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RCII - Q3 2017 Rent-A-Center Inc Earnings Call

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OVERVIEW:

Co. reported 3Q17 consolidated total revenues of $644m and net diluted loss per share, excluding special items, of $0.15.

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PRESENTATION

Operator

Good morning, and thank you for holding. Welcome to Rent-A-Center's Third Quarter Earnings Conference Call. As a reminder, this conference is being recorded Tuesday, October 31, 2017.

Your speakers today are Mr. Mark Speese, 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, Amy. 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 third 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 Mark.

Mark E. Speese - *Rent-A-Center, Inc. - Co-Founder & CEO*

Thank you, Daniel. Good morning, everyone, and thank you for joining us. Today, we'll discuss our third quarter results and the progress that we're continuing to make on our strategic plan. Of course, during the quarter, our results were impacted by unprecedented hurricane activity and our thoughts remain with those affected. We're doing all that we can to care for those in need from donating furniture in Houston to shipping more than 70,000 packaged meals and bottles of water to Puerto Rico. Joel and Maureen will discuss the impact of the hurricanes as well as our operating and financial results in greater detail. Before they do, let me provide an overview of our results and the progress that we're making on executing our strategic plan.

In the Core, the progress we are seeing is in line with our expectations, as the third quarter results are still being impacted by our lower portfolio. We continue to improve our monthly operational metrics sequentially and believe the monthly scorecards have and will continue to provide visibility into our progress. In the Core, significant improvements on our average ticket, delinquency rates and being less promotional have helped drive same-store sales up 510 basis points sequentially. The average ticket of the overall portfolio was up 5.7% year-over-year in September, driven by enhancements to our value proposition and optimizing our product offerings.

By moving through the older idle inventory, the stores now have a higher percentage of new products and lower idle inventory levels, including less Acceptance Now returned products. Overall ownership levels are up year-over-year and delinquency rates are more in line with our historical performance. Stabilizing and upgrading the workforce in the quarter remains a key focus of the company as well. Stores have been empowered to replace part-time hours with full-time hours. Pay ranges have been modified to upgrade talent and maintain the stability of the front-line coworker. Progress has been established -- our processes, excuse me, have been established to obtain feedback from our coworkers and our customers. And as a result of these changes, coworker turnover is significantly lower than prior year and collection efforts have improved. There is still an opportunity to reduce the coworker turnover further, and we plan to continue to invest in our store coworkers who are our foundation for future growth. The more tenured workforce and the enhancements made have put the company in a better position to drive agreement volume growth entering the holiday season. Positive same-store sales in the fourth quarter is still well within reach and would drive positive momentum for the business leading into 2018.

Turning to Acceptance Now. I strongly believe that there are significant opportunities to enhance the Acceptance Now business model to drive increased profitability and cash flow, and we are in the early phases of repositioning the business for profitable growth. Within Acceptance Now, there are a number of key steps being taken to transition towards a more profitable business that position us for future growth. Our value proposition that drives higher ownership and less returned product will be better for our customers, our retail partners and the company. Acceptance Now has been testing a value proposition with shorter terms, lower total costs and more affordable purchase options, with slightly higher average monthly ticket for the last -- past few months. And while still early, the results are promising. The higher monthly rate, coupled with improved retention, points to a quicker return of capital, increased ownership and improved ROI. Less returned product will also benefit the Core business as a result of less product transfers and more control over our product assortment in the Core. The value proposition changes will likely be made systemwide in the coming months, and we look forward to the benefits to both businesses.

And we've also made significant progress optimizing our retail partner relationships to deliver improved service and profitability. The company continues to believe that the hybrid model of being staffed during peak times and unstaffed during nonpeak times is a strategic advantage for Acceptance Now. Acceptance Now is able to offer multiple relationship options with varying service levels for retail partners, while other lease-to-own models in third-party retail locations are almost exclusively virtual. Enhancements have been made to our unstaffed model to improve the user experience through the consolidation or elimination of strange and unnecessary information gathering, making the application easier to use for consumers and retail partner associates. New data elements were also added to the approval process to reduce risk. And continuing to build out our unstaffed capabilities will enable Acceptance Now to more effectively scale operations at a substantially lower cost with a faster speed to market and provide access to a greater portion of the addressable market. A white space opportunity and pipeline for Acceptance Now business continues to be strong.

The company also continues to optimize our decision engine in the risk analytics to reduce losses and increase ownership by implementing enhanced risk assessment policies and strategies. Rent-A-Center's data-driven application and verification processes determine approval rates and amounts using proprietary scoring models, utilizing a vast aggregation of data attributes. Our risk analytics team continuously customize the algorithms to optimize results and the changes made to date are expected to drive lower delinquencies and loss rates as well as improved profitability. The company is also starting to use analytics to determine return mitigation tactics to increase customer ownership rates and reduce returned products by providing post sale account management and decision-making tools for our store coworkers and centralized collection teams. The risk management and analytics are capabilities of the company plans to continue to leverage and invest in, in the future.

Of course, another pillar of our strategic plan is leveraging technology investments to expand channels and improve the customer experience. In the Core, we continued to build out our store, distribution and online integration points. During the third quarter, we rolled out a special order program, which allows our store staff to order specific SKUs from an online catalog to enable a larger selection of products for our customers to choose from across all categories. Included in this program is an extended aisle partnership with Ashley Furniture, the leading U.S. furniture brand and our largest supplier, where we can special order dozens of additional SKUs that we do not typically stock in our stores. This capability provides an enhanced omni-channel customer experience and allows the customer a much larger choice of items to enhance their personal shopping experience. In addition, the mobile app, we announced last quarter, is being tested in the full reason -- region, and we're expecting to expand in early 2018.

And finally, as mentioned last quarter, we've also been working with a third-party franchising consulting firm. Their work is confirmed that franchising can play an integral part in the future of Rent-A-Center. A sizable opportunity exists in franchising with the ability to grow the business and improve the capital position of the company, and we're currently evaluating the timing and level of investment. As I said at the beginning of the year, we expected that it would take time to stabilize and improve results given the portfolio nature of the business. I am pleased with the progress we have made and believe that the changes that we've implemented will drive improvements in the trajectory of the business. The board and management team are committed to holding ourselves accountable for our performance and generating stockholder value.

And finally, before I turn the call over to Joel to discuss our operational performance, I have one personal item to share. Angela Yochem, our CIO, has decided to accept the new position as of year-end. I want to take this opportunity to thank and acknowledge Angela for her service and contributions for Rent-A-Center. We wish her the very best for the future. As I said, she will be staying on through the end of December to ensure a seamless transition and the search for her successor is underway. I do want to thank our 18,000 coworkers for their continued commitment and efforts this past quarter.

And with that, let me now ask Joel to provide you an operational update.

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

Thanks, Mark, and thanks, everyone, on the call for joining us. I've been back at the company now for about 5 months, and I'm very excited about the opportunities that lie ahead for us. My focus this morning will be on the operating results of the businesses and our plans to continue to improve performance.

I'll start with our Core business. Historically, the Core business in the third quarter performs lower in terms of top line and bottom line performance. The customer agreement count drops in the first quarter since customers use their tax refunds to obtain ownership of a merchandise on rent. And there typically isn't a material increase in the agreement count until the fourth quarter. In addition, delinquencies typically increase in the third quarter which impact bottom line performance. As mentioned, the company was impacted by 3 hurricanes in the third quarter. Our hearts go out to all those affected, including our coworkers and end customers and their families. Overall, about 300 of our Core stores and about 200 of our Acceptance Now locations were impacted by Hurricanes Harvey, Irma or Maria. All but 4 of the U.S. stores are now back open, but many of the Puerto Rico stores are still closed or at least not yet fully operational. We have 38 Core stores and 25 Acceptance Now stores located on the island that produce about $5 million a month in revenue. I will note that our Core stores in Puerto Rico trend slightly below our overall store average for profitability. And as we move forward, we'll be evaluating our store footprint in the territory, while continuing to take care of those in need.

Excluding the impact of the 3 hurricanes, we are pleased with the results of our Core business, as performance for the quarter was in line with our internal projections. And our turnaround of this business continues as planned. We are very proud of our operational teams as they were able to grow our portfolio in both August and September against some very strong challenges. And we typically see a decrease in our portfolio historically in those months due to the seasonality of our business. To illustrate the significance of growing the portfolio consecutively in these 2 months, we've not done this in at least the last 12 years.

Same-store sales in the quarter improved by 510 basis points sequentially, helped by year-over-year improvements in our ticket, pricing discipline and reductions in Free Rent amounts from new rentals, which demonstrates strong sales execution on the part of our store teams. Even with the hurricane effect, the year-over-year gap on operating margin has closed and is now flat, driven by lower charge-offs and a focus on labor management.

The quality of our agreements has improved as displayed by our improvements in delinquencies and has also driven ownership rates higher year-over-year by almost 5%. In support of our inventory strategy, our percent of new merchandise in our stores is running well ahead of last year, which has also fueled us to help our comp numbers improve by 740 basis points since Q1. As we mentioned last quarter, we've recently rolled out a mystery shopper program which we're using as a training tool for our store personnel to use to improve their point-of-purchase success in delivering a great customer experience. We are pleased with these results so far and have already seen improvements in sales conversion and sales lead follow-up rates. We attribute some portion of our August and September success in growing our portfolio to the impact of this program. We're confident our front-line coworkers are strengthening their skills and delivering value for our customers.

Additionally, we've also launched our first ever voice of the customer initiative, which has already begun to give us better visibility to customer experience opportunities. We are very excited to have the ability to gain the insights we need to take the best care of our customers and nurture a better experience.

In the fourth quarter, we expect a combined high single-digit improvement in average ticket and better collections year-over-year in the Core business, offsetting the lower agreement count and driving positive same-store sales. Throughout the year, we have consistently reduced the rate of churn in our portfolio of customer agreements. In the fourth quarter, we expect the rate of customer agreement growth per store to be higher than last year, driving stronger same-store sales performance from a better store assortment, enhanced value proposition and higher quality agreements.

Over the past 6 weeks, Mark and I have traveled across the U.S. and held meetings with every multi-unit manager and above and some of our highest performing store managers for both the Core and Acceptance Now brands. We did this to ensure alignment across the organization and help build energy and keep our momentum going as we progress into our most important quarter in terms of growing the business. It was great to see the energy, the passion and the confidence on the part of our field team, and we are confident that they will deliver on our expected results.

To our Acceptance Now, the business delivered improved same-store sales of 120 basis points sequentially and 820 basis points year-over-year. Please note that our comp store base is about 1/3 of our total locations mainly due to the Conn's and HHGregg closures earlier the year. We continued our growth of new locations by opening about 70 new stores in the quarter, which gets us to about 190 year-to-date. Revenue was down in the quarter as expected due to the Conn's and HHGregg closures as is operating income due to skip/stolen losses, which were higher than expected. We knew the Conn's agreement will be challenging to collect on due to the quality of this portion of our portfolio, which has driven our loss rates higher. Most of the increase in the year-over-year loss rates are due to the these accounts. However, the locations that received the Conn's and HHGregg transferred agreements have also experienced higher delinquencies on their existing location agreements. To be clear, we are not pleased with our collection results. We have a plan to improve them on a number of fronts. Mark mentioned our plan to shift to building a higher quality portfolio starting with our pricing model as well as our decision engine improvements, which are apparent in the recent results of our first payment default rate in a subset of stores. We're also putting in place several account management strategies, which, we believe, will drive improvements in our delinquency rates, while maintaining a healthy portfolio.

Marketing our AutoPay feature, keeping disciplined around initial down payments from customers, adding their verification steps to our approval process, exiting partners who cater fundamentally to an RTO customer base and implementing a new collection routing software tool are examples of how we're working to shore up our collection capabilities. Additionally, we are focused on improving the training as well as the turnover rates of our store coworkers, who typically spearhead our frontline collection efforts.

Overall, our earnings are still being impacted by a lower portfolio, the fourth quarter is our largest opportunity to grow the portfolio of both businesses during the high seasonality period. The third quarter is expected to be the bottom point, and we expect for profits to improve from here as our initiatives take hold and improve the trajectory of the business.

In Mexico, we continue to operate our 129 stores, which are self-funding and fully managed in country. We've made good strides in our inventory management and capital allocation year-over-year, as we have reduced our overall idle units in both the stores and our DCs by over 30%. We've also reduced our long-term store idle by over 35%. This focus on proper inventory management as well as pricing has helped us raise our ticket on our in-store assortment by over 5% year-over-year as we believe we can install, to some degree, the allocation of good, better and best ratios we have done in the U.S. We continue to push for quality portfolio for our Mexico business as well as a strong focus on operating income.

With that, I'd like to thank our 18,000 coworkers for the dedication and efforts during the third 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. Now I'll walk through the financial performance for the third quarter of 2017 and will present the results, excluding special items unless otherwise noted compared to the same period of the prior year or to the second quarter of 2017, as we measure the sequential improvement against our strategic plans. Consolidated total revenues for the third quarter were $644 million, down 7.2% versus prior year. Adjusted EBITDA was $17.1 million and EBITDA margin was down 170 basis points versus the second quarter. Net diluted loss per share, excluding special items, was $0.15. The company estimates that the effects of the hurricanes reduced our revenue by $5 million and non-GAAP EPS by $0.04 in the quarter. That impact was approximately 65% from the Core business or around $3 million and 35% from Acceptance Now or around $2 million in revenue.

As Joel mentioned, we had almost 500 locations impacted and expect there to be a near-term drag on the business before reaching the full recovery. Charges of $1.9 million were recorded in Q3 for the hurricane damage, primarily related to idle and on-rent merchandise from hurricanes, Harvey and Irma. The company is self-insured in the U.S. for merchandise and fixed assets and has insurance coverage in Puerto Rico for some merchandise, fixed assets and business interruption. We are currently working on estimating the potential charges needed for Hurricane Maria and anticipate booking those in Q4.

Turning to the results for Q3 in our Core U.S. segment. Total revenues were down 8.1% driven by a same-store sales decline of 5.1% and 2% reduction in average store count and the impacts from the recent hurricanes. Same-store sales improved sequentially by 510 basis points driven primarily by the significant increase in the monthly rate of agreement. The year-over-year change in merchandise on rent improved sequentially by 350 basis points, which shows that we are continuing to make up ground versus last year on the portfolio and positive same-store sales in Q4 is still our expectation. Gross profit margin in the Core U.S. business was 70.0%, 120 basis points lower than last year due to the value proposition changes and targeted pricing actions to rightsize the inventory assortment. We are expecting the year-over-year rental and fee gross margin to continue to improve in Q4. Core merchandise held for rent was sequentially -- was up sequentially as the company is preparing for the higher demand fourth quarter and also driven by an increase in the average cost per unit due to the shift towards more, better and best product. Store labor expense was down $3.8 million versus last year driven by lower store count. Other store expenses were down $27.4 million driven by lower losses and lower store count. Skip/stolen losses were 2.4% in the quarter compared to 4.7% last year. And our expectation is that losses will remain at lower levels in Q4 given the improvements made in the quality of the rental portfolio. Core U.S. EBITDA was $32.5 million in the quarter. EBITDA margin was down 30 basis points from the prior year. However, the gap in EBITDA margin year-over-year improved sequentially by 380 basis points.

Now turning to the Acceptance Now business. Total revenues decreased by 5.2% primarily due to the closures of Conn's and HHGregg locations and the impact from the recent hurricanes, offset by higher same-store sales of 7.9%. With the store optimization changes Joel mentioned and the impact of the recent hurricanes, Acceptance Now revenue is expected to be approximately $180 million in the fourth quarter or approximately $800 million for the full year. Gross margin in Acceptance Now was 50.0%, down 300 basis points from last year driven by lower gross profit on merchandise sales due to a focused effort to encourage ownership and reduce returned product by negotiating a buyout amount in lieu of picking up product for select customers. We expect this activity to continue going forward until our value proposition changes result in higher ownership rates. Skip/stolen losses for Acceptance Now were 10.8% and are expected to be elevated next quarter as well. Acceptance Now EBITDA was $16.4 million in the quarter.

Corporate operating expenses increased $2.5 million compared to prior year primarily driven by project expenses related to strategic initiatives, higher depreciation expense from technology investments and higher legal expenses. Corporate expenses for Q4 are expected to be flat versus the current quarter.

Now turning to the balance sheet. As of the end of the third quarter, we had $76.2 million in cash and cash equivalents. Our total debt balance was $637.4 million with $55 million drawn on the revolver. For the quarter, the company's fixed charge coverage was 0.5x, leaving approximately $147 million of available capacity on the revolver, taking into account the additional $50 million necessary given the fixed charge coverage rate. Total liquidity at the end of the quarter was $223 million. Year-to-date, we have generated approximately $135 million of cash from operations.

With that, let me turn the call back over to Mark before we open the line for your questions.

Mark E. Speese - *Rent-A-Center, Inc. - Co-Founder & CEO*

Thank you, Maureen and Joel. Before I turn the call over to Q&A, I want to briefly discuss the 2 additional announcements that we made yesterday. First, we announced that Rent-A-Center's Board of Directors has initiated a process to explore a full range of strategic and financial alternatives available to the company with a focus on maximizing shareholder value. I know I speak on behalf of the management team when I say that we will remain focused on executing on the comprehensive plan to improve the results across the business, while this review process is underway. Please note that the board has not established a definitive timeline to complete its review and no decision on any particular alternative has been reached. There can be no assurance that this process will result in any agreement or transaction. We do not intend to discuss or disclose developments regarding the board's process unless and until the board has approved a specific course of action.

Second, regarding the dividend. We also announced yesterday afternoon that our board has suspended the quarterly cash dividend. To be clear, and as Maureen just mentioned, our cash position remains strong as the company generated $135.4 million of cash from operations for the 9-month period ended, the third quarter -- and ended the third quarter with $76 million of cash and cash equivalents.

So before turning the call to Q&A, I would like to remind you that the purpose of this call is to discuss the third quarter results. I ask that you limit your questions to that topic. Thank you in advance for your consideration and cooperation.

And with that, we would like to now open up the call for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Your first question comes from the line of Brad Thomas with KeyBanc Capital Markets.

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

I wanted to first ask about same-store sales. Mark, since you've rejoined the company, you're clearly making progress improving same-store sales in the Core and ANow. Could you just help us understand a little bit more about maybe the pace of improvement that you're expecting in the Core business, in particular, in the fourth quarter? By my math, it looks like you need to get to perhaps a low single-digit comp in the Core in the fourth quarter in order to get to overall positive comps. And if you could just talk about, if that math is right and what you are seeing in the business that gives you confidence, you could hit that in 4Q?

Mark E. Speese - *Rent-A-Center, Inc. - Co-Founder & CEO*

Yes, let me give you a couple of data points and then Maureen, feel free to expand in some other areas. One of the key drivers, it's the number of BOR or contracts that you have on rent, what is the pricing or value of those individual contracts. And then how are you collecting or performing against those. And let me try to give you a couple of data points, Brad. At the end of the third quarter, the portfolio was about 10% less than it was year-over-year. So if you think of the size of the portfolio the end of September. By the way, the end of August, it was 11% difference and the end of July was 12% difference. And you heard Joel comment how we gained portfolio in August and September first time in 12 years, okay? So the gap is shrinking when you think of the size of the portfolio. Now go to those other 2 points that I referenced. Our pricing is up 5.5% year-over-year. And you see this in the monthly metrics that we've put, the delivery APU, right? The other key driver I mentioned is, how are you collecting against the performance of that portfolio. And that's in delinquency or percent collected, use of free time actually collecting on the accounts. We've stated, we're now back to our historic norms in terms of pretty close to historic, in terms of monthly, weekly delinquency, certainly our losses are back. And I think you heard Joel and Maureen, 2.4% in the Core compared to 4.7% a year ago. So think of it this way, we have 10% gap in the size of the portfolio, the pricing is up 5.5% and collections or the percent we're collecting against that is up 3%. The gap is now something around 2%. And of course, when we started the year, that first number was something akin to 15% and pricing was 0 and collections were 0, okay? And again, we put out this monthly report card to try to show this is a portfolio business, it doesn't happen overnight, you got to move through the inventory, you got to improve the collections, you have to right size the value proposition. Hence, where we are today and what reaffirms our belief, and I've stated before, and I'll repeat again, I'm not sure everyone appreciates the challenges the company faced in the third and fourth quarter of last year. And so we believe we can continue to narrow the gap on the portfolio size as well as continued improvement in the pricing value propositions. I think it's fair to say, we don't expect any more on the collection side because we've been running at our historical norms now. So the question is can we get the 5.5% to 6% or 6.5%. We believe we can continue to move upward. And we believe we're going to continue to narrow that gap, that 10% I referenced, which was 11% the month before and 12% the month before that. So it gives us pretty good confidence. Maureen, I don't know if you want to add any more color or hopefully...

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

No. You have covered it.

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

That's helpful. And so with September Core comps having been down, I think, a little over 4%, the expectation is basically that will continue to improve as the portfolio gets healthier from what you're working on?

Mark E. Speese - *Rent-A-Center, Inc. - Co-Founder & CEO*

Yes. Like it has every month since April.

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

Great. And Mark, turning to sort of the expense side of the equation, you referenced some flexibility that stores have to put more into labor. Can you help us just think about the cost structure of the business and where you think there are opportunities to continue to bring down costs? And where, maybe, from a timing perspective, are we maybe getting to lean in certain areas that you need to keep putting more back into the business?

Mark E. Speese - *Rent-A-Center, Inc. - Co-Founder & CEO*

That's a good question. I guess, there's 2 lines of business. So if you think about the Core, I think, generally speaking, throughout the P&L below the gross profit line, I think, I feel comfortable with the cost structure that we have there. Now part of the way that we're going to deleverage is you got to grow the top line. And I would tell you in the Core, it's not about taking costs out, it's about leveraging the costs that we have. I do think that we can continue to make some improvements on the gross profit line. And Maureen has spoken to -- we're still -- some of the impact from some of the decisions that we made early in the year in terms of how do we move through the old inventory faster, so whether it was the pricing or the discounting and some of that inventory, you've seen the gross profit margin or depreciation go up a little bit as we've moved through that. But I would expect that over time, there's an opportunity to pick up improvement on that line as we continue to move through the older inventory. Of course, the Acceptance Now, so I'm talking about the 2 lines of business, but it rose up in the aggregate. Clearly, there is opportunity on the loss line. And we recognize that and I'll remind everyone, just like the Core business, this is a portfolio business also. And what's really important is the steps that we are taking today is that going to show, and Joel mentioned, with some of the enhancements on the risk engine and the decision-making, the analytics, our first payment defaults in the Acceptance Now, which is a leading indicator, right? What percentage of the portfolio misses the first payment, that's a leading indicator into how they may perform further down the road. I can tell you, we are at levels we haven't seen in 2 years. Now okay, that's the first payment default, but most the contractors, so again it's a portfolio that's going to take some time. But I think, we all believe strongly that over time we're going to be able to improve the delinquencies, which will enhance the overall profit margins. There's probably some optimization that can still be recognized or done in the Acceptance Now. When I say optimization, whether that's some of the unmanned, how do we think about the level of performance in those stores and where the unmanned solution may be the better options. And we have those kinds of opportunities also. And you can expect to see more of that as we move forward.

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

That's helpful, Mark. If I could squeeze in one last more. I know you're not going to want to give a lot of detail on the decision to review strategic alternatives here. But maybe if I could just ask, maybe, in your mind and the minds of the board, what's changed, if anything, from 6 or 9 months ago in terms of maybe why now as a moment to explore these alternatives?

Mark E. Speese - *Rent-A-Center, Inc. - Co-Founder & CEO*

I think the only way I could answer it, Brad, is the board obviously is and has always been committed to taking actions in the best interest of the stockholders and the company. And they determined that -- again, I'm not on the board, but they concluded or determined that now is the right time to initiate a review to focus on maximizing the value. And so as I said, they'll review a full range of alternatives with the assistance of the outside advisers. And we won't -- I'm not going to be able to comment any more beyond that, frankly.

Operator

Your next question comes from Kyle Joseph from Jefferies.

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

Just wanted to get some color on markets post hurricane. Obviously, you had a lot of store disruptions and whatnot. What sort of trends you saw in September or October in the markets that were impacted by hurricanes in terms of FEMA refunds? And have you seen demand recoveries there? Or when you would you anticipate demand recoveries? I know Maureen mentioned that there would be a drag in the fourth quarter because of the hurricanes.

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

Yes, this is Joel, and Maureen can -- will chime I think as well. I think when it comes to hurricane, you can look at it almost on 2 different lenses, 1 lens being Texas and Florida and what occurred there versus Puerto Rico. In Texas and Florida, obviously, there was some damage there to our stores and to the surrounding areas. The stores have come back online. They're not totally back up to speed yet, especially from the percent collected standpoint, in terms of getting the revenue back in the stores but they're making good progress. And we think in fairly short order, we will be back to normal run rates. Puerto Rico, I think, is a different animal just because of the -- they experienced a once-in-a-lifetime type of weather event, which sent the entire island back some -- for some period of time. And like I said, we've got 38 Core stores on the island, 25 Acceptance Nows. And it will take some time for them to get back up and running. When you look at the power grid, you look at communications being challenged in Puerto Rico right now, just getting connectivity to stores is a day-to-day occurrence for us or challenge for us, I should say. So hard to say exactly when we'll get to a point where those stores are back up and running. We do know that we're going to take advantage of the opportunity to look our footprint and make sure that we can -- based upon profitability of the current store base as well as lease expiration dates and whatnot, to give a better grasp of what our footprint long-term should look like on the island.

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

Yes. That's helpful. And then transitioning to Acceptance Now. You talked about the value proposition for the customer. In terms of the terms, can you give us an idea of where they were and where we should anticipate them going in terms of portfolio duration?

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Mark E. Speese - *Rent-A-Center, Inc. - Co-Founder & CEO*

Yes, we -- a little bit like the Core, the term is somewhat driven by total cost. So there's a range, right? But generally speaking, in the Acceptance Now, generally, the range was between 12 and 36 months. And what I can tell is more of the top end that we don't -- you can -- the expectation is we won't have anything longer than 24 months. And whether or not that's where we'll settle, it may be still being tested also. So when I say shorter terms, it's 24 months or less. Everything that we are testing is different right now. Again, we'll give up a little bit on the margin in terms of how you may price it initially. But obviously, the idea of being able to collect more money faster, shorten the term, help drive more ownership, carrying people that far out is a little -- it's not good for anybody.

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

Got it. And one follow-up there. Would you anticipate rolling out this new value proposition in both the staff and the direct? Can you give us a sense for long-term plan in terms of mix between staffed and direct?

Mark E. Speese - *Rent-A-Center, Inc. - Co-Founder & CEO*

The answer is yes. This would apply across any of them. We've said it and the unmanned is -- listen, there are tens of thousands of potential retail partners out there, right? And I think we all know that the manned is not the right way to go on all of those cases. And so having a viable unmanned solution is important. And that's what we continue to work on and develop. And in terms of what the optimal mix is, I -- that's a little hard to predict, Kyle. I don't -- I think what excites us is having -- putting ourselves in a position to where we can, again, offer a value proposition for the partner that they may not be able to get somewhere else. So -- and that can be, if you think about it from a continuum, in some case, it may be fully unmanned all the time. In another case, it may be manned on the weekends when they're busy in terms of traffic and/or to the extreme, it's manned all the time because where we are in the flow and the opportunities and so forth. So being able to be in that position is I think that's what is really exciting for us and that's what we are working towards.

Operator

Your next question comes from John Baugh from Stifel.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

I guess, if you start with ANow. And just to be clear, you're saying your first payment defaults are at extremely high levels currently. Is that what you said, Mark?

Mark E. Speese - *Rent-A-Center, Inc. - Co-Founder & CEO*

No, no, no. We -- first of all, we never said they were extremely high at any point. They're at lows that we haven't seen in a couple of years. So the opposite of that. We have visibility into payments and performance and all that kind of stuff. And the first payment defaults that all the new contracts that we've been doing are at the lowest levels we've seen in the last couple of years, which is a good thing. So all of the things we've been doing is much better looking.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

And so is that primarily or solely related to not obviously originating counts recently with Conn's and/or HHGregg? Or are you making progress even within other retail partners?

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Mark E. Speese - *Rent-A-Center, Inc. - Co-Founder & CEO*

It's all the above. So the partners themselves and then obviously the decision engine and the risk analytics, the algorithms that are being used in terms, again, of how we score, if you will. So it's a combination of all of those things.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Okay. And it sounds like that, again, a dangerous assumption that performance of the unmanned is not as good as the staffed. Is that correct? Or what kind of metrics or gap could you discuss between staffed and unmanned?

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

I would say it's not that they perform differently, it's just they're different comps. So we know that we typically would put a manned solution in if the volumes dictate it and an unmanned solution in as the volumes dictate it. So if the lower volume are lower, we typically go with an unmanned solution where it doesn't justify putting and spend the money on the labor to support a lower agreement count in that location. So it really depends upon each location and what we feel is justified from a model perspective for that partner in that specific location. And really, it's driven by a location by location decision.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Okay. I guess it wasn't driving at revenue, which -- I was driving at delinquencies or charge-offs, staffed versus unmanned?

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

Typically, with unmanned, you want to put those locations in where there's more of a banked customer, higher quality customer. Just so you could -- because, again, it's not a manned location, we typically see better default rates than a manned location versus an unmanned. And because we typically will handle both the banked and a struggling underbanked customer at a manned location. Whereas at an unstaffed location, you have no staff there to handle collections and whatnot on site. Typically, we would want to stick with more of a banked customer base.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

So your delinquencies and charge-offs would be better in the virtual or unmanned, or not?

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

It's hard to say one way or the another. It would depend upon that location, specifically. I mean, typically, if you're with a banked customer, you would think you would see better first payment defaults and better loss rates, yes.

Mark E. Speese - *Rent-A-Center, Inc. - Co-Founder & CEO*

Here's something I can share, John. And this isn't -- this applies not just to us, I think any financial lender would support this comment. But what we see, those that apply online at 3 a.m., that's a little higher risk on average, and I'm not trying to paint everyone with the same brush. But there are facts and so forth that, that's a different than the customer that walks in at 11 a.m. And so when you think about the underwriting and the decision-making, how do you adjust or account for those kinds of things. And that's -- so you're going to have probably some different underwriting rules depending on which environment you're working in and where they're coming from. But that's just the science of -- and again, that's used in any one, not unique to us. So -- but it's those kind of tweaks or differences that you might see between the different channels and so forth.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

And I think I heard Maureen say that the revenues for ANow would be around $800 million this year. I'm curious as to roughly what -- and I assume you'll still be collecting some revenue from Conn's and HHGregg into '18 but not as much. Is there any guide? And I believe you said the comp base is only 1/3 of the total storage or something like that. I'm just trying to get some guide for the next year in terms of the composition of ANow revenue that's comp-based and what we'll lose, if you will, in revenue from those 2 retail accounts?

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

John, this is Maureen. Yes, so the comp base is just 1/3 of the overall store base within Acceptance Now. We will continue to see the agreements slowly continue through the first quarter on the Conn's and HHGregg agreements, because we didn't stop writing new agreements in those locations until around May of this year. So we will continue to see the fall off of those agreements. But there will be less of an impact in '18 than obviously they were in '17. We did provide guidance, overall, for the fourth quarter. In the year, we're working on understanding the store optimization plan that Joel talked about and the impact that will have on 2018. And we'll likely provide more guidance or direction about what the Acceptance Now business looks like in 2018 on the next earnings call.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Okay. Is there a plan to further reduce Core store count, Mark? Or are you kind of where you want to be currently?

Mark E. Speese - *Rent-A-Center, Inc. - Co-Founder & CEO*

Well, we continue to evaluate all the store's performance. And I said that at the beginning of the year, we will revisit it at the end of the year, we've made a lot of great progress. You've seen or you will see when the Q is filed. I mean, part of the normal -- there's some regular hygiene, if you will, is kind of how I think about it, that has taken place. You saw it last quarter but again this quarter. As I sit here today, I'm not expecting do any large store rationalization, if that's what you're asking. It's more regular, normal hygiene at this point. And then we also -- how do you think about my comment around franchising and what might that made me now? That's a much larger, right? That's a -- that's not a solution to underperforming stores, that's a much more thought-out strategy about balance sheet, a white space, on and on and on. But -- so I think, we're going to be able to approach it from a couple of different ways and right now, you can just expect to see regular hygiene.

John Allen Baugh - *Stifel, Nicolaus & Company, Incorporated, Research Division - MD*

Got it. And then my last question is on Puerto Rico. Obviously, a difficult situation there. Is the reason for not taking the charge until Q4 due to uncertainty around what's covered insurance wise? And therefore, what maybe the net will be? Or is it decisions around what you'll do with those stores? I'm just curious whether you can frame any better, financially, what we're looking at in Puerto Rico or do we just have to wait?

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

Really, the reason why we waited is we just wanted to have better information. It was fairly late in the process that we started to get information from our coworkers on what the impact was within the stores and the inventory and the successes and then also trying to get a hold of our customers and understanding their situation. So we do understand what the insurance will bring for us. It's just a matter of tying the knot and determining what the charges are expected to be going forward. But we're -- we've gathered a lot of that information, and we're currently in the process of reviewing, and we'll be taking those charges next quarter.

Operator

Your next question comes from the line of John Rowan with Janney.

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

Just so I'm clear, the $50 million worth of reduced liquidity out of the revolver, I assume it's a fixed charge coverage ratio. I just want to make sure that you guys have enough further room on the borrowing base covenant to move up liquidity when and if you kind of solve the fixed charge coverage issue?

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

Yes, John. So the way we look at capacity on the revolver is we have a minimum of the borrowing base or $350 million in capacity. We have about $100 million in letters of credit, we have $55 million drawn on the revolver currently. And because we did not meet our fixed charge coverage ratio, we have to hold back an additional $50 million because of that requirement. So that leaves us with $145 million -- $147 million in capacity on the revolver, plus we have $76 million in available cash at the end of the quarter. And so that leaves us with $223 million in available liquidity. So we feel very comfortable with our amount of liquidity. Again, that was one of the reasons why we amended the credit facility, because we understood that the fixed charge coverage would be under some pressure for some time. And so rather than having those covenants and pressure there, we felt like the $50 million in available liquidity was not an issue for us since we drive strong cash flow generation for the business and expect to continue to drive strong cash flows.

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

Okay. And then you guys mentioned something about a new, I wouldn't say new inventory system, but a new ordering system for Ashley Furniture, where you have access to certain things that you don't typically keep in stock. Is that for the company stores or is that in RAC Acceptance?

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

No. That's for the company stores, we are working with Ashley Furniture and also across all of our categories that we use for our standard merchandising at our stores. We would create more of an extended aisle, where we added several dozen more SKUs for our customers to choose from going forward. So it's not just our current merchandising base in the store products, but now a much larger suite of products between all categories as well as Ashley.

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

But it's not -- it's not open season on all SKUs, right? I just want to make sure that...

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

No.

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

You're not getting back some absurd sell you have no chance of retailing because someone ordered a custom and you got it as a return.

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

Great question. We've got a very slight number of SKUs that we -- we focus on SKUs, that's fit our business model.

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

Okay. And then, Maureen, I think you gave some guidance on -- I think, you said the corporate expenses were going to be flat sequentially. I just want to make sure, corporate expenses you're talking about G&A, right?

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

Yes. Yes, we are talking about the corporate segment, which includes G&A as well as depreciation.

Operator

Your next question comes from the line of Laura Champine with Roe.

Laura Allyson Champine - *Roe Equity Research, LLC - Senior Analyst for Consumer and Retail*

Could we dig into the gross margins on Acceptance Now? Again, it sounds like you're sorting of making a deal with customers so that you don't have to pick up products. And I heard Maureen said that, that sort of situation pressuring that gross margin will continue until the value proposition changes. Can you just explain to me a little bit more what that means? And maybe, how much of the pressure it has to do with the changes in some of your retail partnerships?

Mark E. Speese - *Rent-A-Center, Inc. - Co-Founder & CEO*

Yes, what she was alluding to if -- of course everyone knows under either line of business, at any time the customer has an early purchase option available to them. And that comes at a discount, if you will, to the total cost that they would pay if they were to continue to rent. And depending on where they are in the lifecycle of that agreement, meaning how long they've had it, how much they paid, how they paid and so forth. And then again, in an effort to mitigate the returns, we are -- we've empowered the district managers and so forth to negotiate, I guess, for lack of a better -- somewhere between the remaining value and what the EPO would've been otherwise. If there is a way to extract more money and keep the unit out of the system and get the customer paid off, they are empowered to do that. And so we've been doing that, again, in an effort to save some of the returns and work through some of that. I don't know, Maureen, I don't think we can quantify exactly is that 100 basis points of the increase. I can't give you that, Laura. I don't know -- our expectation. I want to be clear, when I talk about the value proposition, it's much like the Core. And you saw this in the Core with the changes we've made on both moving through the previous inventory and the value proposition changes. The gross profit margin or at least depreciation line got worse, which we know it was going to. But where we make that up is in loss line and then some of the other expense categories in the P&L, and we don't view this any differently. So there's a near term impact that over time, as we implement the other corvette or the value proposition and make further changes, we would expect it to drive improvements in the total box.

Laura Allyson Champine - *Roe Equity Research, LLC - Senior Analyst for Consumer and Retail*

Got it. So changing the value proposition, I'm still a little unclear on what that means because I know you don't have as much control on what you sell in those partner locations as you do in your Core.

Mark E. Speese - *Rent-A-Center, Inc. - Co-Founder & CEO*

Yes. So think of it -- let me try to describe it this way for the benefit of everyone. I know we -- over the last several quarters, we've talked a lot about the Core and the value proposition, and I know I've shared examples of -- and I think people understand this, which is why I want to use this as an example here, because, I think, when we think about it the same way, you'll get there. In the Core, you recall me talking about the 2 by 2 pricing formula and so that's a 4 turn, but then how many times is it rented. And ultimately, when the product leaves the system, what do you get? It's not where you start, it's where do you end up. And in the Core, you heard me talk about, historically, we were at a 4 turn pricing methodology. And all in, when products left the system at the end of their life, we would get something akin to a 3.2 turn. That's taking into consideration early purchase options, write-offs of losses, the second life, so forth and so on. You heard me say that in the Core, that got damaged a little bit, right? So the average product was rented more times, it was on rent for less time. But at the end of the day, when it left the system, we were only getting the 2 rate or something like that a turn. So think of Acceptance Now the same way. Regardless of where we price it, and today if it's around the 3 turn, when it leaves the system what are we getting? So we're talking about the value proposition in a way that maybe it's not a 3 turn on the front end, maybe it's 2.2 or 2.5. And so where that may show up in front of the gross profit line in addition to the depreciation. When it leaves the system, am I improving my losses and am I getting my money back quicker or am I taking the whatever it is today? That's why I'm getting a better return on my investment, ROI and so forth. And that's -- those are the kinds of things I'm talking about that I'm working on.

Operator

Your next question comes from the line of Anthony Chukumba with Loop Capital Market.

Anthony Chinonye Chukumba - *Loop Capital Markets LLC, Research Division - Analyst*

I just had a question on the CFO search. You're now coming up close to a year without a CFO. And no offense Maureen, you're doing a great job. But just I was wondering, where you are in that process and whether some of the sort of disagreements or issues at the board have impeded that process at all?

Mark E. Speese - *Rent-A-Center, Inc. - Co-Founder & CEO*

Well, as I mentioned last time, I just started the search. For, I think, everyone knows why it wasn't started initially. In light of everything that's taken place up to that point. And suffice it to say, in light of the news that we just announced, don't expect me to be doing much at the moment either. And to your point, Maureen has done a wonderful job and I'm thankful for that. And she continues to do so. So I've got no issue with it, and I probably won't have anything to say on it for any time soon either.

Operator

This concludes our question-and-answer session. I will now turn the call back over to Mark Speese for closing remarks.

Mark E. Speese - *Rent-A-Center, Inc. - Co-Founder & CEO*

Thank you, everyone, for joining us. As always, we appreciate your interest and support. And as always, Maureen and I are available for any follow-up discussions. Thanks, and have a great day.

Operator

This concludes today's conference call. You may now disconnect.
