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RCII - Q3 2012 Rent-A-Center Earnings Conference Call

EVENT DATE/TIME: OCTOBER 23, 2012 / 2:45PM GMT

OVERVIEW:

RCII reported 3Q12 revenues of $739.3m, net earnings of $39.9m and diluted EPS of $0.67. Expects 2012 revenue to exceed $3b and diluted EPS of $3.05-3.15.

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CORPORATE PARTICIPANTS

David Carpenter *Rent-A-Center - VP IR*

Mark Speese *Rent-A-Center - CEO, Chairman*

Mitchell Fadel *Rent-A-Center - President, COO*

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CONFERENCE CALL PARTICIPANTS

Laura Champine *Canaccord Genuity - Analyst*

John Rowan *Sidoti & Company - Analyst*

John Baugh *Stifel Nicolaus - Analyst*

Budd Bugatch *Raymond James & Associates - Analyst*

Jon Braatz *Kansas City Capital Associates - Analyst*

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Chuck Ruff *Insight Investments - Analyst*

PRESENTATION

Operator

Good morning and thank you for holding. Welcome to Rent-A-Center's third-quarter 2012 earnings release conference call. (Operator Instructions). As a reminder, this conference is being recorded Tuesday, October 23, 2012.

Your speakers today are Mr. Mark Speese, Chairman and Chief Executive Officer of Rent-A-Center; Mr. Mitchell Fadel, President and Chief Operating Officer; Mr. Robert Davis, Chief Financial Officer; and Mr. David Carpenter, Vice President of Investor Relations.

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

David Carpenter - *Rent-A-Center - VP IR*

Thank you, Alicia. Good morning, everyone, and thank you for joining us.

You should have received a copy of the earnings release distributed after the market closed yesterday that outlines our operational and financial results that were made in the third quarter. If for some reason you did not receive a copy of the release, you can download it from our website at investor. RentACenter.com.

In addition, certain financial and statistical information that will be discussed during the conference call will also be provided on the same website.

Also, in accordance with SEC rules regarding non-GAAP financial measures, a reconciliation of EBITDA is provided in our earnings press release under the statement of earnings highlights.

Finally, I must remind you that some of the statements made in this call, such as forecast growth in revenues, earnings, operating margins, cash flow, and profitability, and other business or trend information, are forward-looking statements. These matters are, of course, subject to many factors that could cause actual results to differ materially from our expectations reflected in the forward-looking statements. These factors are described in the earnings release issued yesterday, as well as our annual report on Form 10-K for the year ended December 31, 2011, and our quarterly reports on Form 10-Q for the quarters ended March 31, 2012, and June 30, 2012. Rent-A-Center undertakes no obligation to publicly update or revise any forward-looking statements.

Now I'd like to turn the conference call over to Mark. Mark?

Mark Speese - *Rent-A-Center - CEO, Chairman*

Thank you, David. Good morning, everyone, and thank you for joining us for a review of our third-quarter 2012 results.

Overall, I am pleased with the results that we delivered in the third quarter as total revenues increased 5% and earnings per share increased approximately 12%. And for the first nine months of the year, total revenues have grown 8.4% and our earnings per share, over 10%, both within our stated long-term ranges.

I'm very pleased with the continuing execution and excellent result from our RAC Acceptance business. Revenues there grew to $84 million for the quarter, an over 60% increase from the same quarter a year ago, and at the same time generated operating profits of $7.4 million. It is also worth noting that the gross profit margin was 59.3%, within our expectations and above the new store economic model. Overall, a strong performance with still plenty of opportunity for expansion in the future.

As for the core business, our revenue was soft in the quarter. We continue to face the headwind caused by early purchase options, both those that occurred in the first quarter, pulling revenue forward, as well as those simply caused due to product inflation, leading to shorter lives.

Nonetheless, the year-to-date revenue in the core business has grown over 2% and same-store sales will be positive for the year. Now Mitch will provide some additional color on the core business in a moment, but suffice it to say that the core continues to generate strong recurring revenue, profits, and cash flow

Regarding our updated guidance, given now three quarters of the way through the year, we have narrowed the ranges. Both revenues and earnings per share remain within the original ranges, while same-store sales have been updated to approximately 2% for the year. We do expect an approximate plus 2% comp in the fourth quarter as well.

I'll remind you that if you were to average that with the first three quarters, positive 7.1%, plus 2.8%, and plus 1.2%, you would get an average comp for the year of approximately 3.3%. However, again as a reminder, we do not count stores in the annual comp unless they have been there for the entire year. For that reason, the annual reported comp is expected to be approximately 2%.

All in all, I remain confident about our ability to hit these numbers and I remain excited about the future.

I do want to thank all of our coworkers for their continued efforts, and as always, we appreciate your support. With that, I would like to ask Mitch to provide you some additional color on the core businesses -- or the various businesses.

Mitchell Fadel - *Rent-A-Center - President, COO*

Thanks, Mark, and good morning, everyone.

As you heard Mark mention, overall we are generally pleased with both our top and bottom line results in the third quarter. Our same-store sales of plus 1.2% was driven by RAC Acceptance segment that had an impact of about 2.5% with only about 450 of the kiosks in the quarterly calculation. So a 2.5% impact on the same-store sales, out of only about half of the RAC Acceptance kiosks being in the calculations at this time, is sure an impressive number.

We are very pleased with the RAC Acceptance operating profit of $7.4 million, a 7% increase over the prior quarter, and even more impressive when you consider we opened approximately 180 of them in the last six months. This continues to be a very fast-moving and very effective growth strategy for our Company.

Our core business same-store sales were down 1.3% for the quarter, but remain at positive 1.2% year to date.

As you'll recall and Mark just reiterated, we've experienced a significant increase in early purchase options this year, especially back in the first quarter, which pulls the revenue forward. So although negative for the quarter, the core same-store sales are positive year to date and we continue to expect a positive number at year-end.

Equally important is we expect our gross profit margins in our core business to be flat year over year in the fourth quarter as we anniversary our promotional strategy that was implemented last year. So we expect the previous gross profit margin deterioration in the quarter to flatten out in the coming quarter and start to improve as we move forward into 2013.

Our weekly collections metrics remain in line, and our customer losses of 2.6% in the core rental stores for the quarter continue to run better than last year.

Our inventory remains in good shape. You may have noticed the inventory held for rent in the core segment up over where it was last year at the end of the third quarter. This is a result of certain fourth-quarter promotional product and the timing of that product coming in. Overall, not a concern to us due to it being a result of a timing issue.

On the international front, most of you know our primary focus is on Mexico. We opened 15 stores there in the quarter and we ended the quarter at 81.

Due to the timing of getting leases executed and stores opened, we will now add about 40 for the year, rather than the 60 we previously thought we could get open. These are strictly timing issues, and we continue to believe Mexico represents an excellent growth initiative for us and we remain enthused about this thousand-store opportunity.

Overall, a very good quarter for us. I would like to thank our 20,000 co-workers for their tremendous efforts and accomplishments in improving the quality of life for our customers. Robert?

Robert Davis - *Rent-A-Center - EVP Finance, CFO*

Thank you, Mitch. I want to spend just a few moments updating everyone on the financial results during the quarter and review our 2012 annual guidance. After that time, we'll open the call for questions.

And as a reminder, much of the information that I do provide, whether it's historical results or forecasted results, will be presented on a recurring and comparable basis, and therefore excluding any nonrecurring charges. None this year, but there were some last year, so we'll be talking about pro forma results.

As outlined in the press release, our total revenues were $739.3 million during the third quarter, an increase of $35 million, or 5%, as compared to the third quarter of last year. Now this increase was primarily due to an increase in revenues within the RAC Acceptance segment, leading to our positive 1.2% same-store sales comp.

Our net earnings in the quarter were $39.9 million, while diluted earnings per share equated to $0.67, an increase of 11.7%. These results include about a $0.10 drag on earnings in the third quarter, due primarily to the continued investment and ramp up of our international growth initiatives.

Now these investments had only a slight impact on operating margins in the quarter, which were down 10 basis points quarter over quarter and equated to 9.2%, while actual operating profit dollars increased 4.2%. Similarly, our third-quarter EBITDA increased over 7.5% to approximately

$90 million and the margin increased as well, 30 basis points, to 12%. We generated positive cash flow during the third quarter, and year to date we have now generated nearly $259 million in operating cash flow.

Now reflecting our continued confidence in our strong cash flows by returning cash to stockholders, we did disburse over $23 million in cash between share repurchases and dividend payment during the third quarter. And that, along with our 10th consecutive quarterly cash dividend payment tomorrow, will for the year bring our total deployment of capital between dividends and share repurchases to $68 million. Furthermore, as outlined in the press release, our Board has further increased our authorized level for share repurchases by $200 million, bringing the total amount authorized by the Board since the inception of the plan to $1 billion.

We ended the quarter with approximately $82 million in cash on hand, and our leverage ratio continues to improve, and at the end of the quarter, leverage equated to 1.31 times. We continue to believe our balance sheet is in extraordinary shape, and as such, we do believe that we remain well positioned to execute on our growth initiatives and continue to provide long-term value to our shareholders.

Now in terms of guidance, based on how we have performed year to date both operationally and financially, and as you would expect with just one quarter remaining in the year, we are narrowing the ranges on the majority of our metrics in which we provide guidance. So we would continue to expect total revenues to exceed $3 billion by increasing between 7% and 8%. We expect same-store sales for 2012 to approximate 2%. Overall diluted earnings per share for 2012 are expected to be in the range of $3.05 and $3.15, which includes an approximate $0.30 drag on EPS, primarily relating to our international initiatives.

We expect both our consolidated operating and EBITDA margins to decline approximately 50 basis points during 2012, while we continue to invest for growth and for the long term. Yet, we are expecting the dollars will increase in both categories. And more specifically in terms of EBITDA and free cash flow, the Company continues to believe EBITDA will range between $400 million and $420 million, with free cash flow expected to be in the range between $80 million and $100 million.

Now this guidance does not include the potential impact of any repurchases of common stock the Company may make, changes to future dividends, material changes to outstanding indebtedness, or the potential impact of acquisitions, dispositions, or store closures that may be completed after the date of this release.

We will be providing our annual 2013 guidance in January after the completion of this fourth quarter.

And finally, as a reminder, you can find on our investor relations website the unit-level economics for our growth initiatives. These will be updated only on an annual basis as our segments continue to grow and mature.

Alicia, with those prepared comments we'd now like to open the call to questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Laura Champine, Canaccord.

Laura Champine - *Canaccord Genuity - Analyst*

I just have a question about the core business where the comp is softening. Would you attribute that mostly to higher gas prices and continued struggles with unemployment staying high, or is there something else going on in the core that is hurting that business?

Robert Davis - *Rent-A-Center - EVP Finance, CFO*

Good morning, Laura. You know, certainly those don't help us, the two things you mentioned.

But as we talked about and have talked about all year, the additional early purchase options are our biggest headwind, the fact that people are exercising the early purchase options sooner and we're getting more of those, which cuts off the recurring revenue and pulls a lot of revenue forward, as we've talked about. That's why we -- for the year, we're still at 1.2% in the core and that will be a positive number at the end of the year, from all indications.

So, you know, it really is more timing than anything else. Although as you point out, certainly the fuel prices and the unemployment rates aren't helping.

Laura Champine - *Canaccord Genuity - Analyst*

And then, lastly, the Rent-A-Center -- the kiosk growth numbers are higher than what we had expected. You've raised that to 300 new kiosks for this year. Are those additions ahead of previous expectations coming from your existing retail hosts or are you signing on new retailers?

Robert Davis - *Rent-A-Center - EVP Finance, CFO*

Well, we're always signing on new retailers. It's a fast-growing business.

You know, we lost a few kiosks earlier in the year, as we've talked about, with a bankruptcy in one of the furniture chains, and of course, Best Buy, we came out of the few of those stores and so forth. So the net add still appears to be around the 200 range that we started out the year, but we're opening more to make up for the fact that we've lost some in some furniture stores closing, as well as the Best Buy deal.

Laura Champine - *Canaccord Genuity - Analyst*

Got it. Thank you.

Robert Davis - *Rent-A-Center - EVP Finance, CFO*

Thanks, Laura.

Operator

John Rowan, Sidoti & Company.

John Rowan - *Sidoti & Company - Analyst*

Good morning, guys. Did you mention why the tax rate was lower for the quarter?

Robert Davis - *Rent-A-Center - EVP Finance, CFO*

We did not. And as you recognize in our annual guidance, we no longer provide guidance on the tax rate, just given the complexity around that calculation.

There was a rate that was booked less than the prior two quarters; however, if you look back at previous years, there's generally a true-up to a new rate in the third quarter as we file our prior year's tax return. So what you're seeing is a true-up of some of those calculations as we had more information throughout the year.

John Rowan - *Sidoti & Company - Analyst*

Okay. And then, as far as RAC Acceptance goes, has there been any noticeable shift in the rate of returns that you're getting?

Mitchell Fadel - *Rent-A-Center - President, COO*

No, there hasn't, John. We're still seeing that 75% to 80% keep range.

John Rowan - *Sidoti & Company - Analyst*

Okay. Thank you.

Operator

John Baugh, Stifel Nicolaus.

John Baugh - *Stifel Nicolaus - Analyst*

Good morning. I'll jump right into a couple of things here. There was an international intangible charge of about $1 million. Could you discuss that?

Robert Davis - *Rent-A-Center - EVP Finance, CFO*

Yes, John, as you recognized with the goodwill changes in regards to no longer amortizing goodwill, the Company is supposed to be doing or required to do annual impairment evaluations, which we do every year.

However, at the same time, we continue to evaluate store performance, and that charge is related to, in our view, some underperformance from stores in Canada that had been falling behind our expectation for quite some time. And so, as it relates to a few of the stores in Canada, that goodwill is impaired, in our view, and therefore that's what that charge was related to.

John Baugh - *Stifel Nicolaus - Analyst*

So it's Canada and not Mexico?

Robert Davis - *Rent-A-Center - EVP Finance, CFO*

That's correct. In fact, there's no -- currently no goodwill in Mexico, given the fact that we have not acquired any businesses in that country. So goodwill is segmented; however, given the Mexico business is all de novo, there is no goodwill attributable to that country at this point in time.

John Baugh - *Stifel Nicolaus - Analyst*

Okay, thank you. And then, staying on Mexico, it looks like your guidance is to open four locations in the fourth quarter, at least internationally. That's not many, and I'm just curious. Is that all timing and leases, or is there some slowdown of expansion plan that I know you probably won't discuss 2013, but I'm just curious why it's such a low number.

Mitchell Fadel - *Rent-A-Center - President, COO*

I think it's more than four, John. I think we're at 29 year to date in Mexico and we're guiding to approximately 40, so I think it's -- Robert is looking at the number right now, but I think it's 29 year to date and we're guiding to 40, so (multiple speakers)

John Baugh - *Stifel Nicolaus - Analyst*

Okay, maybe I was looking at the wrong number.

Mitchell Fadel - *Rent-A-Center - President, COO*

Yes, 30 (multiple speakers) it's more than four. You might be adding the 29 with the six we've opened in Canada to get that 35, but (multiple speakers)

John Baugh - *Stifel Nicolaus - Analyst*

Yes, that's what I did (multiple speakers). My apologies.

Mitchell Fadel - *Rent-A-Center - President, COO*

If you look at just Mexico, it will be in that 10, 11, 12 range for the quarter. Still less than -- you know, the 60 is less -- I'm sorry, the 40 for the year will be less than the 60 we anticipated, and that is all just timing of the leases and so forth.

And quite honestly, we could probably push a few and get them open right in the middle of December and we've decided not to because it's such a busy time of year. Sure, you want to open the stores for the busy time of year, but not when there's a week before Christmas and our operators are tied up doing that, rather than focusing on the 80 or 90 stores we'll have opened by then. So it truly is just a timing issue.

John Baugh - *Stifel Nicolaus - Analyst*

Okay, and then, staying on Mexico, your nine months' gross margin is only down 100 basis points, but it is down slightly, yet your EBIT loss is significantly higher, even as a percentage of revenue. And I'm just curious. Is this all infrastructure build going on? If you could kind of give us some sort of feel for maybe when you start filling out some of the existing markets and leveraging that expense, because it looks like the gross margin is not changing materially.

Mitchell Fadel - *Rent-A-Center - President, COO*

With new stores, of course, the gross margin would be there from day one, but not EBIT, right? EBIT will be dilutive for new stores.

So it is infrastructure, but it's also just the timing of the new stores. But even when a new store is only 1-month-old, it's still pretty darn dilutive from an EBIT standpoint. The gross profit percent is there from the very first contract we put out. So it's a combination of new store timing and building the infrastructure, John.

John Baugh - *Stifel Nicolaus - Analyst*

Okay, and then, if we could jump over to -- could you discuss computers as a percentage of your business? Has that changed at all year to date or in the latest quarter? And then, what are you doing with tablets and how do you see that impacting the computer segment? Thank you.

Mitchell Fadel - *Rent-A-Center - President, COO*

The computer segment has grown for us, and we -- I guess it's been about a year now. Last summer, we put tablets in, so we've done well with tablets and it's helped the overall category grow.

John Baugh - *Stifel Nicolaus - Analyst*

So you don't see tablets cannibalizing right now your computer business's incremental?

Mitchell Fadel - *Rent-A-Center - President, COO*

Well, it's not all incremental. Certainly not every tablet rental is incremental. Some of it cannibalized the computer business, but overall it's helped us grow the category.

John Baugh - *Stifel Nicolaus - Analyst*

Great. Thank you.

Operator

Budd Bugatch, Raymond James.

Budd Bugatch - *Raymond James & Associates - Analyst*

I just want to follow up on something on the international. It looks like the guidance is for a lower loss in the fourth quarter, and just curious if you'll give us any comments to ramp up to breakeven. When do you expect to see that? Is it first quarter of next year, second quarter of next year?

Robert Davis - *Rent-A-Center - EVP Finance, CFO*

Budd, you're right. Based on the approximate $0.30 dilution and what's been recorded year to date, there is a narrowing of that expected dilution in the fourth quarter.

Part of that is due to some of the comments that Mitch just recently made in terms of stores that we could open in the fourth quarter that we're pushing into the first quarter of next year, not taking on that dilution given the timing relative to the busy season. So to not distract the other 80-plus stores that are operating today, and the management there, some of that dilution is going to be pushed out to next year when we open the stores in the first quarter.

Budd Bugatch - *Raymond James & Associates - Analyst*

So when do you see us coming to a breakeven in profitability? Is it --

Robert Davis - *Rent-A-Center - EVP Finance, CFO*

As we talked about last conference call, Budd, all that depends on timing and how many stores we choose to open. We haven't given guidance to next year yet. We'll be doing that in January.

What we did say directionally is that we do expect international to be, quote unquote, accretive relative to this year, i.e., the dilution will not be $0.30 again next year. It will be something less than that. But again, that will depend on timing and how many stores we expect to open in 2013.

Budd Bugatch - *Raymond James & Associates - Analyst*

Okay, thank you. And looking at the core expense control, if our numbers are right it looks like, given even with the revenue in the quarter, year-over-year expenses in the core, at least if -- and again, we backed into it, were down about $17 million. Can you comment on kind of the core expense control and what may be causing that and what's its likely trajectory for the rest of the year?

Robert Davis - *Rent-A-Center - EVP Finance, CFO*

I think, you know, what we've talked about on prior calls and other conversations with the investors at conferences and so forth is the fact that we're very diligent about managing the P&L all up and down, and not just focused on growth only, but being diligent in how we manage the business.

There is no one thing that we can point to, Budd, and suggest to you that there was a large initiative to remove costs in one area of the Company. We've been focused across all line items in the P&L, and so when you think about labor or, in some cases, delivery and telecommunications, every single line item has been in the crosshairs of management to ensure we're managing it diligently, and we've been successful in doing so.

Budd Bugatch - *Raymond James & Associates - Analyst*

And that should continue into the fourth quarter? How, I mean --

Robert Davis - *Rent-A-Center - EVP Finance, CFO*

We would expect that to continue, yes.

Budd Bugatch - *Raymond James & Associates - Analyst*

Okay. And I know you were asked this before. You're going to open up 300 RAC Acceptance kiosks in this year now. The guidance at the end of the second quarter, I think, was for 200. I think Laura asked are there any new notable retail hosts for that. I'm not sure you answered that.

And the 300 gross is going to net to 200 at the end of the year. Is that the way I understood your comment?

Robert Davis - *Rent-A-Center - EVP Finance, CFO*

Yes, the net add will be still around 200.

We are always adding hosts and we're always testing with different hosts. So we don't have any announcement there with anything significant, but we're always adding hosts and we've come out of a few posts, like I mentioned earlier as far as a bankruptcy that hit one of the furniture companies. We're continuing to add. The demand is very strong, and you know I don't know, we said initially if we could (multiple speakers)

Mark Speese - *Rent-A-Center - CEO, Chairman*

(Multiple speakers) names you may not recognize otherwise.

Mitchell Fadel - *Rent-A-Center - President, COO*

We said initially 1,000 of those, then we said 1,400, and it just keeps going and going as far as the demand. So, very positive about the demand in that business, Budd.

Budd Bugatch - *Raymond James & Associates - Analyst*

And the adds are furniture stores, or how does that play out, furniture versus electronics or --

Mitchell Fadel - *Rent-A-Center - President, COO*

Well, we're adding both at this point. We're adding both.

Budd Bugatch - *Raymond James & Associates - Analyst*

Okay. And lastly, I noticed that there are a few less domestic openings, not material, but just curious if there's anything going on there?

Mitchell Fadel - *Rent-A-Center - President, COO*

I'm sorry. I missed the first part of that.

Mark Speese - *Rent-A-Center - CEO, Chairman*

The domestic stores (multiple speakers)

Budd Bugatch - *Raymond James & Associates - Analyst*

You [never] open up 35 domestic rent-to-own or core rent-to-own locations, and I think the guidance was for 50.

Mark Speese - *Rent-A-Center - CEO, Chairman*

Nothing going on there other than (multiple speakers)

Budd Bugatch - *Raymond James & Associates - Analyst*

(Multiple speakers) so 15 fewer --

Mark Speese - *Rent-A-Center - CEO, Chairman*

(Multiple speakers) of getting leases, executing and getting the stores open. Just didn't get 50 of them executed this year, but (multiple speakers)

Budd Bugatch - *Raymond James & Associates - Analyst*

Timing, okay.

Mark Speese - *Rent-A-Center - CEO, Chairman*

Other than timing

Budd Bugatch - *Raymond James & Associates - Analyst*

Thank you. Have a good fourth quarter. Good luck on the quarter.

Operator

Jon Braatz, Kansas City Capital.

Jon Braatz - *Kansas City Capital Associates - Analyst*

Good morning, gentlemen. The core growth was a little bit soft in this quarter. When you look at a longer-term picture, what kind of growth do you need to begin to leverage expenses or when do you begin to see some deleveraging in expenses? Obviously, you did a good job in this quarter, but what do you need on sort of a consistent basis to leverage expenses?

Robert Davis - *Rent-A-Center - EVP Finance, CFO*

We forecast, you know, at least 1.5% -- 1% to 1.5% topline to leverage expenses. Having said that, that assumes an economy where managers are flat or sort of inflationary to some extent.

As we've talked about previously on this call, we have been managing the P&L up and down and finding opportunities throughout. At some point, that stabilizes, of course, and we expect to go forth through the remainder of this year. But in a steady-state environment, 1% to 1.5% would be a topline that we'd need to leverage and get leveraged through the core business.

Jon Braatz - *Kansas City Capital Associates - Analyst*

Okay. And I think Mark might have mentioned that there were some early purchase, early payment options in this quarter, too, to go along with what we saw in the first quarter. Did I understand that correctly?

Mark Speese - *Rent-A-Center - CEO, Chairman*

Yes, John, I did make the comment. It's not at the pace that we saw on the first quarter, but the fact is the purchase options have been a little higher every quarter or every month, and again, largely driven, product inflation bringing the cost down.

You've heard us say in the past that we usually manage that by adjusting the term and not the rate. So by lowering the term, obviously the products are leaving the system sooner than they would have otherwise. And that headwind, now I can -- I don't -- it's flattened, I'll tell you that. A quarter doesn't necessarily say we've turned the tide, but I'll tell you, the average life actually changed in the last quarter. So let me explain it because I think this is important.

A couple of years ago, you heard us say that the average product was in our system about 18 months from the time we bought it to the time we disposed of it, mostly through a rental transaction, being rented two or three times during that period, if you will. That has come down to as low as 16 months, which is where it's been for the last year or so, anyways. So from the day we buy it to the time it leaves our system, about 16 months, in average, and that again is a byproduct of the product inflation adjusting the terms.

The point, and again I'm not -- we're not inclined to stick -- it's one quarter. We think this is going to continue in the future, but I'm not -- the pendulum shifting. The third quarter actually went back up to 17 months that the average product was in our system. So we're anniversarying the deflation, which we know has slowed anyways. The promotional stuff that Mitch talked about a year ago we're anniversarying, and we're actually seeing the average life extend a little bit, one quarter. So a little cautious to say, but on the other hand, all the leading indicators are pretty encouraging.

Mitchell Fadel - *Rent-A-Center - President, COO*

And we are estimating that gross profit margin in the fourth quarter to be flat with 2011 --

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Mark Speese - *Rent-A-Center - CEO, Chairman*

That's right.

Mitchell Fadel - *Rent-A-Center - President, COO*

-- which it's been running behind year to date, and then we would anticipate some -- obviously we'll speak to it next quarter when we have our guidance for 2013, but we would anticipate some increase in the gross profit margin in 2013, flattening out in the fourth quarter at 12 and then some increase. So it appears that from a deflation standpoint, gross profit margin standpoint, life in the system standpoint, we've bottomed out on that.

Mark Speese - *Rent-A-Center - CEO, Chairman*

Yes.

Jon Braatz - *Kansas City Capital Associates - Analyst*

Okay, is there -- what particular product line are you seeing most of the inflation in?

Mitchell Fadel - *Rent-A-Center - President, COO*

Certainly televisions (multiple speakers)

Mark Speese - *Rent-A-Center - CEO, Chairman*

Electronics.

Mitchell Fadel - *Rent-A-Center - President, COO*

-- primarily, even more so than computers. Televisions would be the primary item.

Jon Braatz - *Kansas City Capital Associates - Analyst*

Okay, okay, all right. Thank you very much, guys.

Operator

Brad Thomas, KeyBanc Capital Markets.

Unidentified Participant

Hi, this is actually Jason standing in for Brad. I was wondering if you can just talk about the trends throughout the quarter and how your customer portfolio looks as you enter fourth quarter now?

Mitchell Fadel - *Rent-A-Center - President, COO*

Trends in the quarter, certainly the headwind of the early purchase options caused us to have a little bit of a shortfall, but the early purchase options ran high for the quarter, higher than we anticipated for the quarter.

The new customer demand was there. It's just we fell short from a revenue and a customer count standpoint because more exercise of early purchase option. And we didn't have an increase in new customers. They were pretty flat.

And so, when you have more early purchase options than you anticipated and don't do more new deliveries than you anticipate, you have a little bit of a shortfall. So it's not like the demand on the front end was down, it's the early purchase options, really, and not doing enough additional deliveries to offset those.

Unidentified Participant

And then, I see in your core rent to own, your merchandise on rent was down about 5.5%. Can you kind of go through how much of that is just the product deflation versus either customers not buying as much, or how that kind of breaks down?

Mitchell Fadel - *Rent-A-Center - President, COO*

Jason, it's almost all product deflation. We've looked at that and we've done some different calculations on it. It's -- 90% to 95% of it's product deflation.

Unidentified Participant

Okay. And then, lastly, on your RAC Acceptance, it's been pretty nicely accretive by our calculations for the year, and just with the higher openings in the fourth quarter and then potentially into 2013, can you talk about where you see that deflation kind of as we move -- or that accretion as we move forward?

Mitchell Fadel - *Rent-A-Center - President, COO*

We would continue -- we would expect it to continue to grow. I'm not sure what 2013 looks for until we work on that guidance, but we would expect that to continue to grow quarter over quarter.

Mark Speese - *Rent-A-Center - CEO, Chairman*

It's (multiple speakers)

Unidentified Participant

Even with the accelerated openings?

Mitchell Fadel - *Rent-A-Center - President, COO*

Excuse me, Jason?

Unidentified Participant

Sorry. Even with the accelerated openings, you think that should continue to --

Mitchell Fadel - *Rent-A-Center - President, COO*

Yes, we opened -- if you think about the 180 we've opened in the second and third quarter and it was still a 7% increase in profit from the second quarter to the third quarter, so yes, I think there's enough of them now that the accretion of the ones that are already opened will continue to outrun the dilution from the new ones.

Unidentified Participant

All right. Thanks a lot, guys.

Operator

Arvind Bhatia, Sterne, Agee.

Arvind Bhatia - *Sterne, Agee & Leach, Inc. - Analyst*

A quick question on international. I know you guys are saying that the dilution is going to be less in 2013 versus 2012. Is that predicated on a similar run rate of store openings, i.e., about 60, or are you trying to catch up for the 20 in 2012 and then open closer to 80? I'm not looking for specific guidance, just wondering the thinking there. Is that predicated on the normal run rate or catch up?

Robert Davis - *Rent-A-Center - EVP Finance, CFO*

Yes, so Arvind, good question. It's predicated on a similar run rate to what this year's original trajectory was.

And if you think about stores in their second year and, in some cases with international, some stores in their third year, contributing -- offsetting some of that dilution from the new stores, so it is predicated on similar numbers. To the extent we ramp that up, then the dilution could change, and if we dial it down, which we don't have any intention to, obviously the impact would be even more positive.

Arvind Bhatia - *Sterne, Agee & Leach, Inc. - Analyst*

Okay, got it. And then, another question on international. Could you give us some color on kind of the losses, bad debt, et cetera, that you're experiencing in Mexico in particular right now?

Mitchell Fadel - *Rent-A-Center - President, COO*

Yes, Arvind, they are running certainly where we expect them to run.

New stores from a percentage of revenue standpoint always run high because you have to have more revenue before they get down into that 3% range. So new stores run a little higher because when you lose one and have to write it off and you're only doing 20,000, it's a big difference between when you're doing 40,000 or 60,000 or 80,000.

But it's in line with our expectations. We're not seeing anything that troubles us. It's in line with our expectations, but not down to the 3% yet because the stores aren't mature enough yet to grow into a 3% loss with number.

Arvind Bhatia - *Sterne, Agee & Leach, Inc. - Analyst*

Right. And so, I know that, long term, 1,000 stores, do you expect to -- down the road, do you feel like at some point you'll need to open significantly more, or do think the 60, 70 run rate is probably what we should expect for at least in the foreseeable future? Just trying to understand if there's any reason why you would step up any time (multiple speakers)

Mitchell Fadel - *Rent-A-Center - President, COO*

I think it will stair-step up. As we get a bigger foundation, we'll be able to, as we think about 2014, 2015, 2016, go stair-step it up from 60 to 80 to 100 to 150 and so forth. We'll be able to stair-step that up as the foundation gets bigger. Because it's a people issue of developing enough people to open a new store, so the more stores you can have, you can then grow faster.

Arvind Bhatia - *Sterne, Agee & Leach, Inc. - Analyst*

And again, are there any differences in your experiences closer to the border versus as you go farther in? Any noticeable stuff that you're noticing?

Mitchell Fadel - *Rent-A-Center - President, COO*

You know, we have seen some differences in certain markets, but it's not a border versus interior issue.

A particular market interior of the country is doing better than another one that's also interior, and the same on the border, so it's not really a border versus interior. But we're certainly seeing some differences in markets.

And we see the same thing in the United States. A lot of times it's our own operator. We might have a better operator in one city than the other, and that's our job is to improve the operation in the city that's falling behind.

Arvind Bhatia - *Sterne, Agee & Leach, Inc. - Analyst*

Very helpful. Last question. I want to go back to RAC Acceptance real quick. In terms of store openings, your opportunity, as you mention, continues to look larger. You're testing various things. Same question there, are you thinking that in 2013, 2014, is there any reason why you would change the trajectory?

You know, you've opened as many as 400-plus in the past. This year, 300, but originally you were thinking 200. Just trying to understand as you're looking at a bigger opportunity if that's changing your thought process in terms of the run rate of store openings here in the next couple of years for RAC Acceptance?

Mitchell Fadel - *Rent-A-Center - President, COO*

I don't think we're going to get back to 400 in a year like that year of 2011 when we had our -- the RAC Acceptance pipeline merged with the TRS pipeline after we bought them, so I think that's a little bit of an anomaly.

I think the 200 to 300 range of openings, the 200 adds, I just think it's a longer runway than we first thought before we hit the end of the runway. It's just longer. Of course, any of the larger players could change that number, you know, some of the obvious larger players. But based on the way we're growing right now, I think the runway is longer but I don't see us getting away from 200 to 300 a year.

Arvind Bhatia - *Sterne, Agee & Leach, Inc. - Analyst*

That's great. Thank you so much, guys, and good luck for the fourth quarter.

Mitchell Fadel - *Rent-A-Center - President, COO*

Thanks, Arvind.

Operator

Budd Bugatch, Raymond James.

Budd Bugatch - *Raymond James & Associates - Analyst*

On your comments about going to 17 months, down from 18 months and down -- and up from 16, is that just in the core, Mark? Is that including RAC Acceptance? And have there been any changes in the EPO? I know -- I think you were testing some other things in EPO options in RAC Acceptance. Can you comment on that?

Mark Speese - *Rent-A-Center - CEO, Chairman*

That's a good question, Budd, and I should've called that out. I was speaking only to the core business. One might suspect that maybe it was influenced by RAC Acceptance, and that was not the case. So that was the core business only.

In terms of are we seeing any behavior difference within RAC Acceptance on their early purchase options, the answer is no. Consistent with what we've really seen and experienced over the last, I guess, two years now, we continue to have a lot of stores. Obviously you've heard the growth that we've put up, the 180 on top of the several hundred last year, so we're getting more and more confident as that business ages and we get more stores that are mature.

At the same time, we've had hundreds come out in a relatively short period of time, but as we segment and look at the results, the older ones and even some of the newer ones, nothing significant difference there. Their keep rates, their -- when they EPO, the collections, anything of that nature. So I think that's why we remain so frankly optimistic about what we're seeing and what we think the long-term opportunity is.

Budd Bugatch - *Raymond James & Associates - Analyst*

(Multiple speakers). And the keep rate is 75% to 85% -- 75% to 80%, I think you've told us, in RAC Acceptance.

Mark Speese - *Rent-A-Center - CEO, Chairman*

Yes.

Budd Bugatch - *Raymond James & Associates - Analyst*

What about repeat purchases in RAC Acceptance? Are we seeing that for some of the retailers, now that you've had enough experience? How much of that are we seeing?

Mitchell Fadel - *Rent-A-Center - President, COO*

We certainly are seeing repeat business. I don't have a number off the top of my head yet, Budd, but we'll be looking at that number.

Certainly it's an important number as we continue to grow. Most of the stores are too new now to worry about repeat business, but as we grow, certainly that's a metric that will become even more important to us. We are seeing some now, and like I said, as we -- as the stores mature, that will be an even more important number to us.

But anecdotally, and the numbers I have looked at, certainly we're seeing it, I think it will be another year or two before it's really prevalent, based on the age of those stores.

Budd Bugatch - *Raymond James & Associates - Analyst*

To me, that's a very critical issue for RAC Acceptance. And for my last question, again it's just -- did you give any commentary on units per agreement and the direction that they are going?

Mitchell Fadel - *Rent-A-Center - President, COO*

We have not yet, but I'd be glad to. We continue to see that metric perform positively. Our add-on rates have done really well for the last couple of years. Last year in the fourth quarter was the only time it went down, for some reason, but in general our add-ons, our units per agreement rental, continue to perform positively.

Budd Bugatch - *Raymond James & Associates - Analyst*

Great. Again, thank you.

Operator

Chuck Ruff, Insight Investments.

Chuck Ruff - *Insight Investments - Analyst*

The $7.6 million charge in last year's third quarter, where is that in the segment information?

Robert Davis - *Rent-A-Center - EVP Finance, CFO*

In the core business.

Chuck Ruff - *Insight Investments - Analyst*

It's all in the core, okay.

Robert Davis - *Rent-A-Center - EVP Finance, CFO*

Yes.

Chuck Ruff - *Insight Investments - Analyst*

And have you disclosed somewhere where all those charges -- there were all sorts of charges, as you know, last year, where they play out in the segment?

Robert Davis - *Rent-A-Center - EVP Finance, CFO*

We have. It's disclosed in the 10-Q and it -- which we plan to file on Friday, but I think it's also in the statements of earnings highlights in the press release, footnoted in the reconciliation of EBITDA.

Chuck Ruff - *Insight Investments - Analyst*

Okay, I'll check that out. I know you don't give guidance for the tax rate. You mentioned that earlier. Can you talk at all about what we should expect for this fourth quarter? Obviously, the third quarter was quite a surprise.

Robert Davis - *Rent-A-Center - EVP Finance, CFO*

Yes, the year-to-date rate is around 36.6%, 36.7% now with the DRIP in the third quarter. That's where we would expect the year to date to come in, and therefore that's where you'd expect the fourth quarter to be booked.

However, the disclaimer being the fall elections and what actions may be taken in December that could change that, and I can't speak to what the impact could be because I don't know what they're going to vote on and legislate on.

So barring any changes in the fourth quarter, we would expect -- or after the elections, we would expect the fourth quarter to be booked at a similar rate to the year to date.

Chuck Ruff - *Insight Investments - Analyst*

Okay, and obviously if they change the law, things change, but absent that, can you talk about your cash taxes this year and next? I believe they're quite a bit more than the GAAP taxes.

Robert Davis - *Rent-A-Center - EVP Finance, CFO*

Yes, this year we're expecting around $110 million, roughly, in cash taxes.

As we've talked about before, we've been a beneficiary of some of the legislative efforts to get the economies stimulated by allowing us to depreciate on an accelerated basis some of our capital investments, and so we've got a large deferred tax liability on our balance sheet that, for all intents and purposes, is coming due next year. So, quote unquote, a wall of debt amortization, if you will, is one way to look at it, coming due next year.

We expect cash taxes next year to be around $250 million, give or take. Now that's a number based on today's knowledge and today's estimate, but it can change, and therefore what we would expect next year is for free cash flow to be virtually nil. In fact, we'll probably be in the revolver next year in order to make our expected continuation of dividend payments, as well as our $25 million of mandatory amortization of debt in 2013.

Chuck Ruff - *Insight Investments - Analyst*

Okay.

Robert Davis - *Rent-A-Center - EVP Finance, CFO*

That will normalize in 2014 and beyond, and we would expect to be positive cash flow again of $150 million to $200 million, but next year certainly is the time to pay the piper, if you will.

Chuck Ruff - *Insight Investments - Analyst*

Yes, yes, I knew it was coming. And lastly, I'm curious as to why you don't disclose the full balance sheet and cash flow statement like most companies do. I know you eventually do it in your Q, but I'm wondering why you don't do it now?

Robert Davis - *Rent-A-Center - EVP Finance, CFO*

Just no particular reason. Generally because there is continuing efforts from a disclosure standpoint between earnings release and filing the Q, making sure it's accurate in terms of disclosures and footnotes that tie out to the balance sheet, and the fact that the Q is filed so swiftly after the earnings release, two or three days later. We haven't felt compelled to, but that's certainly something we'll take under advisement.

Chuck Ruff - *Insight Investments - Analyst*

Okay. Thank you very much.

Operator

John Baugh, Stifel Nicolaus.

John Baugh - *Stifel Nicolaus - Analyst*

I don't know if you said it, and if you did, I apologize for missing it, but did you give a same-store comp number for the core in Q3?

Robert Davis - *Rent-A-Center - EVP Finance, CFO*

Yes, in Q3 it was minus 1.3%, John. The RAC Acceptance positive impact was 2.5%. That's how you get to the 1.2% overall.

John Baugh - *Stifel Nicolaus - Analyst*

Okay, and how would you think -- I know you commented on the gross margin flattening out, but you still have the trailing impact of EPOs and deflation and what not. Would that number be expected to narrow as we move forward or are we just talking about margin changes?

Mitchell Fadel - *Rent-A-Center - President, COO*

Certainly once we start comping over it, the first quarter of next year, that would be beneficial to us to be comping over those extra early purchase options come the first quarter next year, so it would help both starting in 2014 -- I'm sorry, 2013.

John Baugh - *Stifel Nicolaus - Analyst*

Okay, thank you.

Mitchell Fadel - *Rent-A-Center - President, COO*

Thanks, John.

Operator

And we have no further questions at this time. I'll turn the call back over to Mr. Mark Speese for closing remarks.

Mark Speese - *Rent-A-Center - CEO, Chairman*

Thank you, Alicia, and ladies and gentlemen, thank you very much for joining us again.

As you heard, within the core business there continues to be some headwind, largely due to, again, the early purchase options. You heard some what we think is maybe that pendulum shifting a little bit in that the third quarter life actually increased. We know product deflation, generally speaking, has slowed in the marketplace, and of course we're anniversarying some of the things that have taken place over the last year.

RAC Acceptance, you've heard some very good things. We continue to enjoy not just good results, but good demand. We're excited about the future there, both the near and the long term. And international, we remain very excited. Obviously a much longer play at a slower pace, but nonetheless pleased with what we're seeing and what that could create for the Company in the years to come, as well.

So as always, we appreciate your support and we look forward to speaking to you further a quarter from now and talking about our latest results, as well as our outlook for next year. Thanks very much and have a great day.

Operator

And with that, ladies and gentlemen, this concludes today's conference call. You may now disconnect.

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