Rent-a-Center (RCII)

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Rent-a-Center (RCII)
Stock Price: $31.05
Diluted Shares: 55.3MM
Market Cap: $1.7BN
Cash: $53MM
Debt: $833MM ($194MM outstanding on term loan [most of which is due in 2016]; $89MM drawn from revolver [expires July 2016]; $300MM 6.625% senior notes due Nov 2020; $250MM 4.75% senior notes due May 2021)
Other Liabilities, not including Deferred Taxes: $307MM
EV: $2.8BN
2013 EBITDA: $334MM
Multiple: 8.4x

> How do you make a million dollars? Sell to rich people.
> How do you make a billion dollars? Sell to poor people.
> - *Somebody somewhere*

Rent-a-Center is an industry leading brand in the rent-to-own category with more than double the store count of Aarons (#2 competitor) and 5x the store count of competitors #3-#8 combined (RCII rolled-up the industry from 1993 – 2006). Their core customer is a sub-prime borrower (target 35% of US 310MM population; 50% of MX 110MM population) who rents for 4-5 months on average (only 25% choose to buy) – furniture is 37% of rental revenues, electronics are 30%, appliances 18% and computers 15%. Customers pay in advance either weekly (85% of agreements), semi-monthly or on a monthly basis.

RCII is not a new idea – the US "core" is an established business without many growth opportunities that generates significant FCF. But there are two things happening at RCII that many who don't follow the story (not covered by any major banks) are missing: RAC Acceptance and Mexico.

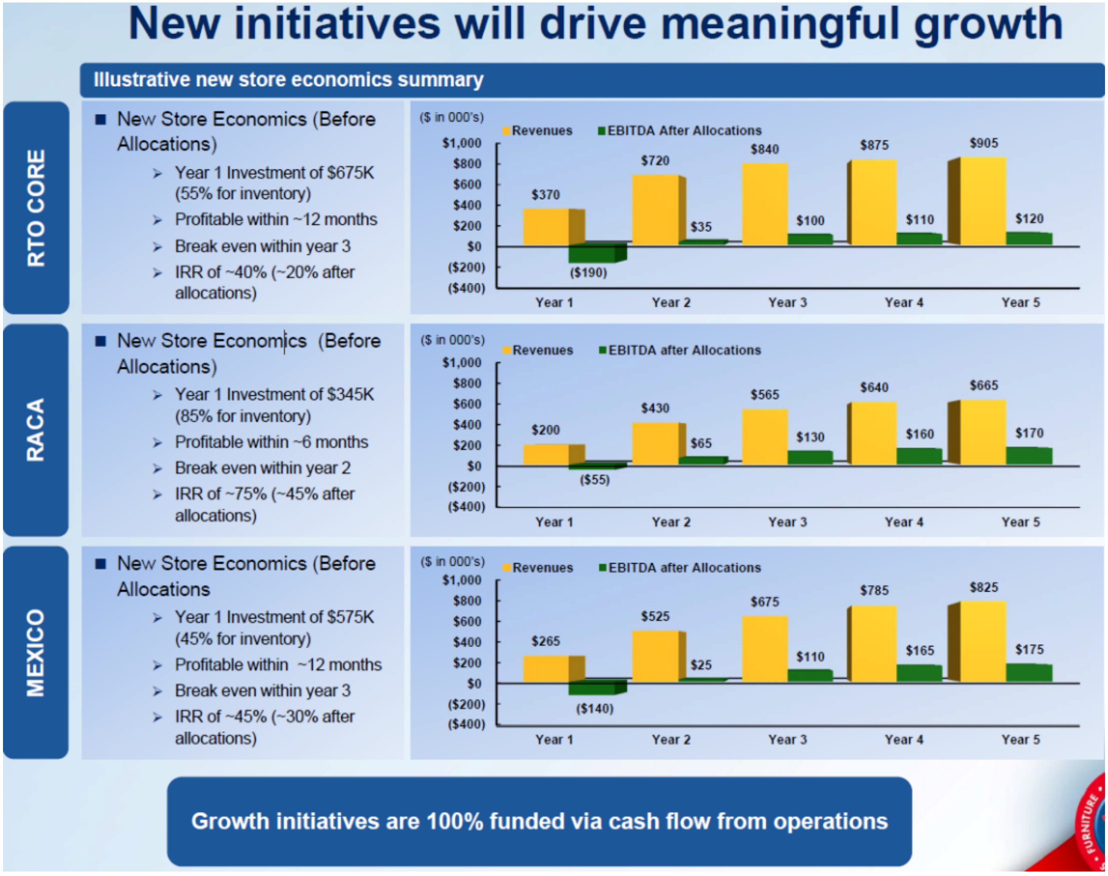
1. The **RAC Acceptance** model is simple: partner with a retailer (lease-free), set up a kiosk inside a store, add a computer and chair, man it with an employee and capture the sales of customers that need credit but don't qualify for the store's credit program (and

typically would be turned away). The retailer “saves the sale” (RCII buys the inventory item directly from the retailer) and RCII gets another customer that is likely outside of its traditional customer base. RAC Acceptance is seeing ~50% conversion rates and now has 1,254 locations (+925 kiosks at +210 furniture partners; +325 kiosks at +20 electronics / appliance partners) from only 384 at year end 2010.

2. **Mexico**: RCII has grown its store count from 5 stores at year end 2010 to 150 today. Mexico is a key expansion opportunity for the company, who believes they can get to 1,000 stores and $1BN in revenue. Commentary on the last call was that RCII expects to achieve “breakeven” for the first time in December 2013 (I put “breakeven” in quotes because it doesn’t include an allocation of corporate overhead and as they continue to reinvest in new stores they will lose money; I suspect overall profit is still a few years out, but that depends on growth). We’ll be hearing more about this segment in a few weeks – the company reports on 27-Jan-14.

What’s interesting about both of these growth initiatives is how capital efficient they are – as if the core RCII business wasn’t capital efficient enough! Here are the numbers:

- **Core US business (81% of revenue; 80% of EBIT):** $675k to open a new store (55% of that is inventory purchase), profitable on a monthly basis in month 12, breakeven after 3 years. Typically 5 year lease with 3-5 year option. 4,700 sq ft.
- **RAC Acceptance (16% of revenue; 33% of EBIT):** No lease signed, no rent, can open and close locations easily, $345k to open a new store (85% of that is inventory purchase), profitable on a monthly basis in month 6, breakeven during year 2.
- **Mexico (2% of revenue; negative contributor to EBIT):** $575k to open a new store (45% of that is inventory purchase), profitable on a monthly basis in month 12, breakeven after 3 years.



As you can see in the slide above, RCII's growth initiatives are 100% financed with existing cash flows from the core business.

In MX, the growth is at a very early stage. The company believes it can add 850 more stores to today's store count of 150 (makes sense, MX is 1/3 the size of the US). They are focused on ramping up – 48 stores were added in 2012 and 60 were added through 3Q13. In the last call, the CEO said: "given our continued confidence in Mexico, we have decided to increase our investment there and preparations for entering Mexico City in the first quarter of 2014." Here's the recent operating results from the International segment (note that there are 18 Canadian stores included here):

International	2010	2011	2012	1Q13	2Q13	3Q13
Revenue	$10,054	$18,490	$40,211	$12,335	$14,095	$14,968
Gross Profit	$7,128	$13,011	$27,831	$8,705	$10,184	$10,739
Operating Profit	($5,226)	($13,551)	($30,322)	($5,973)	($6,746)	($7,665)
CapEx	$691	$18,276	$12,498	$2,647	$2,775	$3,781
# Stores	23	80	108	128	148	168
Gross Margins	70.9%	70.4%	69.2%	70.6%	72.3%	71.7%
Op Margins	-52.0%	-73.3%	-75.4%	-48.4%	-47.9%	-51.2%

At RAC Acceptance, growth has been exceptional – the top line was up 78% from 2012/2011 and RCII added another 288 stores through the first 3 quarters of this year. Gross margins are ~60% with operating margins in the mid-teens. This unit (16% of revenues and growing) lifts the EBIT margins of the entire company.

RAC Acceptance	2010	2011	2012	1Q13	2Q13	3Q13
Revenue	$18,203	$193,295	$343,283	$127,163	$117,493	$123,798
Gross Profit	$12,074	$114,228	$194,607	$67,107	$68,770	$74,083
Operating Profit	($5,372)	($13,985)	$27,972	$15,917	$17,612	$18,855
CapEx	$1,450	$5,881	$5,275	$1,940	$2,262	$2,819
# Stores	384	750	966	1,053	1,153	1,254
Gross Margins	66.3%	59.1%	56.7%	52.8%	58.5%	59.8%
Op Margins	-29.5%	-7.2%	8.1%	12.5%	15.0%	15.2%

Others are starting to recognize the beauty of the RAC Acceptance model and are moving to copy it. Sears entered the market a few months ago by funding a product called "Why Not Lease It?". The problem with the product is that it's a virtual one that has to be self-accessed by a computer at the store. Since there isn't a salesperson explaining the benefits of renting in person and because it's a rent-to-rent product (not rent-to-own like RAC Acceptance), RCII hasn't seen any impact to its business. Conn's also offers credit for its customers, but is fairly strict in its terms, so they also have a RAC Acceptance kiosk in some of their stores for the less credit-worthy customers. It's been rumored for a few quarters that Aaron's Rents (#2 competitor) may enter the kiosk market, but they have a problem to overcome: they have a large franchisee base (749 at YE12) with contracts that preclude competition from the parent within a certain radius. On a recent earnings call, the CEO of AAN was asked 3 different times about what they're going to do to combat RCII's kiosk strategy – his response: "So, we're going to keep it very close to our mind and keep evaluating and decide if we want to do something different than we're doing now." Seems like RAC is in a wonderful position to continue winning.

While others are trying to copy, RCII continues to be the leader and is focusing on growing its partner list – HH Gregg is currently a running a test (they also have their own financing options a la Conn's) and it's "going well. We both want to do even more. We have been happy so far. And I think they are too."

It's hard to tell where the saturation point is for the RAC Acceptance business. The company is fairly confident that it's not cannibalizing its existing locations – per the company, "we've get names of all of our customers. So we can look at overlap, whether the customer ever was with us before, and if they are with RAC Acceptance now, have they ever done business with Rent-A-Center and vice versa. And it's very, very de minimis, the overlap there." You can do a sanity check against this by looking at the number of agreements in their US Core segment (discussed below). In any event, it's a great business and RAC Acceptance is capturing a significant percentage of this new market.

Here are other bullets on RCII:

- Consistent record of returning cash to shareholders
  - Spent $530MM since 2010 repurchasing stock (diluted share count down 12MM shares or 18%)
  - Raised $250MM in a 2013 bond offering to buy back $200MM in stock
  - Dividend is $0.84 / share, or 2.5%
- Attractive FCF despite increased investment in growth
  - 2012 op cash flow was $218MM; they used $97MM for net CapEx, $62MM was spent on share repurchases, $53MM went to paying down debt, and $38MM went to dividends
  - Through 3Q13, op cash flow was $173MM; $74MM went to CapEx, $17MM for share repurchases (in addition to the $200MM), $36MM for dividends.
  - 2013 FCF expected to be $90MM
- Other assets
  - Own the land and building (175k sq ft) to their corporate headquarters (5501 Headquarters Drive, Plano, Texas) – land was purchased in mid-2000s
  - $22.5MM in federal NOLs, $304MM in state NOLs and $7MM in foreign tax credit carryforwards
- Operational notes – couple of things to point out:
  - A customer may terminate a rental purchase agreement at any time without penalty
  - Store managers track collections on a daily basis – corporate goal is to have no more than 5.99% of rental agreements past due. For 2012, 2011, and 2010, the average week ending past due percentages were 6.76%, 7.07% and 6.90%, respectively.
  - Operating expenses are primarily merchandise costs, salaries and benefits for employees, lease expense, advertising expenses, lost, damaged, or stolen merchandise, fixed asset depreciation, and corporate and other expenses.
    - Charge offs due to customer stolen merchandise in Core U.S. rent-to-own stores, expressed as a percentage of rental store revenues, were approximately 2.4% in 2012, 2.5% in 2011, and 2.3% in 2010.
    - Depreciation of rental merchandise is included in the cost of rentals and fees in earnings statements. RCII uses the income forecasting method, which is similar to the units of production method (rented merchandise is depreciated in the proportion of rents received to total rents provided in the rental contract). Unrented merchandise (unrented for at least 180 days) is depreciated using straight-line over 20 months.

The bear case here is same store sales, which have been a drag on operating margins. Here is the 1H13 trend in SSS:

- 1Q13: Down 4.3% overall
  - Core down 8.9%
  - RAC was up 34%
  - MX was up 80%
- 2Q13: Down 1.6% overall
  - Core down 5.9%
  - RAC up 32%
  - MX up 54%

The thing to consider when you're doing SSS / Y-o-Y comps is: did any fundamental change occur that would cause these numbers to be off? And in RCII's case, the answer is yes. In 1Q12 and 2Q12, RCII's Core business had a wave of people unexpectedly choose an early buyout – driven by tax refunds – which had the effect of pulling forward revenue (a "larger-than-expected number of customers exercising their early purchase options or paying off their agreements in full. While that helps revenue in the current quarter, it does adversely affect the future, in that the recurring revenue associated with those agreements is no longer there."). So the first and second quarters of 2013 were lapping difficult comps.

In the last quarter, SSS were:

- 3Q13: Down 0.8% overall
  - Core down 5.1% due to (1) average ticket being down due to electronics deflation and promotions, and (2) the absence of sales income from early buyout programs (yes, the effect flipped and not getting typical sales buyouts is a drag).
  - RAC up 29%
  - MX up 33%

So you can see the trend in the Core SSS comps: 1Q13 was -8.9%; 2Q13 was -5.9%; 3Q13 was -5.1%. Things are improving. The good news is that this year's bad comps are next year's tailwind. Because sales / buyout income was down in 1Q13 – 3Q13 ("less than anticipated"; "payouts are down, and they are not higher in April than historical numbers."), next year's numbers should have a fairly easy hurdle. On their last conference call, the company even alluded that their Core rental business is getting less bad: "although the fourth-quarter overall core revenue count will be negative again, we estimate our rental and fee counts in the quarter be about flat."

COO Mitch Fadel also said: "remember, we started the year with a major deficit in our agreement count. We've made that up and now crossed the line. It's showing up unfortunately on the ticket side, and it will be another couple of quarters before we have enough agreements to make up for the ticket and then have a positive same-store sales sometime in 2014."

What he is saying is that agreement count is up but pricing is down (the drivers of RCII's business are (1) agreement count – how many accounts are on the books and (2) ticket size / average revenue per agreement – driven by product mix and pricing).

“Our whole ticket problem is in electronics. Whether you consider promotional activity or everyday pricing, you know, the 5% we are down -- we've crossed the line on agreements. So the agreements are down year over year. So if we are down 5% in the comp, it's all in ticket, and we can tell you it's all in electronics, and that's about half our business. So you can calculate that, that the electronics is down probably closer to 10% year over year.”

So the main driver of their negative comp in 3Q13 was electronics deflation. This isn’t something I would consider structural – as new TVs come out, the ones in inventory get deflated. It’s the nature of the rental business. Anecdotally, the company stated in their last call: “recent stabilization in the average ticket pricing gives us confidence in our long-term strategy of improving the results in the core.” So the overall message is, the bear case is getting weaker by the day.

Two final things to note:

1. The average life of a customer is 4-5 months – you can consider this “recurring revenue” for any one customer cohort (it’s weekly revenue that recurs for 4-5 months). So when you think about same store sales (which is a year-on-year comparison metric), what you are really doing is comparing cohort groups from last quarter and the current quarter with cohort groups 5 quarters ago and 4 quarters ago. So the previous quarter’s cohort group will have an impact on the current quarter’s revenue numbers – which could be a positive or negative, depending on the trend. This is unlike nearly every retailer, as most retailers have one-time transactional businesses. I suspect these guys have more visibility into their next quarter than most retailers. So the insights they have provided about 4Q are instructive.
2. A leading indicator for RCII is deliveries – so you can listen to the company’s commentary on deliveries (which they provide color on each quarter). In 3Q13, they said deliveries were up over 7% Y/Y.

I have no special insight into timing an entry, but I’d at least wait until the stock stops going down every day. In general, the stock is too cheap and its recent fall presents an opportunity. One big unknown is how Obamacare is going to affect their customer base. I don’t know what the bigger effect will be – more people finding their stores because they have less money or their existing customer base having a more difficult time renting a center.

I put together details of the company operations – see here.

Sources:

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Presentations: http://investor.rentacenter.com/phoenix.zhtml?c=90764&p=irol-presentations

Last Earnings Call: http://edge.media-server.com/m/p/szb9y97f/lan/en