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RCII - Q1 2015 Rent-A-Center Inc Earnings Call

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OVERVIEW:

RCII reported 1Q15 revenues of $878m.

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CORPORATE PARTICIPANTS

Maureen Short *Rent-A-Center, Inc. - SVP of Finance, Investor Relations & Treasury*

Robert Davis *Rent-A-Center, Inc. - CEO*

Mitch Fadel *Rent-A-Center, Inc. - President & COO*

Guy Constant *Rent-A-Center, Inc. - EVP of Finance & CFO*

CONFERENCE CALL PARTICIPANTS

Brad Thomas *KeyBanc Capital Markets - Analyst*

John Baugh *Stifel Nicolaus - Analyst*

JR Bizzell *Stephens, Inc. - Analyst*

Matt McCall *BB&T Capital Markets - Analyst*

Jason Smith *Cantor Fitzgerald - Analyst*

David Vargas *Raymond James - Analyst*

PRESENTATION

Operator

Good morning, and thank you for holding. Welcome to Rent-A-Center's first-quarter earnings release conference call.

(Operator Instructions)

As a reminder, this conference is being recorded, April 28, 2015. 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, Finance and Chief Financial Officer; and Ms. Maureen Short, Senior Vice President, Finance, Investor Relations and Treasury.

I would now like to turn the conference over to Ms. Short. Please go ahead, ma'am.

Maureen Short - *Rent-A-Center, Inc. - SVP of Finance, Investor Relations & Treasury*

Thank you, Alyssa. Good morning, everyone, and thank you for joining us. You should have received a copy of the earnings release, distributed after market close yesterday, that outlines our operational and financial results that were made in the first 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, 2014. Rent-A-Center undertakes no obligation to publicly update or revise any forward-looking statements.

I'd now like to turn the conference call over to Robert.

Robert Davis - *Rent-A-Center, Inc. - CEO*

Thank you, Maureen, and good morning, everyone. Thank you for joining us. As you know, it has been a year since our Investor Day when we announced our multi-year strategy to improve the performance and profitability of the core business. I'm excited to say that we have made significant progress and are already realizing benefits.

In the first quarter, we beat our revenue and EPS expectations. In the core business, same-store sales swung to the positive, the first time in 11 quarters. Labor costs are lower, we are underway with the margin-driving Flexible Labor and Supply Chain initiatives, and we have taken significant steps to manage smartphone losses.

At the same time, we were able to take the competitive advantage of our Acceptance Now customer value proposition to produce outstanding same-store sales growth, and do so with industry-leading margins. Having the best business model in the space, strong retail partnerships, and the recent expansion of our sales channels uniquely positions the Acceptance Now business to drive even better margins in the future, with continued positive outcomes for our retail partners and the consumer.

As we mentioned on our last call, 2014 saw a number of big wins with our strategic initiatives as we began testing our new Flexible Labor model; launched a new product category, smartphones; hosted our first ever supplier summit; launched promising pricing tests; deployed new technology to nearly half of our existing Acceptance Now staff locations; and launched our new POS system. That momentum continued to build in the first quarter as we rolled out the Flexible Labor initiative to more stores, hit crucial milestones in our sourcing and distribution transformation, and launched our first Acceptance Now direct location, which is what we call our unstaffed locations.

After two pilots of testing, we determined the optimal approach for the structure and roll-out plan of the first phase of our Flexible Labor model initiative. We are currently in 150 stores with the new model as part of our expanded pilot, and the program will be rolled out nationally in June -- faster than originally anticipated -- with part-time coworkers filling open positions as attrition occurs. All part-time coworkers will initially be focused on deliveries, allowing our full-time employees to have more time inside our stores with our customers, focused on sales and collections.

Based on historical attrition rates, we estimate that virtually all core stores will have transitioned to the new model by early 2016. After completion of this first phase, each store will average three part-time coworkers. We remain on track to achieve 100% of the benefits that we originally expected in 2015, and rolling the program out through attrition will be less disruptive to our existing store coworkers and customers. Our field coworkers have embraced our new model and are anxiously awaiting the transition.

As demonstrated in the first quarter, we expect to also continue to capture meaningful labor savings throughout 2015, even before the new Flexible Labor model is fully transitioned. As we have previously mentioned, we believe the annual overtime premium opportunity of $20 million to $25 million from employing this more efficient labor model. Our new model will provide store managers the ability to modify work schedule based on individual store demands. And looking further ahead to future phases, we believe there is additional opportunity by determining the optimal amount of store labor hours.

Moving on to our Sourcing and Distribution initiative, our supply chain and logistics work continues and is on track for full deployment in 2015. In the first quarter, we completed system integration with our third-party logistics provider, NFI. We also finished our initial sourcing waves for several product categories to optimize our products, supply our partners, and gain cost efficiencies from the new supply chain.

On the distribution side, in partnership with NFI, we are well on our way to standing up the US operations. Our first of five US DC's began operations this month. In addition to significant product and distribution cost savings, this supply chain transformation will equip us to quickly react to changes in business trends, better serve our stores and customers, and drive sales growth. We will provide more specific dollar savings after completing the remaining sourcing waves next quarter.

Following the successful pilot tests of our new POS system last quarter, today I'm proud to say that 34 stores are running the new system exclusively as an expanded pilot. General deployment of our new POS system through the remainder of our Core US RTO stores will start midyear and continue throughout this year, giving us the tools to understand and serve customers like never before.

Now, as I referenced earlier, we saw strong revenue growth in our Acceptance Now business in the first quarter. As the innovators of this model -- and given its great success over the past six years since its inception -- it only stands to reason that we began to see competitors enter the space. What our first-quarter results demonstrate is that we have no intention of ceding market share in this space and we expect to expand that share in the coming quarters.

Our staff model is already the preferred option for retail partners that can drive better volumes that can support the associated labor costs with volumes that are as much as eight times the size of the next best direct model. In fact, in locations where our staff model competes directly with the next-best direct model, almost all of the volume runs through our staffed option. We expect to continue to grow with additional partners for our staff model, as well as continuing to seek efficiencies that will allow us to use the staff model in a greater number of locations.

At the same time, we have now started the rollout of our direct model to those locations that don't have the volumes to support our staff model. This new approach will allow us to both secure new retail partnerships as well as expand the number of locations for Acceptance Now within our current retail partnerships. And the future of this model will include the ability to take our long and differentiated history with unbanked customers and include them in the direct solution, allowing us, as with our staff model, to approve significantly more customers than any other competitor, making us the preferred option for this set of retail partners as well.

In short, we believe we have the best mousetrap in the industry. And we are the player with the history and knowledge of the unbanked customer, allowing us to deliver the volumes to retailers that no one else can -- a competitive advantage that we fully intend to leverage. Additionally, we began online approvals via the website of several third-party retail partners, leveraging our proprietary application decision engine. This allows visitors to our retailer partner websites to select a rent-to-own payment option while shopping online.

In summary, our focus continues to be on achieving the desired balance between sales growth and margin improvement, while providing a better experience for our customers and coworkers. We are making tremendous progress on our strategic initiatives and, as CEO, on behalf of my management team, I want to acknowledge all of the great folks -- both in the field and at our field support center -- that are making this happen. Thank you for your dedication and commitment toward delivering on our initiatives and providing our customers the level of service that they deserve.

Now, I'll turn the call over to Mitch to provide more detail in the quarter and an update on some of our other exciting initiatives. Mitch?

Mitch Fadel - *Rent-A-Center, Inc. - President & COO*

Thanks, Robert, and good morning, everyone. In the first quarter, we continued to make significant progress on improving top-line performance in the Core business. Core same-store sales were up 1%, primarily due to smartphones and higher merchandise sales. Rental and fee revenue was flat in the quarter, and smartphones were over 8% of our total Core revenue.

Merchandise sales were up more than we anticipated, primarily due to lower pricing on smartphones. We continue to optimize our pricing strategies and have taken opportunistic actions based on our test results. Ownership rates are up and our new-to-use product mix is better, both of which are good for our customers and for our future business. Our Core US rent-to-own skip/stolen losses came in at 3.8% in the quarter, 100 basis points higher than the same period last year, driven by smartphones. In April, we added the smartphone device protection locking feature as a way to protect our customers from theft, as well as minimize our losses if customers fall past due.

We expect this, along with the registering of phones that we talked about last quarter, will help mitigate smartphones skip/stolen losses going forward. We continue to believe that our smartphone business is driving significant incremental revenue and operating profit growth. About 25% of our customers who rent smartphones are new customers and about 50% of them take on an additional agreement, so expanding our customer base and effectively upselling additional products. Smartphones remains a strong category for us, even with lower gross margin percent and higher losses.

Our inventory held for rent is running higher than last year due to the smartphone inventory, which -- that will continue until we start to comp over the rollout in the third quarter. Excluding smartphones, though, and also excluding our second-quarter promotional buys that are going through our distribution network, our held-for-rent Core store inventory was 24.2%, essentially flat to where it was at the end of Q1 last year with that, but with a higher new-to-use mix that I already mentioned.

Moving on to Acceptance Now, same-store sales were up significantly versus previous quarters, at 34.1%, due primarily to the increase in the 90-day option transactions. The 90-day option pricing is now offered in about 80% of our locations, and the incremental revenue and number of customers exercising the offer exceeded our expectations during the first quarter.

The rollout of our iPad-based customer approval engine and agreement tool at nearly half of our Acceptance Now staff locations last year also continues to drive a lift in business due to our improved customer experience and shorter transaction times. Now, regarding the rollout of our new Acceptance Now direct sales channel that Robert mentioned, I'm thrilled to report that we've successfully launched our first 10 of these direct locations and we expect to have more than 1,150 in place by the end of this year. We will also continue to build on the success of our staffed Acceptance Now model by opening 150 new staffed locations.

The pipeline of retailers interested in adding the staffed model remains robust, for the reasons Robert mentioned. And, in the first quarter, we opened 53 new staffed locations. Expanding our sales channels by adding the direct option will also help us optimize all of our locations.

As you are aware, our Acceptance Now team has been focused on bringing our skip/stolen losses back in line by improving execution. The skip/stolens in Acceptance Now for the first quarter were 7.7%, up 120 basis points year over year, but down 260 basis points sequentially. And I'm pleased to report that we exceeded our expectation of being flat by the end of Q1 since we had better skip/stolen losses year over year in March, and we expect this trend to continue for the balance of the year. So good news there.

In Mexico, we continue to implement improvements to optimize our business model and increase profitability. New approval standards were instituted nationwide, and we are testing a centralized approval process with the intention of reducing our credit exposure and bringing additional efficiencies to our store labor model. Our short-term results have shown an overall decline in approved applications but, also, positive early indicators in the performance of the portfolio.

Even with the new approval standards, when we calculate Mexico same-store sales using a constant currency -- in other words in pesos -- we still had a 15% same-store sale increase. We will continue to monitor the results of our new approval criteria to evaluate the overall and long-term impacts on the business. Our actions in Mexico demonstrate our overall focus on balancing sales growth and margin improvement, as Robert mentioned.

Additionally, Robert mentioned last year that we were pausing on new store openings in Mexico so that we can improve the profitability of the business before making further investments. We believe that, by year end, we should have enough information to determine the right go-forward strategy.

In summary, we've stabilized Core revenue and are well on the way of implementing our strategic initiatives to grow profitably. Acceptance Now continues to grow market share at industry-leading margins. And we plan to optimize our offerings to further enhance profitability in the future, as well as getting those skips and stolens in line in the first quarter as we discussed.

Thanks to our 20,000-plus coworkers for their hard work and dedication improving our business and passionately serving our customers. And, with that update, now I'll turn the call over to Guy to discuss our quarterly financial performance.

Guy Constant - *Rent-A-Center, Inc. - EVP of Finance & CFO*

Thank you, Mitch, and good morning, everyone. This morning I'll walk you through the highlights of our financial results for the first quarter. I'd also like to mention that, as I refer to our first-quarter performance -- either this year or versus a year ago -- all numbers will be presented on a recurring basis, excluding special items.

As outlined in the press release, total revenues were $878 million, which represents a 5.9% increase, driven by revenue increases in our Acceptance Now and Mexico segments, and the same-store sales increase in our Core US retail segment, offset by the impact of the 150-store consolidation we completed in the second quarter of 2014. We are encouraged that our first-quarter consolidated same-store sales numbers represent a sequential improvement of over 300 basis points versus the year-over-year change seen last quarter, accelerating a further 50 basis points from the end of the fourth quarter.

Our total US same-store sales, when you include all of our US formats, was up about 8% versus a year ago, the fourth consecutive quarter with a year-over-year increase and representing a sequential improvement of over 300 basis points when compared to the fourth quarter. And, on a two-year basis, same-store sales in the Core began showing sequential improvement versus the previous quarter, up 100 basis points in Q1 versus Q4. In fact, since the first quarter of 2014, two-year comp sales in the Core have improved by 970 basis points.

We now expect consolidated revenue to be at the high end of our guidance range, due to higher Acceptance Now revenue, which we now project to be between $850 million and $875 million for the full year, offset by gross profit margins that we project to decline more than the 50 to 100 basis points we outlined in February.

Now, turning to the expense side of the business, gross profit dollars were up by $2 million, and gross profit margin fell 360 basis points to 64.3%. Our Acceptance Now segment experienced gross profit growth of $16.8 million, however, at lower gross profit margins, which were down 590 basis points, both driven by the growth of our 90-day option pricing, particularly in Q1, with the seasonally higher mix of merchandise sales. In the Core, segment gross profit dollars dropped by $15.7 million, and gross profit margin fell 170 basis points. While the lower gross profit dollars are caused largely by lower store count, the higher mix of smartphones is driving the gross profit margin decline due to lower 90-day prices in that category.

We are encouraged with the growing customer base as evidenced by our strong comp store sales. However, as Robert outlined previously, we are executing on initiatives to optimize our gross profit margins.

Store labor, which includes the expenses associated with coworkers at our stores and at the district manager level, decreased by $5 million, to 25.4% of store revenues, an improvement of 210 basis points versus last year. Store labor in our Core segment was down $9.3 million, an improvement of 120 basis points, and was positively impacted by lower store count year over year and labor-hour reductions that occurred in the second half of 2014.

In our Acceptance Now segment, while labor was up $4.5 million, we continue to see improved leverage in the business, with labor better by 330 basis points versus a year ago. Other store expenses, which include expenses related to occupancy, skip/stolen losses, advertising, delivery costs, and utilities, were up $9 million, but 50 basis points better than a year ago, driven primarily by lower store count in the Core and lower fuel prices, partially offset by skip/stolen losses in Acceptance Now and a higher mix of smartphones in the Core business.

We ended the quarter with approximately $93 million in cash and cash equivalents, and our quarter-ending leverage ratio was 2.92 times, well below our covenant requirement of 4.5 times and down more than 6/10 of a turn as compared to the end of 2014. This includes $120 million drawn on our revolving credit facility as of the end of the quarter, leaving approximately $450 million of available capacity.

Similar to last quarter, at the conclusion of the call we'll be posting quarterly financials by segment to our website located at investor.rentacenter.com. With that, I'll turn the call back over to Alyssa to open the line for questions.

QUESTIONS AND ANSWERS

Operator

Thank you.

(Operator Instructions)

Brad Thomas, KeyBanc Capital Markets.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Wanted to first just dig in on trends within the core segment, if I could. You've obviously quantified the impact of phones, and alluded to early payouts and the quality of the rental agreements outstanding as of the end of the quarter. But I was hoping you could just give a little bit more color on the cadence of business in the quarter, ex some of these one-time items, and your thoughts as we move into 2Q?

Robert Davis - *Rent-A-Center, Inc. - CEO*

Well, as I said, Brad, the rental and fee revenue was flat. We had a positive same-store sales, based on merchandise sales. So, just the rental and fee, which is the recurring piece, was flat.

So, we certainly see good things ahead. It's the first time we've been at these levels, like we said earlier, in 11 quarters. So, certainly see positive things -- saw positive things in the first quarter, and on the horizon.

The demand is there; it's been solid. Some of our initiatives, from a pricing standpoint, are starting to -- we're starting to implement some of the things we learned in testing. Like I said, from a pricing standpoint, smartphones obviously has helped, but other categories are performing strong, too, so, feel like we've turned the corner in the core, for sure.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Great. And then a follow-up on the flexible labor: I recognize it's early, but could you talk a little bit about -- at a per-store level, if you get up to three part-time employees, what is the savings per store on a net basis that you think you will realize? And what, if any, benefits to revenues and the customer experience do you think you might see from doing this as well?

Guy Constant - *Rent-A-Center, Inc. - EVP of Finance & CFO*

Brad, this is Guy. Let me maybe cover the second half, first.

As we roll out the initiative, and we've commented on this before, there's a wrong way to go and get costs in these businesses, and we certainly have our eyes towards making sure that any time we make changes to the labor model in the store, what we're doing will benefit the customer, as well as the coworker. And so, these changes that we've got, we think will allow us to staff more appropriately for the patterns of demand that we see in the Business, whether it's by season or by day of week or even by daypart.

One of the challenges we have today with the full-time model is that it doesn't give us a lot of flexibility to adjust our staffing during the week; so, often we have to have too many people on in the middle of the week when we are not as busy, and we don't have enough people on, on the weekends, when we're busier. By introducing some part-time labor, it enables us to have a higher number of people in the store at the times when we're busy, which we think will be good for customers. We really filter every initiative that way, whether it's the labor model or the new supply chain model -- any changes we make -- while certainly cost savers are a nice driver of what we're doing, we also want to make sure that we benefit the customer as well.

Long term in terms of the benefit that we see, Robert talked about the $20 million to $25 million of overtime, but he also mentioned that that's really the first phase and the most obvious opportunity that we can generate. Once we've got the part-time labor in the stores, we think the managers will seize the opportunity to flex that labor and, again, staff it when needed. And then the stores that perhaps don't have as high a volume, it will give us an opportunity to flex hours down, and in the stores where we do have higher volume, we can flex those labor hours up.

So, we think the opportunity is greater than the $20 million to $25 million, but that's what we can identify in the first phase just by removing the overtime.

Brad Thomas - *KeyBanc Capital Markets - Analyst*

Great. Thank you very much.

Operator

John Baugh, Stifel.

John Baugh - *Stifel Nicolaus - Analyst*

I wonder if you could comment more specifically on, quote, unquote, pricing initiatives in the core business and overall? Are you taking prices up -- some up, some down? And then, specifically what you're doing with pricing on smartphones?

Mitch Fadel - *Rent-A-Center, Inc. - President & COO*

John, it is a mix. As you know, for a long time we used a cost-base formula, pretty much for every category. We've referred to it as a two-by-two formula, and those kind of things.

It's much different as we test some of these things. Some categories are up, some are down, some are being used as traffic drivers. Some are being used to improve the margins.

There's a lot of different levers. We talk about rate term. What's the same as cash -- the 90-day same-as-cash factor? It's different on different products; whether it's 50% of the rent-to-own amount, maybe 40%, maybe 60%. So, using much more customer-centric pricing, and using -- the levers can be different in any category.

Like I said, not just rate -- about term, and cash pricing, and what's the early purchase option percentage and so forth? So, much more customer-centric, or fully customer-centric, and not just cost based. Like I said, some drive margins, some drive traffic.

And we are focused not only on driving business, but also retention -- how long the customer keeps it and so forth. And you can drive retention with, again, not just rate, but term and what the opportunities are to pay out the product for the customer also. So, focus on the customer, not only from a demand standpoint, but a retention standpoint.

So, I know that's a strategy answer to a question, but it really does depend. Some things are up, and some things are down. It depends whether you're talking about whether that category is targeted from a retention standpoint or a demand standpoint and the like.

John Baugh - *Stifel Nicolaus - Analyst*

So, Mitch, are prices, net-net, going up, flat, down -- any kind of guidance there?

Mitch Fadel - *Rent-A-Center, Inc. - President & COO*

I think from a rate standpoint, they're slightly down, if you think about it from rate, primarily because of deflation on the electronics side. But it's slight. And it is about deflation on, primarily, televisions. But overall, we're looking at margin per agreement being higher from a retention standpoint and so forth. So, slightly down, but really it's pretty slight, John, driven by deflation more than anything.

John Baugh - *Stifel Nicolaus - Analyst*

Okay, thank you. And then, on the Acceptance Now, you mentioned the direct locations you hope to have; I think it was 1,150 by year end. I'm curious, how many of those, roughly, would be with new retail merchant partners versus existing?

Mitch Fadel - *Rent-A-Center, Inc. - President & COO*

Well, there is a lot of fill-in with existing, but most will be with new partners and new stores.

John Baugh - *Stifel Nicolaus - Analyst*

Okay. And then, could you comment on Acceptance Now? Again, in locations where you had the 90-day same-as-cash option or retail merchant partners where you had that program a year ago, if you did, did their usage of that option go up? Or is this strictly an influence of your -- I think you mentioned 80% now, converting more retail merchant partners? And I guess where does that number top out timing-wise and numerically? Thank you.

Mitch Fadel - *Rent-A-Center, Inc. - President & COO*

I think the 80% is all incremental year over year. We really didn't have anybody on the 90-day option in the first quarter a year ago.

I don't see it changing a whole lot from here, at 80%. It's going to fluctuate probably between 80% and 90%, but we're pretty much there.

I'll remind you that the first quarter, from a gross margin percentage basis, is going to be the worst quarter because more people are going to be able to exercise the 90-day option in the first quarter because of income tax returns than any other time of the year, so we'll see margins go up from here. I think this is the low point, for that income tax reason. And certainly driving much more from a gross margin dollar standpoint.

I think we also mentioned that, even having said that, even though they're naturally going to go up the next three quarters of the year, we're still working on ways to improve the gross margin business there, and tweaking some of the offering to improve that. So, it's going to go up naturally, but we're still working on some things that we're going to implement that will drive it even higher.

John Baugh - *Stifel Nicolaus - Analyst*

Thanks for answering my questions, appreciate it.

Operator

JR Bizzell, Stephens, Inc.

JR Bizzell - *Stephens, Inc. - Analyst*

Something I was interested in, and wanted to talk about -- the Acceptance Now growth is impressive, and just wondering if you could dig in a little bit deeper on what you're seeing there, and the cadence? And is this maturation that you spoke to in the release -- is that something we should expect to continue to accelerate, and just more detail around Acceptance Now growth moving forward?

Mitch Fadel - *Rent-A-Center, Inc. - President & COO*

It's certainly been good, JR. That's for sure. And the demand is high.

We read the same reports that everyone else does, that subprime credit's getting a little easier. And we get asked the question a whole lot -- if that's going to hurt us yet. The demand is as strong as ever with our retail partners, as far as people coming to our option, which obviously doesn't require credit.

So, the demand is very strong; the demand model, as Robert talked about -- our staff model's just worked very well. We approve more than anyone in the industry because -- for a couple reasons. One, we have a person there in that instance, but also because we approve unbanked customers.

We've got the collections back in line. Like I said, we beat March by 50 basis points year over year, which had been a big issue for us, but the team really focused and executed well on that. And the demand is high, and we see nothing but continued growth.

Now we're adding the direct channel for the stores that don't have enough volume for the staff model. As Robert mentioned, the staff model does somewhere around 8 times more than the competitive models. And we expect our direct model to do more than the competitive direct models as well. So, a lot of exciting things there going on.

And when you can accelerate same-store sales in a period where there's less -- the stores are maturing -- that's pretty impressive in this business, when you've got a maturing group -- not that they are mature, but they're more mature than they were a year ago, yet same-store sales accelerate. That's a pretty impressive performance by that team.

Robert Davis - *Rent-A-Center, Inc. - CEO*

Highest levels of approvals in revenue, along with highest margins. Sometimes you go with lower margin for higher revenue; we've got both.

Mitch Fadel - *Rent-A-Center, Inc. - President & COO*

Great point.

JR Bizzell - *Stephens, Inc. - Analyst*

Thanks for the detail there. Kind of building on that, in this direct -- because I think you all are excited about that model as well, and the opportunity that creates. Just to clarify: The direct model that you're testing now is only in current customers, and not new customers, correct?

Mitch Fadel - *Rent-A-Center, Inc. - President & COO*

I think the 10 stores -- I think one of them is a new customer that were in already in this test. So, yes, we're actually testing it with a new partner here in the Dallas area.

JR Bizzell - *Stephens, Inc. - Analyst*

And I know it's probably early, but feedback from those retailers that are testing it? And then, what you are seeing -- if you can talk about it -- the acceptance trends and the credit trends? I know it's really early, but your expeditions there around that direct model?

Mitch Fadel - *Rent-A-Center, Inc. - President & COO*

Well, it's certainly early. It's only been a few weeks that we've been in these stores. So, I don't have a lot of feedback there.

We certainly anticipate it being lower volume than demand model. It will be lower model than the staff model. We're starting out with only the banked customer; unbanked will come in a later phase.

But nothing surprising us in the first couple weeks. There's business there. Again, it won't do what the staff model does, but then again you don't have the overhead of people either. We are putting it in stores that can't justify the overhead of putting in the staff. So far, so good, JR -- don't have a lot more detail because it's only been a couple of weeks, but we're excited that the tool's working, and we're also excited to be adding unbanked here in the next phase.

JR Bizzell - *Stephens, Inc. - Analyst*

Great. Last one for me, and on this direct model -- have you been out marketing it to additional third-party retailers? Is the pipeline starting to build? And if so, give us an update there?

Mitch Fadel - *Rent-A-Center, Inc. - President & COO*

Yes. We talked about having 1,150 of them by the end of the year, and that's based on the demand and commitments we have from third-party retailers. That's not just an estimate. Those are commitments from third-party retailers.

JR Bizzell - *Stephens, Inc. - Analyst*

Okay. Great. Thanks for an impressive quarter.

Operator

Matt McCall, BB&T Capital.

Matt McCall - *BB&T Capital Markets - Analyst*

Can we go back to the 90-day initiatives? I think, you talked about margins naturally improving, but can you talk about the progress on the other things that you're doing? How we should expect the margin progression, both naturally and from some of the initiatives, to improve that profitability?

Mitch Fadel - *Rent-A-Center, Inc. - President & COO*

Well, we don't have exact numbers to give you at this point. We're still tweaking a few things. We're negotiating with some retail partners on how to use that 90- day option, as far as what we pay for the product if the customer exercises that? What our markup is, potentially, on 90-day? There's different fees that we are testing and so forth. So, there's a lot going on there, moving that.

Suffice it to say, there will be an improved margin as we move forward, not just because of the timing -- and naturally it gets better in the second quarter and third and fourth after the income tax money runs out -- it will be also because we are tweaking the model. But more specifics than that -- probably we'd be able to talk more about that, Matt, next quarter, after we implement them.

Matt McCall - *BB&T Capital Markets - Analyst*

Okay. All right. That's fair.

Guy, maybe one for you: G&A was a little better than we thought. I don't know if there was -- if I looked at the seasonality wrong, but I think you gave some guidance last quarter on what the G&A line's going to look like for the full year. Is there anything that's changed there?

And then, I know it was up year over year for 2015 versus 2014. How should we think about 2016? How much of that ramp in spending is temporary?

Guy Constant - *Rent-A-Center, Inc. - EVP of Finance & CFO*

Well, for the full year, Matt, no real change to what we are thinking for G&A for the full year. So, any fluctuations that you get during the year are probably more timing, not necessarily anything else.

As for 2016, it's a little early, but certainly some of the G&A we have is associated with now the operationalization -- I don't know if that's a word -- but moving from development to operationalizing some of the initiatives we've got right now. So, things that might have been capital as they were in development before, now moving on to expense as we start to execute on them.

But there is some one-time nature in the standing up of that, that we hope will allow us, going forward, to start moving G&A down. But some of it will be ongoing as we now put things into full operation, like sourcing and distribution, or like additional recruiting, for example, that we have to do to add more staff into our stores on a part-time basis. But that's how I would see it moving forward for 2016.

Matt McCall - *BB&T Capital Markets - Analyst*

Okay. And when you talk about G&A going down, is that dollars or is that percent of sales?

Guy Constant - *Rent-A-Center, Inc. - EVP of Finance & CFO*

Both.

Matt McCall - *BB&T Capital Markets - Analyst*

Okay, sorry.

I guess the next one is Mexico. Can you talk about the plans there? As we look at it into next year, I know there's some initiatives going on, both top line and profitability. How should we look at just broadly the profitability trends, 2016 versus 2015, or 2015 versus 2014? How do you expect that to progress?

Mitch Fadel - *Rent-A-Center, Inc. - President & COO*

Well, certainly we'd expect it to be better as the stores mature. You can see in the first quarter, from a year-over-year standpoint, the improvement almost cut the losses in half -- the operating losses in half. As we mentioned, we are evaluating the operations, testing some things on approvals, as well as centralized approval process, and doing some different things on collections in the portfolio. So, working on some things to improve the operation down there.

And as we've said, by the end of the year we'll have enough information, enough data to figure out the go-forward strategy. As far as how 2016 looks, we don't know until we get to the end of this year, and know what our go-forward strategy is. But suffice it to say, we anticipate the operating loss to go down quarter over quarter, and continue to go down from a sequential standpoint.

Matt McCall - *BB&T Capital Markets - Analyst*

Okay. All right. Thank you, Mitch.

Operator

Laura Champine, Cantor Fitzgerald.

Jason Smith - *Cantor Fitzgerald - Analyst*

This is Jason Smith on for Laura. Thanks for taking my questions.

First question -- just to get a sense as to what percentage of sales are currently being sourced through NFI?

Mitch Fadel - *Rent-A-Center, Inc. - President & COO*

Well, we just started with NFI -- just this month. We'll end up with five distribution points.

I mentioned, when I was talking about our core-store inventory, some of our product already being in our distribution network, and that's product that's in our service centers that goes -- primarily it's product that's in our service centers, because we've been using them also to distribute product. Once NFI's up and running, they'll still be a small piece of the distribution network. Right now they're all of our distribution network, until NFI is up and running by the end of July.

So, the little bit of distribution we're doing now is through our service centers, where we make bulk buys and they deliver them. As they return repaired product to the stores, they'll also deliver some product. So, there's a little bit of distribution going on through service, but NFI will be up and running by the end of July.

Robert Davis - *Rent-A-Center, Inc. - CEO*

But ultimately, the majority of all of our sales will be going through the NFI network, other than a couple of small --

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Mitch Fadel - *Rent-A-Center, Inc. - President & COO*

Correct, yes, once it's up and running, by the end of July, right.

Jason Smith - *Cantor Fitzgerald - Analyst*

Got it. And then, if I could just ask a question on charge-offs, specifically with smartphones -- you guys have been doing the registry now for at least a quarter. Just trying to get a sense -- do you guys have any idea if that's had an impact, or what kind of impact that's had?

Mitch Fadel - *Rent-A-Center, Inc. - President & COO*

It has had an impact. In fact, it's over $100,000 already in recaptured phones from that; not a huge number, but we'll take it.

We expect the locking device that started -- that's being implemented in April -- is just about fully implemented, as we speak, in every store right now. That's for the safety of the customer; if they lose their phone, we can lock it. But also if they go past-due a certain amount of days, we can lock it.

So, we think that's going to have a bigger impact than the registry. Registry's having some impact, but we think the locking device -- and the early indications of what we've seen already this month, the locking device is going to have even a bigger impact than the registry.

Jason Smith - *Cantor Fitzgerald - Analyst*

Okay. Great. Thank you.

Operator

Budd Bugatch, Raymond James.

David Vargas - *Raymond James - Analyst*

This is David Vargas on for Budd.

I had a quick question on the gross margin guidance. You said it was going to be lower than the previous guidance range of down 50 to 100 basis points. I was wondering if you could quantify that, at all? Are we looking at now maybe 150 basis points of contraction, and what's driving the change?

Guy Constant - *Rent-A-Center, Inc. - EVP of Finance & CFO*

Hey, Jason, it's Guy. No, we aren't going to quantify it beyond that; but, as Mitch said, the first quarter is going to be our poorest quarter in terms of the gross margin perspective, simply because of the higher percentage of merchandise sales as a part of our mix. So, clearly that was quite a bit below the 50- to 100-basis-point guidance that we gave, but certainly we expect that to get better through the balance of the year. But we don't think it's going to get back within that 50- to 100-basis-point decline that we had in the original guidance.

In terms of what's driving it, the 90-day cash option in Acceptance Now is a big driver of that -- better for gross profit dollars, but poorer for gross profit margins. And then on the core side, smartphones obviously carry with it a little bit lower gross profit margin, and is becoming a greater and greater mix of our sales. But that was expected as we entered into the year, as well.

David Vargas - *Raymond James - Analyst*

Got it. Thanks. And then, on smartphones, what are you seeing in terms of how many of the agreements resulting in customers taking ownership? What percentage are returned? And of the smartphones that come back for re-rent, how are the re-rental rates in terms of price and being able to get those phones back out into the market?

Mitch Fadel - *Rent-A-Center, Inc. - President & COO*

The ownership rates run -- as far as exercising a 90-day option -- run slightly higher than our other products; not dramatically different, but it is higher. More customers take them to ownership, which is a good thing.

As far as re-renting them, we're not having any problem re-renting them. We have a program where they come back, they get refurbished, they get re-boxed -- a return-to-new program, if you will, is what we call it. And they're not sitting around any longer than other products, from an idle standpoint.

It's tricky; as new models come out, from a pricing standpoint, you do end up having lower margins maybe on the older phones. So, you've got to build that in on the front end -- get your margins a little more up front.

But overall, ownership numbers are slightly better than the other categories. And they're not sitting around on a piece count standpoint any longer than anything else. And, like I said, our return-to-new program seems to be working pretty well.

David Vargas - *Raymond James - Analyst*

Thanks. And then one final question on Acceptance Now direct -- you mentioned that one of the customers for that direct model is a brand-new customer to the Firm in the Dallas area. What kind of retailer is that? Is it furniture? Is it electronics? Can you give that information?

Mitch Fadel - *Rent-A-Center, Inc. - President & COO*

It's a local furniture -- regional furniture store.

David Vargas - *Raymond James - Analyst*

Regional furniture. Okay. Thank you very much. Congratulations on the quarter.

Operator

This concludes the time we have for questions today. I will now turn the call to Robert Davis, CEO, for closing remarks.

Robert Davis - *Rent-A-Center, Inc. - CEO*

Thank you, Alyssa, and thank you, everyone, for joining us this morning.

As you can see by the results, we are pleased with the quarter. However, we recognize there's opportunity for continued improvement in some of the areas we discussed: margins, losses that continue to trend more positively than it has last couple of quarters. So, overall very pleased, and we are on the cusp of -- the next couple of quarters -- some of our strategic initiatives coming online and having a meaningful impact to the Business. So, we're excited about where we are; we're optimistic about the future; and appreciate your support and continued interest in Rent-A-Center, as well. Have a great day.

Operator

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