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RCII - Q2 2014 Rent-A-Center Inc Earnings Call

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OVERVIEW:

RCII reported 2Q14 revenues of $773.2m. Expects 2014 revenues to grow 2.5-4.0% and 3Q14 revenues to grow 2-3%.

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CORPORATE PARTICIPANTS

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

Robert Davis *Rent-A-Center - CEO*

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

Guy Constant *Rent-A-Center - EVP Finance, CFO*

CONFERENCE CALL PARTICIPANTS

Budd Bugatch *Raymond James & Associates - Analyst*

Brad Thomas *KeyBanc Capital Markets - Analyst*

Laura Champine *Canaccord Genuity - Analyst*

John Baugh *Stifel Nicolaus - Analyst*

Carla Casella *JPMorgan Chase & Co. - Analyst*

Karru Martinson *Deutsche Bank - Analyst*

Hale Holden *Barclays Capital - Analyst*

William Reuter *BofA Merrill Lynch - Analyst*

PRESENTATION

Operator

Good morning and thank you for holding. Welcome to Rent-A-Center's second-quarter 2014 earnings release conference call. (Operator Instructions). As a reminder, this conference is being recorded today, Tuesday, July 22, 2014.

Your speakers today are Mr. Robert Davis, Chief Executive Officer of Rent-A-Center; Mr. Mitch Fadel, President and Chief Operating Officer; Guy Constant, Executive Vice President, Financial, and 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, Keith. Good morning, everyone. Thank you for joining us.

You should have received a copy of the earnings release distributed after the market close yesterday that outlines our operational and financial results that were made in the second 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 concerning non-GAAP financial measures, the 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, 2013, and our quarterly report on Form 10-Q for the quarter ended March 31, 2014. Rent-A-Center undertakes no obligation to publicly update or revise any forward-looking statements.

I would now like to turn the conference call over to Robert. Robert?

Robert Davis - *Rent-A-Center - CEO*

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

Before getting started, I would like to welcome our new CFO, Guy Constant, to the call. Guy is an excellent addition to our management team and he will be instrumental to our success going forward. He is already having an impact and I look forward to partnering with him in our journey.

Now, I will be providing a high-level overview of where we are in our multiyear transformational journey, as presented at our investor day earlier this year, after which Mitch and Guy will be diving deeper into our current results and future outlook.

However, to be frank, our second-quarter results were disappointing. While it is a challenging retail environment, that is not justification for our results. We need to perform better and we will. Despite the results for the quarter, I'm excited and optimistic about the future.

As you may recall as presented at investor day, our future is about meeting customers where they are, getting them exactly what they want, and providing them the service they need and deserve. To be sure, we are well on our way to fulfilling these desires.

To start with meeting customers where they are, last quarter I announced to you that we had just launched our new Acceptance Now technology, and our expectations at the time were to roll out this new technology accelerator to 50 new unmanned retail locations and convert 100 existing manned locations to an unmanned model, given the lower volumes.

However, the results that we have witnessed thus far in testing this new technology within an existing Acceptance Now manned environment have caused us to adjust those plans. Instead, we will be accelerating the rollout of this new technology into a total of approximately 600 existing Acceptance Now manned locations the balance of this year.

Frankly, the performance of this technology, together with our already highly effective field coworkers, has unlocked capacity and growth within our current manned kiosk model that we never expected. It is our current belief that, ultimately, we will utilize this new technology within all Acceptance Now locations, starting with the initial 600 this year.

While the virtual Acceptance Now developments are undoubtedly very exciting, we continue to work on and believe that our digital commerce aspirations will eventually unlock an exciting new growth channel for us and we are anxious about further meeting customers where they are.

And finally, as announced in the press release, we did complete our store optimization work within the second quarter by utilizing an analytical data-driven approach to optimizing our footprint. We will continue to apply these new capabilities over time to ensure our store network is efficiently producing the returns we need and desire.

As for getting customers exactly what they want, we were very excited to announce that by the end of this week, we will be the first national retailer to offer some of the world's best smartphones, along with unlimited talk, text, and data, with the flexibility and convenience of a lease agreement and no contract service plans across substantially all of our brick-and-mortar locations within the US. We have partnered with some of the biggest and the best in this category and are thrilled at the opportunity to change the game in this space. Ultimately, we believe this category alone could provide as much as 10% of our future revenue stream within this segment.

Additionally, now that we rent phones in our brick-and-mortar locations, we believe we can expand Acceptance Now into the cellular phone retail space with current and new retail partners. And as you may know, the smartphone category has already proved highly successful in our Mexico segment as well.

Further since we last spoke, we have landed on our ultimate supply-chain strategy and we will be implementing our new network over the course of the next 12 months. As a reminder, we believe our current direct-to-store supply-chain approach provides us with less flexibility and higher costs, which ultimately is not in the consumer's best interest. Our new, modern supply chain will provide us with the opportunity to broaden the product lines we carry in our stores, as well as lower our working capital investment by lowering the purchase price of our goods, which in turn can enhance our margins or be utilized to provide a more compelling valuation proposition to our customers via pricing optimization.

While in the implementation phase, we will aggressively pursue quick wins and, in fact, have already identified approximately $10 million in cash benefits that we will secure by the end of this year.

As for our new pricing strategy, we are thrilled with the new insights we are gathering and the multitude of tests that we are currently conducting. As a reminder, we are focused on shifting our pricing model from a cost-plus approach to a value-based strategy that is focused on the customer. We are eager to see the results of these tests which are currently in flight, with even more staged for the coming months.

And finally, in terms of providing customers the service they need and deserve, we recognize that nothing is more valuable to the success of our business than the quality of service as delivered by our store coworkers. We have been testing and will continue to test various store talent and labor models that will allow us to attract, hire, train, and retain top talent, while providing us with meaningful flexibility in managing our costs and infrastructure to meet the demands of the business. We have seen some positive early results and look to widen our testing through the balance of the year.

Our customer work is also beginning to bear fruit. As we have mentioned before, we have committed a tremendous amount of effort to developing our customer segmentation and digging deep to understand and ultimately provide the experience that our customers and prospective customers desire. This enriched understanding of our customers is beginning to reorient our go-to-market strategies, and due to the immediacy of these changes, we expect to see improvement this year in our marketing effectiveness and we will continue to implement the action plans from this work into 2015 and beyond.

So in summary, while the second-quarter results were disappointing, we do remain steadfastly focused on improving our business long term and delivering the returns our shareholders deserve. We will do this by maintaining focus and discipline on executing our strategy. We have made great progress in the last 90 days since our last call, and as I do, I know you wish the work would be done sooner. It has not been easy work, but it is paramount to our ability to deliver upon our long-term strategy.

Before I turn the call over to Mitch to provide more detail on the quarter, I would like to sincerely thank all of our hard-working coworkers for their passion and dedication in support of our mission. Mitch?

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

Thanks, Robert, and good morning, everyone.

In the core segment, our deliveries were down year over year, due to softer demand, driving the negative 4.7% comp in the core segment. Now that was a 140 basis-point improvement from the first quarter. In addition to the improvement that we are already seeing, we will see even more improvement from the rollout of our new smartphone lineup.

As you can see in our guidance, we expect to see a negative same-store sales number in the current quarter, albeit improved again on a sequential basis, and then we expect the fourth quarter to be flat to slightly positive range in the core segment.

Now in addition to focusing on improving our sales trends, we're also analyzing our expenses as the store level and more specifically at our labor line. We are currently testing some ways to build flexibility in our labor models so that we can flex up and flex down based on business trends. More to come on that in the coming months, but suffice it to say, the expense line is under just as much evaluation as the revenue line.

On the collection side, our weekly performance metrics remain generally in line with our goals and our core US rent-to-own skip and stolen losses came in at 2.7% for the quarter, a 10 basis-point improvement from last quarter.

Our inventory held for rent at the end of the quarter was skewed up by the buildup of our smartphone inventory for rollout this month. Excluding those smartphones, our held-for-inventory percentage was 24.1%, another 10 basis-point improvement and better than we ended the last quarter, by 10 basis points.

Regarding Acceptance Now, we remain very pleased with the growth in this segment. Overall, our revenue grew close to 33% and our same-store sales were plus 25.1%, a very similar number as last quarter.

Our customer keep rate metrics remain in line with our expectations and with our historical averages, while we have opened over 200 manned kiosk locations over the last 12 months. And as Robert mentioned, our new technology is being added to this space as we remain extremely excited about the prospects for this segment and what that new technology can do from a growth standpoint.

Now our growth in this segment, as I just mentioned, and as we've talked about before, remains very strong, and Acceptance Now continues to help us grow the overall US rental market, which for most retailers is not an easy thing to do right now. In fact, when you add the core and the Acceptance Now segments together, our revenue in the United States is up about 1.1% in the quarter. So we are growing our US market share, and Acceptance Now has been and will continue to be a very successful growth vehicle for us.

Having said that, we are also scrutinizing all expense lines in this fast-growing segment. Although most of their expense growth is due to the building of the team and the labor involved in positioning us for that growth today and for tomorrow's tremendous opportunities, we are looking at some areas that are higher than they should be running. Again, our expense lines are being scrutinized as much as our revenue line.

In Mexico, revenues grew over 56% in the quarter, with same-store sales of 17%, as 30 stores have been opened in the country this year. Since those new store openings were front-end loaded this year, we expect the dilution in this segment to trend down in the back half of the year and end at our guided number of approximately $0.25 per share. Overall, Mexico generally remains in line with our operating model and we remain excited about the opportunity for growth in the country.

In summary, though not pleased with our current results, we remain confident in the strategies we have developed and are implementing, in particular our smartphone rollout, Acceptance Now's great current and future growth opportunities and the new technology we're unleashing there, and our initiatives are in process to improve -- to continue to improve the core, both from a topline and an expense standpoint.

I'd like to thank our 20,000-plus coworkers for their steadfast commitment with regard to execution of these initiatives and to our great Company in general. And with that, I will turn it over to Guy.

Guy Constant - *Rent-A-Center - EVP Finance, CFO*

Thank you, Mitch, and good morning, everyone.

I'm very fortunate to join the leadership team here at Rent-A-Center at this exciting time in our Company's history. I look forward to working with everyone on the call and I thank those with whom I have already spoken for your genuine welcome to our future partnership.

This morning, I will first walk you through our financial results for the second quarter, after which I will spend a few moments reviewing the updated guidance for 2014. We will then open up the call for your questions.

I would also like to mention that as I refer to our second-quarter performance, either this year or versus a year ago, as well as our outdated full-year guidance, all numbers will be presented on a recurring basis, excluding special items such as the $0.05 restructuring charge related to the closing of 150 stores in the second quarter and the $0.03 charge related to our senior credit facility refinancing in Q1.

As outlined in the press release, total revenues were $773.2 million, an increase of $12.7 million as compared to a year ago. This represents a 1.7% increase, driven by revenue increases of $38.3 million in our Acceptance Now segment and $6.4 million in our Mexico segment, offset by a revenue decrease of $30.4 million in our core US retail segment.

Same-store sales increased 0.6% in the second quarter, as compared to a year ago, driven by an increase of 25.1% in Acceptance Now and a 17% increase in Mexico, partially offset by a 4.7% decrease in our core US retail segment.

As Mitch outlined earlier, our total US revenues, when you include all of our US formats, was up 1.1% versus a year ago, despite the challenging retail environment. We are encouraged that our second-quarter same-store sales numbers represent a sequential improvement of 140 basis points versus the year-over-year change seen in the first quarter a year ago and, on a two-year basis, represent an improvement of over 400 basis points.

Costs of rentals and fees were up 60 basis points versus a year ago, driven by an increased mix of sales in Acceptance Now locations, which carry higher merchandise costs. Cost of merchandise sold was flat compared to a year ago.

Gross profit fell 40 basis points to 69.4%, driven by a higher mix of sales in our faster-growing Acceptance Now business. Salaries and other expenses increased by $29.9 million, or 300 basis points, driven by expenses associated with new store expansion in our Acceptance Now and Mexico segments and store-level investments we are making to execute on our transformational initiatives.

As Mitch mentioned earlier, the impact of fixed-store labor costs on our second-quarter results has highlighted the need to accelerate testing ways that we can bring more flexibility into our store labor model, so that we can discreetly adjust our labor costs commensurate with sales trends broadly, as well as traffic patterns by season, day of week, and even daypart.

General and administrative expenses increased by $7.8 million to $46.1 million, an increase of 100 basis points, due again to investment at the field support center to support expansion in our Acceptance Now and Mexico segments and to support our transformational initiatives.

Operating profit was $44.5 million, a decline of 440 basis points, driven by lower revenues and sales deleverage in our store and field support center labor costs. EBITDA margin for the quarter saw a similar decline.

Interest expense was $11.8 million, an increase of $2 million versus a year ago. In May 2013, we issued $250 million of senior unsecured notes, so we experienced an additional month of interest on those notes this year, as compared to a year ago. The variance was also driven by an increased rate on our senior credit facility.

We will make our 17th consecutive quarterly cash dividend payout later this week, on July 24, and we ended the quarter with approximately $68 million in cash on hand. Our quarter-ending leverage ratio was 3.17, well below our new covenant requirement of 4.5, leaving us well positioned to execute on our initiatives.

Now, onto our guidance for the balance of the year. We now project full-year 2014 total revenue growth to increase between 2.5% and 4%, with Q3 2014 total revenues to be up between 2% and 3%. This includes a same-store sales assumption for the full-year 2014 of plus 1.5% to 2.5% and a third-quarter same-store sales assumption of plus 2% to 3%, representing continued sequential improvement in our one- and two-year same-store sales trends.

By segment, we project Q3 same-store sales for the core US retail segment to decrease 3.5% to 4.5%, Acceptance Now same-store sales to increase between 25% and 30%, and Mexico same-store sales to increase between 15% and 20%. We project full-year 2014 EBITDA of $300 million to $310 million and we project our effective tax rate to be 37% to 38% for the full year and 33% to 34% for the third quarter.

Capital expenditures for the full year are now expected to approximate $95 million.

We project full-year 2014 unit openings in our Acceptance Now business at 190 locations, while our Mexico business will open approximately 30 locations, all of which were already open as of the end of the second quarter.

As Robert and Mitch both outlined, we are disappointed with our second-quarter results. We all share in the urgency to address the opportunities in our business and make the necessary changes to transform our business into one that provides reliable and sustainable EPS growth for the future.

By taking our business and turning it into a returns-focused and disciplined allocator of capital, we believe the revenue growth and margin opportunities exist to prepare our business for the maturation of the core US retail segment. And when combined with what we see as exciting growth opportunities in both our Acceptance Now and international businesses, we believe our Company is poised for that reliable and sustainable EPS growth of which I just spoke.

With that, I will ask Keith to open the line for your questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions). Budd Bugatch, Raymond James.

Budd Bugatch - *Raymond James & Associates - Analyst*

Welcome, Guy, to the call and thank you for taking my questions. I guess, Mitch, you had said something about merchandise held for rent and that's my area of focus. I was a bit spooked by the growth in the core, and you gave a number, I think, of 24.1%. Can you go over what that means and give me a better read on that? And I have a few more questions about that as well.

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

Sure, Budd, good morning. We had -- to build up for the rollout of smartphones this month, in July -- most of them, probably all of them, were in by the end of the June -- it was close to $60 million of inventory in smartphones for the rollout, and that's what drove that number up.

When you back it out, it's about 24.1%, which was a 10 basis-point improvement from last month. So our inventory didn't go up; it was just building up the smartphone -- for the smartphone rollout.

Budd Bugatch - *Raymond James & Associates - Analyst*

24.1% of what, total inventory between on rent and held for rent?

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

Yes.

Budd Bugatch - *Raymond James & Associates - Analyst*

In the core? 24.1% of the core inventory?

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

Yes, compared to the overall core inventory, 24.1% was in held for rent when you back out the smartphones.

Budd Bugatch - *Raymond James & Associates - Analyst*

Okay. And then $60 million, because I calculated about $43 million, if I use that number, so I am just trying to figure out where my difference is on that.

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

You got to add -- you add the held for rent and the on rent together, if you take $60 million out of the held for rent, you'll be in that 24% range.

Budd Bugatch - *Raymond James & Associates - Analyst*

That's what I did.

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

(multiple speakers). And you got to take $60 million out of the held for rent and $60 million out of the total.

Budd Bugatch - *Raymond James & Associates - Analyst*

Okay. All right. You've got to take it out of the numerator and the denominator. Okey-doke on that, and so on the held for rent, can you give us a feel of how much of that is in store and how much of it is in DC, and also, what is the -- how much of it has been previously rented and how much of it is new, other than the $60 million of smartphones?

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

Pretty much other than the smartphones, it's all in the stores, because we don't have DCs. Those smartphones were held primarily at our service centers around the country for distribution out to the stores in July, so it is pretty much all in the stores, except for the smartphones.

The new-to-use mix is consistent with where it has been in the past. In fact, at the end of the quarter with smartphones, it was actually higher than it was a year ago. Backing out the smartphones, it was slightly below where it was a year ago, but pretty much in line, similar to numbers we normally run.

So, it is staying pretty consistent. Again, it was higher if you figure in the smartphones, but without the smartphones, it is very similar to where it has been.

Budd Bugatch - *Raymond James & Associates - Analyst*

And what is that mix that you usually run?

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

It's in the range of 75%/25%. 75% being used and 25% being new is a normal mix for a weekly rent-to-own store.

Budd Bugatch - *Raymond James & Associates - Analyst*

Okay, that's what I was hoping to hear. Can you -- on the -- and if you can go now just to the new kiosks going in, any change, Robert, in the thought about pricing, then, for Acceptance Now to the customer? I think you average around, what, 2.3 and some competitive dynamics we see are in the 1.9 range and 2.1 range.

Robert Davis - *Rent-A-Center - CEO*

I will let Mitch take that question.

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

Right now, we are not making any changes. The technology, as Robert explained, the new technology is going into our manned locations because what we saw in the first number of sources a lift by adding that technology into our manned locations, so we still have the overhead in those locations of the manned kiosks.

If there is any need to take the pricing down, it will be when we are in unmanned kiosks where we don't have the overhead of the labor in the manned kiosks. For right now, the pricing is staying consistent. You are right; some virtual competitors have a little lower turn, if you will, in their number. But again, that's without having the manned support there to help.

So just by adding this technology, we wouldn't be looking at any pricing changes. If there is any, it will come down the road when we are in unmanned, if there is a need then or not. We certainly haven't seen a need to change our pricing at this point.

Budd Bugatch - *Raymond James & Associates - Analyst*

Okay, and my last question just goes on Mexico. You opened up all the stores, but you opened up a bunch of stores in Mexico City, and I expected a faster ramp in Mexico with the Mexico City stores. What has been the experience in Mexico City in the international planning?

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

They have ramped up -- there is only 12 of them in Mexico City out of the 30. They have ramped up a little bit faster than in the rest of the country.

We have been happy with the ramp-up. We are trying to figure out other issues as far as doing business in the city that is that densely populated and so hard to get around. So we're still trying to figure that out. But they have ramped up a little faster.

I don't know that you would see 12 stores ramping up, I don't know, 20% or 30% faster than the other ones. I don't know that you would be able to tell that in a model within three or four months anyhow, but they are ramping up a little bit faster than the rest of the country.

Budd Bugatch - *Raymond James & Associates - Analyst*

But the cost of business is doing higher in a metropolitan area, is that what you are finding?

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

Slightly, yes. Yes, a little bit higher. Not (multiple speakers)

Budd Bugatch - *Raymond James & Associates - Analyst*

Thank you very much. I will let others (multiple speakers). Thank you very much. I will let others speak and good luck on the balance of the year.

Operator

Brad Thomas, KeyBanc Capital.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Good morning, and Guy, welcome to the call.

Guy Constant - *Rent-A-Center - EVP Finance, CFO*

Thanks, Brad.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Just to follow up on some of Budd's questions, I wanted to ask a few follow-ups about the unmanned kiosks. And first, just from an approval and application standpoint, could you tell us if there any differences?

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

In the technology that we are adding into the manned kiosks right now, and we will eventually use in an unmanned space, it is an automated approval, and that would be the biggest difference is having a risk engine in the technology versus the coworkers approving.

And that's probably one of the reasons we are seeing the lift in the manned kiosks; it's faster. The approval process is a matter of seconds versus what the coworkers used to have to do. So that helps us, especially during peak periods. So it's a risk engine versus a manual approval, if you will, Brad.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Great, and then from a collections standpoint, who is doing the calling on the customer from a collections standpoint?

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

That hasn't changed. In our manned kiosks, it -- the coworkers in the store, and then there is some outside support for pickups, but the coworkers in the store do the initial calling. And then, like I said, there is what we call a collection center that supports multiple stores that will go to the consumer's house when they need to, but that hasn't changed.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Okay, great. And then just lastly on Acceptance Now, I know earlier in the year there was explicit revenue guidance. Any update to the total revenue expectation?

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

We decided to put same-store sales in there. It seemed to be more what everybody was focused on is the same-store sales number, rather than just a gross number that is so dependent on how many stores we open and when we open them. And as Robert pointed out, how we are going to -- our plans changed as we saw what this technology did in the manned kiosks.

So, as those changes take place and the numbers of stores change and closures change, we have got -- the same-store sales is the primary focus. Instead of trying to keep updating people on the gross number, we decided same-store sales was what everybody wanted to focus on.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

All right, great. Thank you so much and I will turn it over to somebody else.

Operator

Laura Champine, Canaccord.

Laura Champine - *Canaccord Genuity - Analyst*

Could you give us the reason that -- or the way that you have almost doubled the number of kiosks that you're looking to open this year, relative to your April release?

Robert Davis - *Rent-A-Center - CEO*

Pretty much, it has been demand. And we wanted to -- Laura, we went into this year with opening less stores than we had in the past, 400 a couple of years in a row, and we're only going to open 100 this year. And we're focused on getting the new technology done.

But we also said that we would support our existing retail partners and not take say no to them on any stores they want to go into. So a lot of it has been our existing partners adding stores that weren't in the plan and we don't want to say no to them.

So it really hasn't been a change of strategy as much as just the demand within our existing partners and some relationships we don't want to affect negatively by saying, no, we said we're only going to do 100 this year and we're going to stick to 100. So we are letting it go up to take care of our current -- of the current demand with our current retail partners.

Laura Champine - *Canaccord Genuity - Analyst*

And just so I understand the plan so far, so for now you are putting unmanned kiosk technology into manned locations, and it sounds like there is a plan to eventually convert all the locations to unmanned? Am I hearing you right on that?

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

No, the plan is to get this technology into all of the manned kiosks, because we are getting a lift when we combine the technology with our manned kiosks.

We will have 600 of them done by the end of this year. Actually, going into the fourth quarter, we will have 600 of them done, and then next year, we will finish that, as well as be able to go into unmanned kiosks with that same technology.

But the focus this year, because of the lift, has switched over to putting the technology into the manned kiosks, and starting with the first quarter of 2015 is when we will start to do actually unmanned kiosks in lower volume stores.

Laura Champine - *Canaccord Genuity - Analyst*

Got it. And then, lastly, on the smartphone rollout, how many locations did you test that in? And what was your experience on skips and stolens for smartphones?

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

Great question. We did -- we actually phased a few different tests. Total, it was about 200 stores, and it went -- it goes back about from the very first stores we tested, in about nine months, so we had plenty of testing time in store, and we saw no -- nothing out of the ordinary from a skip and stolen standpoint compared to our normal business.

Laura Champine - *Canaccord Genuity - Analyst*

Got it. Thank you.

Operator

John Baugh, Stifel.

John Baugh - *Stifel Nicolaus - Analyst*

Welcome, Guy. I wanted to follow up on the smartphone, the 10% guidance you thought. Could you give us the building blocks to how do you get to that number?

Robert Davis - *Rent-A-Center - CEO*

Yes, we -- based on the test that Mitch just helped Laura understand, the nine-month testing timeframe, we have seen enough demand for us to believe that over time, it can become 10% of our business. And really, that is backing into how many agreements are on rent. The pricing is about the same from an AP perspective on smartphones as other categories.

And so, from a number of agreements on rent compared to the total agreements in the store, we believe we are going to get up to that approximately 10%, and that will ramp over the course of 12 to 15 months.

John Baugh - *Stifel Nicolaus - Analyst*

Were those 200 stores you just -- I am sorry, those weren't all Mexico or -- I wasn't clear. Were those US stores, some Mexico?

Robert Davis - *Rent-A-Center - CEO*

Those were US stores. We tested it in the Kansas City market, the San Antonio market, as well as Oklahoma market.

John Baugh - *Stifel Nicolaus - Analyst*

Great, thank you. And no new additional stores in the back half of the year in Mexico. Is that just temporary or how do we think about that in the broader context of this could be a 1,000-store market?

Robert Davis - *Rent-A-Center - CEO*

I think what you -- the short answer, John, is that for the back half of this year, we have got 180 stores now that are open. We have opened them very swiftly in a market that was new to us and new to the consumer.

Guy alluded to it some in his prepared comments about becoming returns focused and an efficient allocator of capital. We want to make sure before we make any longer-term decisions on stores in Mexico, Acceptance Now, share repurchase, and the like that we understand the different levers that are available for us to pull.

We still are excited about Mexico, but our intent is to utilize the back half of this year to fortify the ranks and make sure that those stores are delivering the results we expect.

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

And that was our plan at the beginning of the year was to open 30 and get them all done in the first half of the year, to give ourselves some time to do what Robert just spoke about on the back half of the year.

Robert Davis - *Rent-A-Center - CEO*

Right.

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

So that hasn't changed from the beginning of the year.

John Baugh - *Stifel Nicolaus - Analyst*

Great. And then on Acceptance Now, I may be in error here, but I think the EBIT percentage margin is down, and I guess there is infrastructure buildout or whatever. Just help me, is that correct? And how do we separate between the underlying organic model, if you will, versus the incremental one-time expenses in that segment?

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

It is -- the percentage is down. A lot of it is building the infrastructure, John; you are right.

Although, as I mentioned briefly at least in my prepared comments, we are looking at some of that overhead that we have built on how we can take it down, looking at the labor in that model also. Is there a few hours here or there we can take out of the model?

Quite honestly, our losses, we are running slightly higher than we would like and we need to get that down, not that they are charging off more than the -- they have been or more than we charge off in the core, but the percentage is higher because of the cost of the product, so how do we reduce that number and do even better on collections?

So there is a wide range of whether it is overhead, store labor, working on the losses, very focused on the expenses both in the core and in Acceptance Now. But again, most of it is just because of the ramp-up, but that doesn't mean we are satisfied with that. We are looking at some ways to improve that over the back half of the year.

John Baugh - *Stifel Nicolaus - Analyst*

So Mitch, if we were able to look at just Acceptance Now and look at that EBIT line and look at totally organic -- in other words, eliminate the infrastructure build, the margin would have deteriorated slightly meaningfully year over year and it would have done so because losses are higher, and not a lower revenue turn? Help fill in those blanks. Thanks.

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

No, not a lower revenue turn. It would have been down probably on the mature stores less than 100 basis points, so it would have been down slightly, I believe, John, being pretty familiar with the numbers.

Losses are running a little bit higher than last year, and that would have been the biggest component of that less than 100 basis point change that you would see if you were able to split it out. A little bit, also, in store labor. We need to focus on store labor and overtime. It would be between those two areas.

John Baugh - *Stifel Nicolaus - Analyst*

Great, and my last question quickly is just to clarify, the new technology that we are talking about, that's specifically a software program that makes automated approvals.

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

Yes, yes, but it starts with a customer adding their information into the program versus a manual form, pencil and paper form, and goes all the way through the process of payment and so forth. So, it's more than just a risk engine. A risk engine is built in, but it takes the whole process and automates it.

John Baugh - *Stifel Nicolaus - Analyst*

Great, thank you very much for that color. Good luck.

Operator

Carla Casella, JPMorgan.

Carla Casella - *JPMorgan Chase & Co. - Analyst*

One guidance housekeeping question. Do you still -- I didn't hear whether you reaffirmed the free cash flow guidance of negative $65 million?

Guy Constant - *Rent-A-Center - EVP Finance, CFO*

Yes, Carla, our expectation would be that we would come very close to that number still for the balance of the year. So that's unchanged.

Carla Casella - *JPMorgan Chase & Co. - Analyst*

Okay, and then on the competitive standpoint, can you talk about whether you are seeing a larger number of competitive openings or more stores offering installment sales that may also be just dampening the same-store sales?

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

Relative to the core, no, we are not seeing more rent-to-own stores open. The trends have been pretty similar or more stores installment sales.

There is certainly more activity in the retail partners around the Acceptance Now kind of model. There is competitors in that space, although, again, other than our one competitor, Progressive, that Aaron's owns, there really isn't -- everybody else is very, very, very small in that space.

Carla Casella - *JPMorgan Chase & Co. - Analyst*

Okay, and then as you are looking to add new retail partners for that, are you finding that process more competitive in terms of what you have to offer to attract the retailers?

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

Not really, no. The demand is very high.

Carla Casella - *JPMorgan Chase & Co. - Analyst*

Okay, great, and then one smartphone question. The margins built in in the smartphone, would they -- what products would they be most similar to?

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

The core business model. I think Robert had mentioned the AP will be similar and the margins are similar to the core business model.

Robert Davis - *Rent-A-Center - CEO*

Although to the extent there is a higher propensity for those to pay out early, particularly during tax season, the margins will be slightly lower because we have taken the cash price to be a little bit more competitive with retail, as compared to our core products. So to some extent, the cost of goods sold on merchandise sales may be slightly lower.

Carla Casella - *JPMorgan Chase & Co. - Analyst*

Okay, but would it be more like an electronics purchase versus, I guess, a furniture? Margin, I guess?

Robert Davis - *Rent-A-Center - CEO*

It's hard to land on that as a final answer, just because of all the pricing initiatives that we have going on right now. We have several pricing tests that are in flight. Some will address your question longer term and we have not solidified ultimately which of those tests are successful and which ones we need to tweak.

The retention on the smartphones are more like appliances, though, so ultimately the way we have priced it is similar from an AP perspective with every other category, but for now the cash price is slightly lower.

Carla Casella - *JPMorgan Chase & Co. - Analyst*

Okay, and then, just one last one, how much of the deferred tax now have you paid through the year?

Guy Constant - *Rent-A-Center - EVP Finance, CFO*

The vast majority of it we have now paid through the year, so most of that we did in the second quarter.

Carla Casella - *JPMorgan Chase & Co. - Analyst*

Okay, great. Thank you.

Operator

Karru Martinson, Deutsche Bank.

Karru Martinson - *Deutsche Bank - Analyst*

My apologies if I missed it, but I didn't hear if you guys broke out how much was actually spent on the transformational initiatives in that kind of salary and expense line?

Robert Davis - *Rent-A-Center - CEO*

We did not. At investor day, we mentioned it would be about $25 million over the course of the year. Some of that is OpEx; some of it is CapEx.

We do anticipate for 2014 approximately $18 million to $20 million, the majority of which would be in salaries and other and a smaller amount, a few million dollars, in G&A.

Karru Martinson - *Deutsche Bank - Analyst*

Okay, and when I look back at that expense line, we started to see that ramp up in the third quarter last year. As we go forward, do you feel that those comparisons will get easier and the rate of increase that we've been seeing will be slowed, or do you feel these are the kinds of increases we should be modeling in going forward?

Robert Davis - *Rent-A-Center - CEO*

I think the former. It should moderate, to your point, as opposed to have a continued ramp over time, particularly given that the majority of some of the new growth initiatives have been put in for the year, particularly in Mexico. There is still some slight ramp in Acceptance Now in the back half of the year, but as a growth rate, it should moderate over the back half of the year.

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

And that's -- as a growth rate, it would get easier, to your point, Karru, but also as we test around a more flexible labor model, we are going to take some of the pressure off that way and improve -- not just have easier numbers to compare it to, but to also improve our expenses going forward with a more flexible labor model.

Karru Martinson - *Deutsche Bank - Analyst*

Okay, and just on the CapEx revision of $95 million, just a modest drop from the original $100 million, is that just timing or was there any specific projects that were delayed or canceled?

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

No, it's just a minor change. I would probably more describe it as timing and just minor changes to our expectations.

Karru Martinson - *Deutsche Bank - Analyst*

All right, thank you very much, guys. Appreciate it.

Operator

Hale Holden, Barclays.

Hale Holden - *Barclays Capital - Analyst*

Thanks very much for taking the call. I had three quick ones. On the smartphone rollout, I was wondering how the payments there work for you? Do you capture in margin ongoing payments to the carriers? Is there a giveback from the carriers as you sign people up, or is it just simply the rental fee for the hardware?

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

We get a rental fee for the hardware, as well as we collect money for the carrier on the plans if the customer takes a plan and then end up with a commission off of that plan.

Hale Holden - *Barclays Capital - Analyst*

Is your commission dependent on the customer staying on the plan for a certain amount of months?

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

Yes. For as long as they are paying, then we are getting our commission. It will depend on that plan.

Robert Davis - *Rent-A-Center - CEO*

They are prepaid and they're monthly, so it's not like a long-term contract where the customers have to commit to two years to pay. It's one month at a time, basically.

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

And we will get a commission each month.

Hale Holden - *Barclays Capital - Analyst*

Great, thanks. And then, second question is your guidance seems imply a decent sequential uplift in the fourth quarter, if I run your full year versus the third quarter you gave us. And I was wondering, what's driving your confidence there?

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

Certainly the smartphones are a big part of it as those ramp up with the rollout in July. That would be the number one thing.

Some of the other initiatives that we are rolling out that Robert referred to, especially around the price testing, would be the other one. But smartphones would be probably three-quarters of that and then some of the other initiatives that we've been talking about would be the rest of it.

Hale Holden - *Barclays Capital - Analyst*

Okay. And then, last question from us is I was just wondering if you could walk through the difference, again, between the Acceptance Now customer, where only one in four customers don't take the contract to buy out, versus the core, where you see three in four customers give back the product before buyout. I was wondering what drives that delta.

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

I think the -- one, Acceptance Now is a monthly business model versus a weekly model. The consumer went into a retail store primarily to buy versus renting, in that case. Those would be the two main difference.

It is a little bit higher income-level customer, a little bit higher when we go back -- we don't check credit, but when we go back and look at the creditworthiness of the customers, in hindsight the credit scores are higher on the Acceptance Now. The income levels are a little higher. They went in to buy it versus renting in the first place, and hence monthly versus weekly would be the four main things, Hale.

Hale Holden - *Barclays Capital - Analyst*

Great, thank you very much. I appreciate it.

Operator

William Reuter, Bank of America.

William Reuter - *BofA Merrill Lynch - Analyst*

I have a question following up on one of your responses to Carla's question. You talked about there being more activity in your retail partners in the Acceptance Now model, so I assume that this means some of your -- some retailers that are offering some of these services themselves. I guess, is that the case, and then can you talk a little bit about what you're seeing there?

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

No, I am not familiar with any retailers, certainly of any size, offering this themselves.

Our competition in this space really is Progressive. We do share a lot of stores with them where we are both in the same stores and so forth. Of course, we're in there right now with a manned kiosk and they would be just a virtual solution. But I'm not familiar with any retailers doing it on their own versus either us or Progressive.

William Reuter - *BofA Merrill Lynch - Analyst*

Okay. That's useful. And then, I was curious if your credit scores or any of the data on average income of your customers have changed over the last 12 months. Just what you are seeing from that.

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

From the majority of information, we haven't looked at credit scores that recently, but all the other data appears to be the same. There hasn't been much of a change at all in income levels, average age, and all the other demographic stuff we look. We haven't seen a change in the last 12 months. Certainly nothing (multiple speakers)

William Reuter - *BofA Merrill Lynch - Analyst*

Okay. And then, one last one. I think you said that you tested the smartphones over nine months in three different markets -- Kansas City, San Antonio, and one other. Did you say how many stores you tested it in in those markets?

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

About 200 total.

William Reuter - *BofA Merrill Lynch - Analyst*

Okay, that's useful. Thank you very much.

Operator

There are no further questions at this time. I would like to turn the call back over to Mr. Robert Davis.

Robert Davis - *Rent-A-Center - CEO*

Thank you, Keith, and again, thank you, everyone, for joining us. Suffice it to say, as we opened the call, we are disappointed with our results. We understand the urgency to respond and are excited about the opportunities going forward. A lot of good things going on in the Company, and we look forward to updating you on our progress next quarter. Thank you very much.

Operator

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