. The pricing that was done last year was -- is on the right track, but I think it just needs to be tweaked by product category, a little more to give some incentives. When -- even though the promotional free time offers in the fourth quarter hurt the revenue, as Joel mentioned, it built the portfolio, I mean, the customer was there in the fourth quarter. It built the portfolio. Joel mentioned the January, now that the portfolio ended the year strong, that January was flat year-over-year, essentially flat in the Core business. So I think, sure, the customer has a few more options out there when it comes to the traffic in the brick-and-mortar stores. But with some enhancements that we're doing, correcting some of these self-inflicted wounds and some of the enhancements I'm mentioning, we can get that back in a positive direction. And as I said, January is probably the best indicator of that so far.

Kyle M. Joseph - *Jefferies LLC, Research Division - Equity Analyst*

Got it. And then one last one from me. On tax refunds, can you give us any sense you have for the timing and the magnitude of those this year versus last?

Maureen B. Short - *Rent-A-Center, Inc. - Interim CFO*

Yes. I think we expect tax refunds to be similar to last year, to come in starting late this week. And to be similar to last year.

Operator

Our next question comes from the line of John Rowan of Janney.

John J. Rowan - *Janney Montgomery Scott LLC, Research Division - Director of Specialty Finance*

Cash flow guidance for 2018, does that include the refund and possibly -- the possibility of no cash taxes being paid because of the bonus depreciation? Just give me an idea of what that $130 million consists of?

Maureen B. Short - *Rent-A-Center, Inc. - Interim CFO*

Sure, yes, John. The $130 million in free cash flow does include a tax refund of $30 million to $40 million. It includes the cost savings benefits that we expect to achieve in 2018, which is about 2/3 of the $65 million to $85 million improving EBITDA from the cost savings side. It also includes the $20 million to $25 million in working capital benefit that will be achieved in 2018. It includes the CapEx guidance that I gave of $40 million to $50 million. And then it also includes additional working capital benefits on top of the $20 million to $25 million from the cost savings initiatives due to store closures and the value proposition changes, where we're getting our cash back faster from our customers. And then an assumption around the base business.

John J. Rowan - *Janney Montgomery Scott LLC, Research Division - Director of Specialty Finance*

And then -- but, okay, so $130 million includes $30 million to $40 million of tax refunds. How much does that include increases in the DTL, which I assume is from the bonus depreciation? How much of that number is the lack of cash taxes being paid in 2018?

Maureen B. Short - *Rent-A-Center, Inc. - Interim CFO*

The majority of the tax refund is due to the adjustment of our deferred tax liability. And then also just based on our expected pretax earnings.

John J. Rowan - *Janney Montgomery Scott LLC, Research Division - Director of Specialty Finance*

Okay, that's what I was getting too. So you have $200 million over the next couple of years. I assume over the next 3 years of benefit from lower -- or from bonus depreciation, is the $30 million to $40 million refund included in that $200 million? Or is that -- or is the $200 million in addition to the $30 million to $40 million of tax refund?

Maureen B. Short - *Rent-A-Center, Inc. - Interim CFO*

It is included in the $200 million. The refund is included.

John J. Rowan - *Janney Montgomery Scott LLC, Research Division - Director of Specialty Finance*

So if we were to take out the $30 million to $40 million and gross up that expected tax savings, I mean, is that basically what your projections are for pretax income over the next 3 years?

Maureen B. Short - *Rent-A-Center, Inc. - Interim CFO*

Yes. That would be the majority of the tax -- cash taxes that we expect to pay is based on the pretax earning estimates in our forecast as well as the benefits from the bonus depreciation.

John J. Rowan - *Janney Montgomery Scott LLC, Research Division - Director of Specialty Finance*

Okay. What's the -- additional one open board seat, correct?

Mitchell E. Fadel - *Rent-A-Center, Inc. - CEO & Director*

Correct.

John J. Rowan - *Janney Montgomery Scott LLC, Research Division - Director of Specialty Finance*

What's the plan for that board seat? And is there -- were the other kind of the non-Engaged board members up for election? And any color around what's going to happen with the composition of the board this year.

Mitchell E. Fadel - *Rent-A-Center, Inc. - CEO & Director*

Well I think as we announced in that cooperation agreement with Engaged Capital, we're going to add a seat. The board is very well unified at this point. I can speak to as a board member and we're going to add one more seat. And I think we're -- the board is working hard on the strategic review and financial alternatives process and working together on it. So I think we'll add another important board member and move forward in unison.

John J. Rowan - *Janney Montgomery Scott LLC, Research Division - Director of Specialty Finance*

Okay. And then just lastly, can you just explain to me what refranchising looks like? Is that selling stores to franchisees or selling markets? Just help me frame out what exactly refranchising strategy looks like?

Mitchell E. Fadel - *Rent-A-Center, Inc. - CEO & Director*

It's a great question. We're still working on that and it's probably both of which you just mentioned, John. Some of it's selling certain stores to franchisees, there may be markets that we sell. Now this is a multiyear plan. And as I mentioned in my prepared comments, 2018 is really preparing to do more franchising. And in fact, there's a little bit of cost associated with it this year and no benefit. We might, later in the year, be in a position to franchise some stores. But there's -- it's really a preparation year for that. So it's more -- it's small, but there's some cost in our -- in that cash flow guidance we gave you for this year. So as you think -- if you think the next 4 or 5 years out though, our plan is to sell some of our current stores. But I think it will also help us expand the footprint because as you sell markets, what we've seen so far when we sold a few then the franchisees we'll then fill in those markets, which we're not doing now on the company stores. So if we sell a particular market, the franchisees will -- like I said, what we've seen so far is we see fill in openings. But I think you can help put more Rent-A-Center flags out there as well. So I think it's a growth strategy as well as a refranchising strategy, for the reasons I just said. And I think it's a combination of those things, selling existing markets, selling some stores. But mostly, to have a robust franchising model you've got to sell full markets when you do it, versus a store here or a store there. So we're still working on which markets and the whole marketing plan around that. And really, it's something you hear more about as the year goes on. But it's something that's really we're working on this year as part of our strategy and really doesn't become robust till late in the year.

Operator

Our next question comes from the line of Brad Thomas of KeyBanc Capital Markets.

Bradley Bingham Thomas - *KeyBanc Capital Markets Inc., Research Division - Director and Equity Research Analyst*

Just wanted to follow up on the free cash flow guidance and Maureen, I think that was helpful walking through it with the last questions. But just to try to connect the dots with, I guess, EBITDA, could you give us a sense of what kind of EBITDA is assumed to get to the $130 million free cash flow number?

Maureen B. Short - *Rent-A-Center, Inc. - Interim CFO*

Brad, we're not providing guidance around EBITDA. I outlined most the guidance component that can get you pretty close to what our EBITDA projections would be. But we're not providing guidance on EBITDA.

Mitchell E. Fadel - *Rent-A-Center, Inc. - CEO & Director*

Yes, Brad, with the strategic review process going on, we just decided that we'd hold to the savings that we've identified, the EBITDA savings and how much we can realize this year versus annualized. And then of course, the cash flow number. Again, because of the strategic review process, we've decided not to put out EBITDA guidance.

Bradley Bingham Thomas - *KeyBanc Capital Markets Inc., Research Division - Director and Equity Research Analyst*

Got you. So should we think of it as, you're building a little more off of what you've done here in '17 in layering on these initiatives, and that's kind of how you get to the $130 million?

Mitchell E. Fadel - *Rent-A-Center, Inc. - CEO & Director*

Yes. I would say, as long as you use the whole year of '17, I would agree with the way you just said it. I wouldn't -- obviously, I wouldn't use the fourth quarter based on what happened with free time, some hurricane impact and some of the expense issues that happened in the fourth quarter. So I wouldn't build off the fourth quarter, but I would build off 2017.

Bradley Bingham Thomas - *KeyBanc Capital Markets Inc., Research Division - Director and Equity Research Analyst*

Got you. Okay. And then Mitch, just on some of the changes in the business model, I guess, maybe starting with Acceptance Now. It sounds like you're trying to shorten term. Am I hearing this correctly, that you may be raising prices and shortening term to try to increase the cash flow you get closer to the time that you initiate the agreements? Is that basically what's happening?

Mitchell E. Fadel - *Rent-A-Center, Inc. - CEO & Director*

That's correct. I think it's also to be more competitive in the marketplace from an overall turn standpoint. And I think you know from following it, when you shorten the terms and get more ownership, even if the projected turn that you started out with is lower than the previous model, the previous pricing model, the realized turn, ultimately, is higher when you get more ownership. So we lowered our overall turns by lowering the term of the agreement, raising the rates a little bit, still competitive and much more competitive on the overall price, not concerned with the margins because more ownership will help with the margins and the cash flow, as you mentioned. So it it's a more competitive model and a better model from a cash flow standpoint for us.

Bradley Bingham Thomas - *KeyBanc Capital Markets Inc., Research Division - Director and Equity Research Analyst*

Got you. And then with respect to the Core, I mean, I guess, taking on the whole, do you intend to be lowering pricing? Obviously, a number of references to needing to be more competitively priced. What do you think happens on the whole in the Core?

Mitchell E. Fadel - *Rent-A-Center, Inc. - CEO & Director*

It's pretty much margin-neutral, as we've looked at it. As we talked about, there's some things, some categories that need some traffic drivers, but other categories that can help make up for that. It's a -- so I think the pricing model that was put in last year was certainly much better than what was happening before that. We just think it needs to be little bit more targeted and there's some traffic drivers we can use on the electronic side and make up for it on the more inelastic categories like furniture and a little bit on appliances. But it's just a more targeted approach, but really, net neutral from a margin standpoint.

Bradley Bingham Thomas - *KeyBanc Capital Markets Inc., Research Division - Director and Equity Research Analyst*

Got you. And on the store base, Mitch, I know the company has been thoughtful about pruning overlapping stores in recent years. I mean, what do you think you need to do with the store base here over the next 12 or 18 months?

Mitchell E. Fadel - *Rent-A-Center, Inc. - CEO & Director*

Well we've identified -- as we're working on looking at nonproductive stores and combining it with looking at -- wanting to do more franchising as the year moves on and as the years move on, there's alternatives, rather than whether it's just to close and merge a store and possibly in some cases sell to franchisees. So we're going through that process now. I think it's fair to say there's somewhere in the range of 150 stores in that range that we're looking at to do one or the other with. So it's not huge but there's certainly something pretty significant there when you start to talk about 150 stores or so. So that's the extent of it. And I'm not sure we'll close them all. We may be able to sell some of them. And we're still -- we'll have that finished up here in the next couple of weeks, that whole analysis on the -- on potential store closures. But that's the range. It's in the 150 store range, whether we sell them or franchise them or close them.

Operator

Our next question comes from the line of Budd Bugatch of Raymond James.

Katherine West

This is Katherine on the line for Budd. In the release, you commented on the strategic initiative to improve Core traffic trends. Can you explain that initiative further and kind of what negatively impacted traffic trends. I know you commented on the competitive pressures but kind of what your thoughts are there?

Mitchell E. Fadel - *Rent-A-Center, Inc. - CEO & Director*

Well I think the -- with the pricing model we got put on last year by shortening terms in the Core business and raising pricing, certainly the expectation was there'll probably be a little less traffic. And as you saw the ticket performance was fantastic all year long, and really helped drive sequential improvement in the comps throughout most of the year, and we already talked about the fact that January was approximately flat. So I think there's a lot of good news in that. We want to drive a little more traffic, a little more -- be able to pull a little more of that traffic rather than accept less traffic or to make it a more sustainable growth model, now that we're -- you get back to flat, you still want to try to get better than that. So I think it's just a matter of being a little more targeted around the pricing. Again, a few categories with some traffic drivers and a few categories that can make up for that. I think beyond the pricing, there is -- as Joel mentioned, there's quite a few execution initiatives in place, whether it's the mystery shop program to help our execution, something I haven't talked about yet putting the full-time labor back in the stores is going to help our execution and we're almost done with that conversion back to that model. So I think execution is a big part of it beyond just the pricing. I mentioned the Chief Marketing Officer, Chief Customer Officer/Marketing Officer, Ann Davids coming back actually today to help us from an advertising standpoint and drive traffic and help with the overall customer experience. So there's -- those are the bigger things in there. We have moved beyond the IT system issues that came up in late 2016. Certainly, we continue to enhance that program but that's starting to not be an issue as far as being able to operate the stores. So there's a lot of good things going on to be able to take that hype, that nice performance on ticket and delinquency in the Core last year and get even better.

Katherine West

All right. And now turning kind of to Acceptance Now, you've seen higher delinquency rate there over the quarter. How are you managing the returned merchandise? Have you had any problems with that lately? Or do you think that's an issue that's been solved?

Mitchell E. Fadel - *Rent-A-Center, Inc. - CEO & Director*

Yes. I'll let Joel talk about the improvements we made on that credit. But just keep in mind, the losses were higher for the quarter, the delinquency wasn't. The delinquency is coming down but it takes a while before you see that in the losses. So the delinquent accounts, we've got some good trends going on. We like the direction where we're going on delinquency. Of course, the charge-offs are down after what, 4 or 5 months of delinquency. So they trail the improvements we're making. But we're seeing improvements in the first quarter. And Joel, you want to talk about a few of the things that you'd mentioned earlier about the enhancements as well as the returned product question?

Joel M. Mussat - *Rent-A-Center, Inc. - COO & Executive VP*

Yes. The enhancements we've done, a number of things putting up -- we have a lot of -- much higher percentage of our portfolio now on our AutoPay feature, which makes collections a much easier process for us. We put in place a new software tool that helps us route our activity when it comes to collections. And just overall, I think we've made some very good tweaks, improvements to our decision engine. So our first payment default rates have come down substantially in the back half of -- since the back half of 2017. So all those ingredients, if you will, have shown good results so far, last couple of months in bringing those overall loss rates down, which is good to see. As I mentioned in my prepared comments, we do see our loss is getting back more toward historical levels here in the first quarter.

Mitchell E. Fadel - *Rent-A-Center, Inc. - CEO & Director*

And even within the quarter, we saw October was...

Joel M. Mussat - *Rent-A-Center, Inc. - COO & Executive VP*

Yes. October was a peak and then came down in November and December after that. So it's good news. Those numbers are all going in the right direction, which is great to see for that business model. And so it's got to be a better balance for us when it comes to sales and collections than it had been in the past. In terms of the returned product, our products -- as we do have a process in place where we either return item to the store -- to our core rent-to-own store for rerenting or in some cases, given the age or the duration of certain agreements been on rent, we will do some kind of a mitigation plan with our customer to try and keep that item in their home and work out some kind of payment strategy with them going forward. So there are really 2 outlets for returns for Acceptance Now and we've utilized more of the mitigation plan over the last couple of quarters to help keep items in customers' homes and out of the core rent-to-own stores.

Mitchell E. Fadel - *Rent-A-Center, Inc. - CEO & Director*

There's been lot -- there's a lot of good news in that. The fact that with the new pricing model with some of the pricing model enhancements from last year and some we've already made this year, as I mentioned, the returns are not the issue they used to be in this company. So that's really good news.

Operator

Our next question comes from the line of Carla Casella of JPMorgan.

Carla Marie Casella Hodulik - *JP Morgan Chase & Co, Research Division - MD and Senior Analyst*

You mentioned, on your capital structure side, you've only got $85 million left on the revolver, your focus is going to be paying down debt. Is there a point where you're using this excess cash flow, free cash flow for the year to take out some of your longer-dated bonds?

Maureen B. Short - *Rent-A-Center, Inc. - Interim CFO*

I'm sorry, Carla, can you say the last part again?

Carla Marie Casella Hodulik - *JP Morgan Chase & Co, Research Division - MD and Senior Analyst*

Would you use some of your cash flow to consider refinancing or taking out some of the longer-dated bonds?

Maureen B. Short - *Rent-A-Center, Inc. - Interim CFO*

Regarding our refinancing, the company is currently exploring refinancing options, which does not include any kind of refinancing assumptions in our projection. Our credit facility does expire in March of 2019. And once the outcome of the strategic alternatives review process is determined, we'll decide on the best path forward regarding our capital structure. And just to clarify an earlier point that I made, the tax refund season that we expect for our customers, occurs later this week and into next week. The cash refund that the company expects to receive will be about $10 million in the first quarter and the rest will come once we file our 2017 tax return. So that will be later in the year. Just wanted to clarify that point.

Carla Marie Casella Hodulik - *JP Morgan Chase & Co, Research Division - MD and Senior Analyst*

Okay, great. And then just as you look at the Core stores and the number you've been -- your goal has been to increase the number of customer agreements. Where would you say you stand on a per-store basis today versus either where it had been at peak and/or where you think you can get back to in today's environment?

Joel M. Mussat - *Rent-A-Center, Inc. - COO & Executive VP*

Well year-over-year, we're a little bit ahead on the per-store basis with the overall portfolio. When it comes to historical numbers, it's going to be down as our customer costs have gone down since the last 3, 4 years.

Mitchell E. Fadel - *Rent-A-Center, Inc. - CEO & Director*

I think it's down -- it is up year-on-year because of the closures from the last couple of years, so that's good news. It's down a little bit from historical highs, not all that dramatically. Honestly, Carla, as I've been talking about this morning, when you think about this business and EBITDA it used to make, a lot of it is -- the overhead has just continued to balloon, not just at the corporate overhead but even at field management, corporate overhead has ballooned faster. And the average store is down a little bit. So not dramatically though, it's not like our average revenue per store is down 20% or anything like that because we have reduced the footprint. So it's down a little bit. But I don't have the exact numbers in front of me, but it's not down all that dramatically and if we rightsize our overhead to the match where it is today, I think there's an awful lot of opportunity there.

Operator

Our next question comes from the line of Karru Martinson from Jefferies.

Karru Martinson - *Jefferies LLC, Research Division - Analyst*

My apologies if I missed it, the expense for the cost savings, is that -- what was the number? And does that flow into the $130 million free cash flow or is that separate from that?

Mitchell E. Fadel - *Rent-A-Center, Inc. - CEO & Director*

It -- part of -- it's $65 million to $85 million on an annualized basis, with about 2/3 -- we believe we can recognize about 2/3 of it this year. So 2/3 of $65 million to $85 million is flowing into the -- at least in the $130 million of free cash flow.

Karru Martinson - *Jefferies LLC, Research Division - Analyst*

Okay. But the costs to realize the $65 million to $85 million, are there expenses associated with that? Or it is $65 million to $85 million of costs associated with the savings?

Mitchell E. Fadel - *Rent-A-Center, Inc. - CEO & Director*

The $65 million to $85 million doesn't have the cost associated with achieving those savings within the $65 million to $85 million, it's not in that, but it is in the cash flow guidance, the costs of [savings].

Karru Martinson - *Jefferies LLC, Research Division - Analyst*

Okay. It is in the guidance. Okay. And in the past, you guys have talked about Mexico kind of coming to a breakeven point and evaluating what the next steps were there. How do you guys look at Mexico today, separate from the strategic review that you're doing?

Mitchell E. Fadel - *Rent-A-Center, Inc. - CEO & Director*

Well it's hard to look at separate from the strategic review because it's part of the strategic review. But the way we look at it is, it's breaking even. We, from a cash flow standpoint, haven't -- it's been positive cash flow for what, 2 years now, Maureen?

Joel M. Mussat - *Rent-A-Center, Inc. - COO & Executive VP*

Self-sustaining.

Mitchell E. Fadel - *Rent-A-Center, Inc. - CEO & Director*

Positive cash flow, self-sustaining. Obviously, we're not doing anything to grow that model. That's not part of our plan today. We obviously have bigger things to do. We're not going to go down there and invest in growing it. So that's what makes it part of the strategic review process. So that's the way we look at it as -- it's great news, it's self-sustaining. We've got a good group of folks down there, doing a nice job. And it's part of the strategic review process.

Karru Martinson - *Jefferies LLC, Research Division - Analyst*

Okay. And just -- in prior calls and under the prior management, there was a lot of talk about, we want to move our inventory away from those kind of opening price points, get more into that better and best kind of aspirational quality. I would say, where are we today? And is there still kind of that movement to move that inventory up the channel or up the value chain?

Mitchell E. Fadel - *Rent-A-Center, Inc. - CEO & Director*

Absolutely. As I said earlier, we're going to continue that strategy. We're going to mix in, occasionally, from a promotional standpoint, some traffic drivers that we feel we can make up for in some other areas in the more inelastic categories. But a few traffic drivers. It's really a matter of taking what is a good inventory mix today and just tweaking it a little bit with some traffic drivers now and then to help us drive more traffic. Certainly, those kind of things, the devil's always in the details. So you could -- when I say traffic drivers, it's how many do you buy per store. And make sure that it doesn't bring the ticket way down if the store gets a couple of pieces of inventory to drive traffic. So it's all about how you do it. But overall, certainly the strategy of the better and best products and growing that ticket into more aspirational items, that will continue.

Operator

And that was our final question. I would now like to turn the call back over to Mitch for any additional or closing remarks.

Mitchell E. Fadel - *Rent-A-Center, Inc. - CEO & Director*

Well, thank you, and thank you, everyone, for your time this morning and your support. We've covered a lot of ground today. I've been back now for a couple of months. I'm excited to be back. It's something I'm passionate about this business. I'm enjoying it. And as I said earlier, the job for me and my team is to execute on the successful turnaround of the business, in parallel with the board's process that we're going through. But we've got a turnaround plan that we need to do in parallel with that and that's exactly what we intend to do. So with that, I'll wish everybody a great day. Enjoy it. And we'll talk to you soon. Thank you.

Operator

Thank you, ladies and gentlemen. This does conclude today's conference call, you may now disconnect. And have a wonderful day.
