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Rent-A-Center, Inc. (RCII)

Q3 2020 Earnings Call

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MANAGEMENT DISCUSSION SECTION

Operator: Good morning and thank you for holding. Welcome to Rent-A-Center's Third Quarter Earnings Conference Call. As a reminder, this conference is being recorded, Thursday, October 29, 2020. Your speakers today are Mr. Mitch Fadel, Chief Executive Officer of Rent-A-Center; Maureen Short, Chief Financial Officer; Anthony Blasquez, Executive Vice President of Rent-A-Center Business; Jason Hogg, Executive Vice President of Preferred Lease; and Daniel O'Rourke, Senior Vice President of Finance and Real Estate.

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

Daniel O'Rourke
Senior Vice President-Finance, Rent-A-Center, Inc.

Thank you. Good morning everyone and thank you for joining us. Our earnings release was distributed after market close yesterday and it outlines our operational and financial results for the third quarter of 2020. All related materials, including a link to the live webcast, are available on our website at investor.rentacenter.com.

As a reminder, some of the statements provided on this call are forward-looking statements, which are subject to many factors that could cause actual results to differ materially from our expectations. These factors are described in our earnings release issued yesterday, as well as in the company's SEC filings. Rent-A-Center undertakes no obligation to publicly update or revise any forward-looking statements except as required by law. This call will also include references to non-GAAP financial measures. Please refer to our third quarter earnings release, which can be found on our website for a reconciliation of any non-GAAP financial measures discussed on this call to the most comparable GAAP financial measures.

I'd now like to turn the call over to Mitch.

Mitchell E. Fadel

Chief Executive Officer & Director, Rent-A-Center, Inc.

Thank you, Daniel, and good morning, everyone. Thank you for joining us. We will be providing a voice over to the presentation shown on the webcast that can be found on our website at investor.rentacenter.com.

We're very pleased with our third quarter performance and we've increased guidance for the fourth quarter given a stronger outlook. The teams continue to execute extremely well and are on track to close 2020 with healthy lease portfolios and strong underlying trends in our omni-channel businesses. The changes we've made to support customers during this crisis have prioritized safety, while further positioning the business for long-term growth.

As you can see on slide 3, our quarterly and year-to-date performance confirms the resiliency of our model. On a consolidated basis, our results were at the high end of our updated outlook. Revenue increased 9.6%, adjusted EBITDA rose 63% and EPS was up 121%. We're making significant progress to accelerate long-term growth and our digital investments are driving revenue and an improved customer experience across the business.

Preferred Lease invoice volume grew 34% in the quarter as we onboarded new retail partners. Growth in our same-store sales increased 12.9% versus last year and 16.6% on a two-year basis, driven by a 71% increase in e-commerce transactions at rentacenter.com. Adjusted EBITDA growth and profitability were the strongest we've seen in years and Marino will outline our increased guidance in a moment, but the key takeaways from my perspective are that it reflects increases to consolidated adjusted EBITDA, non-GAAP EPS and free cash flow and importantly, it's not contingent on additional government stimulus.

When I think about the journey we've been on since I came back to the company in 2018, we first had to right the ship, attract new customers and dramatically reduce our expenses. Once we were on the right track, we established our digital growth strategy. The pandemic has confirmed and accelerated that the digital strategy is the right approach and we've added significant talent to take it all to the next level. We brought in an exceptional talent in Jason Hogg to lead our Preferred Lease segment. Jason has over 20 years of high-level fintech expertise and success. We matched him with Anthony Blasquez, who now leads the Rent-A-Center segment with his over 20 years' experience in Rent-A-Center. And combining such a high-level fintech person with arguably the best rental store operator in the industry has us extremely excited about taking the success of the last couple of years to another level.

So, today I'll provide some additional perspective on our strategy. Jason Hogg, the Preferred Lease segment leader and Anthony Blasquez, who as I mentioned leads the Rent-A-Center business, are joining Maureen and I on today's call. We trust you'll walk away with a better understanding of our roadmap and a sense of the excitement we all share about the future. As you can see on slide 4, the economic environments remain highly favorable for lease-to-own and we expect tighter credit to remain a tailwind for the business.

The credit dynamic supports our business in times of economic uncertainty and we're seeing the benefits of that dynamic in our financial results. As we start the fourth quarter, we're continuing to experience strong demand and solid customer payment activity. Customers are obtaining ownership of the product at higher rates, resulting in strong customer satisfaction across the business. It's also important to note that we continue to see positive trends without the benefit of further government stimulus. Preferred Lease is adding more retail partners than ever before as we make investments in a national sales team to expand new merchants and improve activation rates.

Rent-A-Center continues to experience strong trends with notable strength in home-related products. We believe the essential role we serve for customers, coupled with our focus on improving operating performance, can continue to support EBITDA growth. We're particularly excited about our digital strategy. As you know, it's been a watershed year for digital as social distancing accelerated strategic investments that are already in progress to interact with shoppers in their preferred settings. And given our experience in 2020, we have confidence in our ability to harness digital and increase both the overall market and our share of lease-to-own.

To that end, as Jason will discuss, we're launching a broad digital offer behind our Preferred brand. The overall umbrella is Preferred Dynamix, which will support a suite of new technology and products around Preferred Lease, Preferred Digital and ultimately Preferred Marketplace. We're committing significant resources and believe we can expand the Preferred partner base, broaden the age demographic and introduce more aspirational brands to more customers. We continue to believe virtual lease-to-own is a significantly underserved opportunity and we're more than confident in our near-term goal of $1.2 billion in Preferred Lease revenue by the end of 2022.

We're also making investments in digital at Rent-A-Center to drive revenue through customer retention. Rent-A-Center had an outstanding quarter with our strongest adjusted EBITDA margin in years and low loss rates, even with significant e-commerce growth. We believe e-commerce penetration could reach 30% to 40% in the next couple of years and we expect our digital investments to support elevated same-store sales and sustainable margins.

Now, before I turn it over to Jason, I'd like to thank our co-workers, our franchisees and retail partners for your dedication to serve customers during this challenging time. [indiscernible] (00:07:16) our value proposition to our customers has never been stronger and our mission to invest in digital strategies that can support long-term growth has never been more relevant. Jason?

Jason J. Hogg

Executive Vice President-Preferred Lease, Rent-A-Center, Inc.

Thanks, Mitch. I'm honored to be here with you today and look forward to sharing our plans for the Preferred Lease business as we move forward. As many of you know, I have a long history of bringing disruptive innovation to financial services via technology. I think we have a fantastic opportunity to grow Preferred Lease and I'm truly excited about the course we're setting.

Turning to slide 5, the third quarter speaks to our strong foundation. Invoice volume grew 34%, 16 points over the second quarter as we onboarded new partners across hundreds of locations and achieved broader diversification across product categories. As Mitch mentioned, we're also becoming more efficient at activating retail partners. As you know, invoice volume drives revenue growth. Total revenue increased 9.3% in the quarter and we expect the invoice volume trend to continue to support accelerated revenue growth.

Adjusted EBITDA was $16.6 million. Skip/stolen losses improved sequentially as we continue to ramp up our centralized collections initiative. The lease portfolio features higher credit quality customers that should allow us to drive revenue and yield as we increase market share. The investments we need in sales this year are supporting more efficient activation of our growing pipeline of retail partners. We're excited about partner growth across the spectrum, from regional accounts to national accounts. While the latter takes time to advance, we're in the final stages on some truly exciting national opportunities. At the same time, the strides we're making in digital are benefiting performance across the business, with improvements in collections and more of our customers using digital payments.

Turning to slide 6, our goal is to take that strong foundation and accelerate growth by driving innovation that positions our Preferred brand as the leading fintech platform, one that spans mobile and e-commerce with expanded proprietary and differentiated products and services. As Mitch outlined, we've organized the team under Preferred Dynamix to accomplish that. As you can see from the slide, Preferred Dynamix is an operating structure to accelerate the pace of innovation and provide a more effective way to onboard new talent and digital expertise as we fast-track our virtual strategy. Preferred Dynamix will support Preferred Lease, our foundational lease-to-own program. It will also house our work for Preferred Digital, which leverages mobile, Web, and in-store technology to create a seamless LTO offering.

Our multi-phased, two-year strategic plan supports a broad set of digital initiatives included in our initial provisional patent suite, which is already filed to improve the customer interface, reduce friction and support better functionality for retail partners.

For example, our mobile offering will feature a more streamlined origination process, with better scalability, more efficient decisioning and the potential for increased adoption from millennials and Gen Z customers. We've been able to lower the approval process to less than a minute from over 20 minutes, which is truly exciting.

We're also using technology to enable frictionless retail partner onboarding, with seamless integration to retail partner e-commerce platforms. We're also implementing new marketing strategies to generate more repeat business from existing customers and an expanded potential customer base.

We've created an innovation partner program and are launching pilots with four of our large national retail partners in the fourth quarter with our new mobile application, and we'll have other tangible examples to share as we turn on functionality. The efforts will support our partner growth and should benefit productivity as we add new merchant partners.

Over time, we think our strategy can extend beyond its existing focus to support preferred marketplace, an expanded set of strategic partnerships with consumer brands that could greatly increase the total addressable market. That would increase the existing total addressable market we see from executing on retail and national partner growth.

Ultimately, we see the Preferred brand as a platform where our customers can move fluidly between retail, mobile and online transactions through a seamless interface to a curated network that expands choices for lease-to-own customers and this creates new opportunities for our partners. Our new strategy will reinvent the lease-to-own transaction, and I look forward to updating you on our progress in the coming quarters.

Now, I'll turn it over to Anthony.

Anthony Blasquez

Executive Vice President, Rent-A-Center Business, Rent-A-Center, Inc.

Thanks, Jason. Let me start by saying I'm a proud veteran of Rent-A-Center with a deep understanding of our culture, customers, and operations. It's been a pleasure working with Jason, and I look forward to continuing to share best practices. There's a lot we can do to revolutionize the customer experience, and many of the things Jason outlined can be applied to Rent-A-Center and our franchisees.

As Mitchell pointed out, sustainability is the hallmark of the Rent-A-Center story for 2020. It played out in the third quarter as we saw positive trends in customer retention and payment activity even as stimulus end. We expect growth to continue as we advance plans to improve our digital capabilities.

Looking at the quarter on slide 7, total revenues were up 8.6% and we saw 78% growth in adjusted EBITDA. Revenue growth in the quarter was driven by strong portfolio entering and continuing throughout the quarter with better collections. E-commerce transactions increased 71%, and its 21% penetration rate helped to contribute to a 12.9% increase in same store sales, our 11th consecutive quarterly increase.

To support growth, we're adding functionality to improve the customer experience at the point of sale. That includes a multi-store e-commerce test using the Preferred Lease decision engine. We're expanding electronic payments, which is driving pure merchandise returns and better customer payment activity. And we're incorporating digital features to improve the communication process. Our customers have clearly shown a preference for texting, for example, and that's improving Net Promoter Scores and improving labor efficiency.

Turning to slide 8. As you can see, e-commerce share of the overall revenues continue to improve during 2020 and we're driving more revenue from the channel. As we look forward using digital to profitably evolving our lease-to-own model remains our top priority. Unlike many retailers, e-commerce is a profitable and largely incremental transaction for Rent-A-Center. The digital transaction is attracting new customers in the lease-to-own, which tend to have a younger demographic.

Higher adoption of digital payments is resulting in better collections performance, and, as a result, skip/stolens are below historical levels. As in past recessions, tighter credit reduced options for customers and we think we're taking an outsized share of that. We have more to share in the coming quarters, and I look forward to updating you on our progress.

I'll now turn it over to Maureen.

Maureen B. Short

Executive Vice President & Chief Financial Officer, Rent-A-Center, Inc.

Thanks, Anthony. As we can see on slide 9, total revenue grew 9.6% in the third quarter versus last year. Adjusted EBITDA increased 63%. Both were ahead of our original and updated guidance. Adjusted EBITDA margin increased 420 basis points versus last year, driven by leverage on strong revenues and lower expenses. Non-GAAP diluted EPS rose 121%.

Digging deeper into the segment performance on slide 10, Preferred Lease revenue trends strengthened to 9.3% growth in this quarter as invoice volume grew sequentially. That was driven by new virtual retail partner additions and organic growth in both virtual and staffed locations. As Mitch mentioned, Preferred Lease made investments to build a sales staff, which drove pipeline growth and more efficient onboarding of new retail partners.

The Preferred Lease portfolio is expected to end the year up approximately 9% versus 2019. And we expect full-year 2020 invoice volume to be approximately 25% higher year-over-year. Invoice volume growth is outpacing portfolio growth as we are accelerating the number of virtual locations while experiencing increased early payout activity the last couple of quarters.

As you know, invoice volume is a leading indicator for revenue growth. We expect the quality of our portfolio to continue to benefit from higher credit tightening across the competitive environment and through enhancements we're making to our decision engine. Skip/stolen losses were 11.3% of revenue, down 710 basis points sequentially and 240 basis points higher than last year. Skip/stolen losses benefited from improved customer payment activity and increased efficiency from our centralized collections team.

Adjusted EBITDA margin for Preferred Lease was lower than last year, primarily due to a higher mix of merchandise sales driven by an increase in early payout activity. In addition, we continue to make investments to support growth. Preferred Lease EBITDA margins are expected to grow as we scale the virtual business and stream line collection cost.

Turning to the Rent-A-Center Business, total revenue increased 8.6% versus last year, a 71% increase in e-commerce sales helped drive an outstanding same store sales performance for the third quarter. The two-year same store sales trend improved to 16.6% with double-digit positive comps in each month of the quarter.

The Rent-A-Center portfolio ended the quarter up approximately 9% over last year, which is a leading indicator for same store sales. Skip/stolen losses for the Rent-A-Center business were 2%, down 210 basis points versus last year and a sequential improvement over the second quarter of 2020.

As Anthony pointed out, increased adoption of digital payments is driving improved payment activity and collections. We're very pleased with performance on this metric, which is more than offsetting slightly higher losses from e-commerce. For the full year, we now expect skip/stolen losses for the Rent-A-Center business to be approximately 3% of revenue, 70 basis points lower versus last year despite growth in e-commerce.

Adjusted EBITDA for the Rent-A-Center Business was extremely strong in the quarter, benefiting from favorable revenue trend in COVID-19-related expense reduction. Free cash flow was $34 million, which benefited from favorable financial performance and included working capital investments to fund future growth. This brings us to $274 million in free cash flow year-to-date and we ended the quarter with zero net debt.

Turning to our full-year guidance for 2020 on slide 11, we've increased our guidance to account for better-than-expected performance in the third quarter and favorable trends as we enter the fourth quarter. On a consolidated basis, we expect revenues in the range of $2.795 billion to $2.825 billion. It's important to note that our guidance reflects the refranchising of all 99 California Rent-A-Center locations, which we closed on October 5. While it will lower top line revenue, we expect the transaction to be essentially flat to earnings going forward as the foregone profit from the California location will be offset by franchise royalty payments and infrastructure efficiency.

We expect adjusted EBITDA in the range of $308 million to $323 million, and non-GAAP diluted earnings per share of $3.35 to $3.50. Free cash flow is expected to be between $200 million and $215 million for 2020. Looking at the segments, we expect Preferred Lease revenues in the range of $812 million to $822 million, with adjusted EBITDA of $66 million to $71 million. Rent-A-Center revenues are expected to be in the range of $1.825 billion to $1.84 billion, with adjusted EBITDA of $352 million to $362 million. Our overall portfolio balances for both businesses are expected to end the year well-positioned for growth in 2021.

Now, to slide 12. Our revenue performance and disciplined cost philosophy continues to generate robust cash flow. We expect to end 2020 with over $360 million in liquidity, and we're prioritizing investment in high return projects to support profitable growth. We are expecting strong cash flow in the coming years as we benefit from the improvements we've made across the organization, and the continued implementation of our digital strategy.

We have repurchased $26.6 million in shares this year leaving $58.8 million of remaining share repurchase authorization. On October 26, we paid a cash dividend of $0.29 per share for the fourth quarter of 2020. As always, detailed income statements by segment are posted to our Investor Relations website and we anticipate filing the 10-Q tomorrow.

Thank you for your time. And I'll now turn the call over for questions.

QUESTION AND ANSWER SECTION

Operator: [Operator Instructions] Your first question comes from the line of Vincent Caintic from Stephens. Your line is open.

Vincent Caintic
Analyst, Stephens, Inc.

Q

Hey, thanks. Good morning, guys, and congratulations on a good quarter. First question on the Preferred Lease. So, a lot of exciting things going on here and excited to hear about you're adding incremental partners. Just wondering maybe if you could talk about the retail partner pipeline, what sort of conversations are you having and what's the typical sales cycle before we can expect to – you pointed to some final stages with national partners?

Operator: Ladies and gentlemen, this is the operator. We are experiencing a technical delay. Please hold for one moment. [Technical Difficulty] (00:23:16-00:23:59). Ladies and gentlemen, this is the operator. We are experiencing a technical difficulty. Please stand by. [Technical Difficulty] (00:24:05-00:24:49).

Jason J. Hogg
Executive Vice President-Preferred Lease, Rent-A-Center, Inc.

A

Well, I'm sorry. I guess we had a problem with the microphone. So should I start over, I guess?

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Ask if Vincent heard.

Jason J. Hogg
Executive Vice President-Preferred Lease, Rent-A-Center, Inc.

A

Vincent, did you hear...

Vincent Caintic
Analyst, Stephens, Inc.

Q

No. I apologize. I didn't hear any of it. Apologies.

Jason J. Hogg
Executive Vice President-Preferred Lease, Rent-A-Center, Inc.

A

That's no worries. So I got a nice warm up. This will be even more polished. So we are – we're pursuing a two-pronged approach. So on the national side, we have developed a robust pipeline where we're in late-stage discussions with a number of national retailers across verticals, both in the retail side as well as the e-com side. And our goal there is to then launch pilot programs in specific regions so that we can support them develop metrics so that we optimize the go-to-market strategy and then to scale those programs.

The second prong that we're pursuing is on our virtual merchant partnership site and there we are actually doing a number of things. First is as we've mentioned in the past, we are growing our direct sales force. We are on target right now with all of our objectives from a hiring perspective, onboarding perspective there and we're seeing the results with regard to being on target with acquiring new merchant partners and like I mentioned earlier seeing the invoice volume increasing in a direct correlation.

In addition to that, in order to optimize those returns, we've implemented inside sales approach which also enables us to utilize targeting and modeling in order to generate the most optimized leads from both the propensity to convert as well as from yields perspective. So, we're going to continue to implement both of these strategies over the coming quarters.

Vincent Caintic
Analyst, Stephens, Inc.

Q

Maybe a comment about national partnership.

Jason J. Hogg
Executive Vice President-Preferred Lease, Rent-A-Center, Inc.

A

Yeah. So, on the national partner front, we're actually very far along with regard to the both negotiation side as well as lining up pilot programs in order to get that implemented and then be able to improve our metrics.

Vincent Caintic
Analyst, Stephens, Inc.

Q

Okay, great. And on a pilot program, I guess typically speaking from going from the negotiations to pilot to national rollout, how long does that – would that typically take just to frame that together?

Jason J. Hogg
Executive Vice President-Preferred Lease, Rent-A-Center, Inc.

A

Yeah. The way in my experience that we do it is − it's turning up the volume type approach. So what we end up doing is we do a rolling thunder approach and it can take place. We don't try and be like one or two-month smart. It's not quarters. It's more months when we get into that type of a rollout.

Vincent Caintic
Analyst, Stephens, Inc.

Q

Okay. Very helpful. And next question on the Rent-A-Center Business side, I thought the franchising of the California stores was really interesting. And just kind of wondering sort of what drove that. Is the – are those stores kind of similar to the national footprint? And is sort of the economics that you laid out in the press release similar to national, so what we can expect if you were to franchise more stores? Thank you.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Yeah. Thanks, Vincent. I'll take that one. This is Mitch. There's only a couple of markets that we felt like as well as we've performed the last couple of years. There's only a couple of markets that we feel we'd be in better hands of franchisee and California was one of them. So, you and I can see a whole bunch of franchising. I think we said before we've used it opportunistically. And like I just said, there's only a couple of markets where we think to better off in the hands of a franchisee, and again, California being one of them. The deal we made will be essentially flat to earnings, plus the revenue – plus the cash from selling the stores. So flat to earnings based on the – what we're making out there.

It's got us the new agreement. The agreement with the franchisee has a 10-store growth agreement over the next five years. So, we [ph] actually going to have (00:29:06) growth which would actually be accretive to earnings. So there's only – there's only a few markets, that being one of them. So, it's not like you're going to see much more on the franchising side, but it'll be pretty limited. But then when we felt really good about the franchisee can handle California better than us and, like I said, it's essentially flat to earnings going forward with – not to mention the proceeds coming in and the growth agreement that comes with it.

Vincent Caintic
Analyst, Stephens, Inc.

Q

Okay, great. Thanks very much.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Thanks, Vincent.

Operator: Your next question comes from the line of Bobby Griffin from Raymond James. Your line is open.

Alessandra Jimenez
Analyst, Raymond James & Associates, Inc.

Q

Good morning. This is Alessandra Jimenez on for Bobby. Thank you for taking our question. First, on the Preferred Lease side of the business. In the press release, you mentioned broader diversification across product categories. Did you enter any new product categories during the quarter?

Jason J. Hogg
Executive Vice President-Preferred Lease, Rent-A-Center, Inc.

A

Yeah, we're actually moving into a number of them ranging from jewelry to tires to further diversification into electronics. And as I referenced a moment ago in my last answer, the ability to act generating proactive leads through an inside sales approach using targeted modeling on who we call enables us to be very thoughtful with regard to how we enter into those markets.

In addition to that, our decision engine enables us to very much understand the initial performance dynamics as we get into the new verticals and that enables us to make sure that we're kind of monitoring performance as we continue to turn up them and then make adjustments to the both vertical as well as the region and the size of the merchant that we bring onboard.

Alessandra Jimenez
Analyst, Raymond James & Associates, Inc.

Q

Okay. That's helpful. And then understanding higher early buyout aspect, but is there anything else driving the large delta between the Preferred Lease merchandise sales and the rental and fee revenue?

Maureen B. Short
Executive Vice President & Chief Financial Officer, Rent-A-Center, Inc.

A

Yeah, this is Maureen. Let me – I can speak to that. The merchandise sales is higher year-over-year because of the macro environment and customers having more money in their pockets. And similar to a tax refund season, anytime there's more money in our customers' hands, it generates more merchandise sales or early payouts, higher ownership rate for our customers which is a great thing. And so, that's contributed over the last couple of quarters to merchandise sales being higher relative to rental sales than previous quarters.

Alessandra Jimenez
Analyst, Raymond James & Associates, Inc.

Q

Okay. That's helpful. And then, do you expect Preferred Lease...

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Hello. This is a...

Alessandra Jimenez
Analyst, Raymond James & Associates, Inc.

Q

Okay. Sorry. Go ahead.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Sorry, this is Mitch. I just want to add to what Maureen said. One of the really positive things you see when you think about the extra payouts based on probably primarily because of the stimulus earlier in the year or earlier in the quarter, not so much anymore, but that drove a lot of it. But the interesting thing is with all of those extra payouts bringing all that extra revenue to the portfolios in both businesses are still well, well ahead of last year where on the Rent-A-Center side, they're both actually about 9% ahead of last year coincidentally.

So the portfolios have held up great which means as we're getting this income in on the early buyouts in both segments, there's an awful lot of replacement of rental agreements, second the portfolios back up. So the Rent-A-Center side of the business stays in high-single-digits, close to the double-digit same store sales going forward when you – and the portfolio at the end of the third quarter at about 9%. That's a leading indicator of what the next quarter same store sales are going to be, at least that number. So, – and the same thing, we don't do same store sales necessarily on the Preferred Lease side, but the portfolios are really outperforming even with all of those payouts.

Alessandra Jimenez
Analyst, Raymond James & Associates, Inc.

Q

Okay. That is very helpful. And then last for me, have you noticed any changes in trends during October given the spike in the number of COVID cases?

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Anthony, do you want to talk to that and the rest [indiscernible] (00:33:41)?

Anthony Blasquez
Executive Vice President, Rent-A-Center Business, Rent-A-Center, Inc.

A

Yeah. Yeah. No. I would just comment that Mitch stated at the end of the third quarter, the portfolio was up almost 9%. October is trending favorably for us, both from a demand as well as a payment perspective. So, we feel strongly. So, we haven't seen anything, and we operated as an essential business and safely served our customers, and we'll continue to do that.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

I mean, the – Alessandra the tailwinds on household durable goods products are really pretty strong, so as far as people are spending more money in their home – on items in their home, right? So, it's been strong on both the Preferred Lease side and the Rent-A-Center side.

Alessandra Jimenez
Analyst, Raymond James & Associates, Inc.

Q

Okay. Perfect. Thank you. Best of luck on the balance of the year.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Thanks.

Operator: Your next question comes from the line of Anthony Chukumba from Loop Capital Markets. Your line is open.

Anthony Chukumba
Analyst, Loop Capital Markets LLC

Q

Good morning. Thanks for taking my question. Just had a quick question on Preferred Lease. You mentioned one of the reasons that the EBITDA margin was down year-over-year was obviously the investments that you're making, and that makes a lot of sense. I guess I'm just wondering like how much longer do you think you'll – that investments will be a year-over-year margin headwind in that business?

Maureen B. Short
Executive Vice President & Chief Financial Officer, Rent-A-Center, Inc.

A

Anthony, this is Maureen. If you look at the guidance that we gave for the fourth quarter, it implies around a 12% to 13.5% EBITDA margin for the fourth quarter. So, you can see it's a very quick recovery from the last couple of quarters where the closures related to the pandemic impacted the business, but we're expecting sequentially to improve quarter-over-quarter with EBITDA. We're expecting higher revenue as you see in the guidance, slightly less payout as we get further and further away from the stimulus.

With less payouts, that'll be higher gross margin. We expect favorable loss trends to continue within the Preferred Lease business. And so, higher margins – EBITDA margins sequentially and we expect them to continue going forward to increase as we scale the business. We've made a number of structural changes that will be permanent, as we've centralized our collections into the call center. So, we haven't changed our belief that EBITDA margins in that business could be 10% to 13% even in the near term.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Yes. Let me add that.

Anthony Chukumba
Analyst, Loop Capital Markets LLC

Q

Got it. That's all.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.
A

I'll just add to that. As the Maureen was talking about the increase from like 8.5% to 13% in the – 12% to 13% in the fourth quarter based on our guidance that also reminded that the third quarter is up about 500 basis points from the second quarter. So the sequential roll on the margin has already started.

Anthony Chukumba
Analyst, Loop Capital Markets LLC
Q

Got it. Now that's very helpful color. And then just one quick follow-up, somewhat related. You mentioned in one of your slides how credit seems like it's tightening. Are you seeing that sort of trade down from a credit perspective in the Rent-A-Center Business, the Preferred Lease business? I would guess that as particularly as subprime credit got tighter than now, that would be a benefit to you and you'd maybe start to see some higher credit score customers in your – sort of entering your funnel.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.
A

We absolutely are and we can tell we have our own proprietary scoring system. So, it's not like a credit score or something like that, but wouldn't – but in our own scoring model, yes, the quality – the numbers again are better than they were before. So, yeah, we're seeing a higher quality customer coming in, getting pushed down into the lease-to-own transaction versus – at subprime, I think that's lighter, that's like say like 19%. It was reported at 19% drop in subprime lending, back on slide 4, so I mean, that's in near prime, 11%, so that's – those are pretty big drops according to the Federal Reserve Bank. So that's – and we're definitely seeing it on our end as well.

Anthony Chukumba
Analyst, Loop Capital Markets LLC
Q

That's helpful. Thank you.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.
A

Thanks, Anthony.

Operator: Your next question comes from the line of Kyle Joseph from Jefferies. Your line is open.

Kyle Joseph
Analyst, Jefferies LLC
Q

Hey, good morning, everyone. Congratulations on a good quarter, and thanks for taking my questions. So on that note, obviously the third quarter was very strong, both in terms of volumes and payment activity and credit performance. The question I get is on the sustainability of the positive results here. And so, can you kind of walk us through how you see your business performing going forward, if there's less stimulus, no stimulus or an equivalent amount of stimulus?

Anthony Chukumba
Analyst, Loop Capital Markets LLC
A

Hey, good morning, Kyle. This is Anthony. I'll take this first. So obviously, to start, the number one thing is, as Mitch commented and I echoed the sentiment, the portfolio being ahead 9%, going into the fourth quarter, October's trending favorably so far. And we've really been taking a multifaceted approach to convert and retain more business across both Web and in the store. And a couple of things that I would comment on that we believe is going to be really beneficial towards our sustainability is we've made a lot of enhancements to our digital payments. It's almost doubling the number of customers that are paying digitally. They're staying on rent longer. And it's allowing really our team to focus their efforts on more conversions.

And then as I commented in my prepared remarks, another thing that we're seeing is we've got our decision engine that we're testing. It's live in about 10% of our stores and initial read on that, it's allowing for a faster and frictionless approval process. So, if you think about the increase in demand coming from the Web, those stores that have implemented it, we're starting to see that their conversion rates are going up. So, that and I would just finish with – we're introducing some new product verticals. So, we feel pretty good about the go-forward plan.

Jason J. Hogg
Executive Vice President-Preferred Lease, Rent-A-Center, Inc.

A

And I would just add to that, Kyle, the – if you look at our – looking at our guidance for the year and obviously that allows you to back into the fourth quarter, we're pretty confident in our guidance. It doesn't rely on stimulus and it's still pretty good fourth quarter. Of course the portfolio's in great shape going in and we have the benefit of seeing what our cohort's done already, so the majority of October. So, we're confident in that, though I wouldn't want to speculate on a – on the stimulus program another package, but that would only be upside to what our guidance going forward is.

Kyle Joseph
Analyst, Jefferies LLC

Q

Got it. Very helpful. And just from a high-level, I know we don't have 2021 guidance yet and there's so much uncertainty right now. But just in terms of the seasonality of the business, obviously in the post-COVID world and 2020, the seasonality has been turned upside down. But just going forward, would you anticipate kind of normal seasonal trends in 2021 or is that largely going to be determined by if when there is more stimulus?

Maureen B. Short
Executive Vice President & Chief Financial Officer, Rent-A-Center, Inc.

A

Hey, Kyle. Yeah. We'll give more guidance as far as 2021 on the next earnings call. But as we look forward, there will be some differences within the seasonality. I mean, we've always got the tax refund season that causes higher performance. Going into 2021, we're obviously 9% ahead in our portfolio, which is a great leading indicator for same-store sales in the Rent-A-Center business. And the invoice volume growth is significant at 34% for this past quarter. The inside sales team is doing a great job of signing on new retail partners. We've accelerated the growth in that area. And so within both businesses, we're in a great position to start out of the gates in 2021 in a great position. And then we'll provide more details on the next earnings call as far as the 2021 guidance.

Kyle Joseph
Analyst, Jefferies LLC

Q

Very helpful. Thanks. Sorry, go ahead.

Jason J. Hogg
Executive Vice President-Preferred Lease, Rent-A-Center, Inc.

A

Kyle, I'd just add to that. When you think about the – when you back into the guidance for the fourth quarter by using the annual, it's not the fact is not – there's no stimulus package contemplated in that. That'll be the closest thing to a run rate that you're going to have going forward. It's – because it's not stimulus-driven in the fourth quarter and it's a portfolio business. So you can start to look at that as there'll be some seasonality within 2021 in any normal year. But that's – it's going to be close a run rate as you're going to see. As we see [indiscernible] (00:43:16) able to see over the last few quarters obviously nothing has been run rate over the last few quarters, but when you backed in your fourth quarter numbers using our annual guidance, you're going to be pretty close to run rate numbers.

Kyle Joseph
Analyst, Jefferies LLC

Q

Very helpful. Good point. Last one for me, in terms of the buyout activity, I know we talked about margins on a year-over-year basis being down, but can you talk about the buyout activity between the second quarter and the third quarter? Obviously you saw gross profit margins recover sequentially. Is that a function of less buyout activity or what's driving that?

Maureen B. Short
Executive Vice President & Chief Financial Officer, Rent-A-Center, Inc.

A

It is. We did see lower buyout activity in the third quarter relative to the second quarter and we think as we get further and further out from the stimulus that that will continue. So for example, in our fourth quarter guidance within both businesses, we're expecting the merchandise sales as a percentage of total revenue to be lower sequentially than the third quarter. But it is contributing to the lower margins, particularly in the Preferred Lease side of the business because it is a lower gross margin transaction.

We do get more customers the ownership, which is great, but it does impact gross margins, which the initiatives that we have and the growth that we have planned in both businesses, EBITDA margins are still expected to grow because of the lower cost year-over-year with centralizing collection, some of the initiatives that Anthony talked about that will help sustain and even grow gross margins and EBITDA margins over time.

Kyle Joseph
Analyst, Jefferies LLC

Q

Got it. Very helpful. Thank you, guys very much for answering all my questions.

Maureen B. Short
Executive Vice President & Chief Financial Officer, Rent-A-Center, Inc.

A

Thanks, Kyle.

Operator: Your next question comes from the line of Bradley Thomas from KeyBanc Capital Markets. Your line is open.

Andrew Efimoff
Analyst, KeyBanc Capital Markets, Inc.

Q

Hey, good morning. This is Andrew for Brad. Over the last few months we've heard of various supply chain disruptions across the industry, particularly in furniture and electronics. Could you comment on any supply chain or capacity disruptions you are seeing in your business or with your partners and how that's impacting the business so far?

Anthony Blasquez
Executive Vice President, Rent-A-Center Business, Rent-A-Center, Inc.

A

Hey, Andrew. This is Anthony. So I can speak on the Rent-A-Center business. So if you recall, I believe last quarter, Mitch commented on our held-for-rent numbers and expectations that it was going to improve and I can say sequentially it has. And as a matter of fact, we feel like we're in good position to go ahead and meet the demand for this quarter. If we just compare year-over-year, we're pretty close. That being said, obviously we all have the wish list of limitless supplies of certain things. But generally speaking, we're pretty well-positioned. And really it's a testament to our merchants and our suppliers and they've been doing a nice job to get us stocked up for the busy holiday season.

Jason J. Hogg
Executive Vice President-Preferred Lease, Rent-A-Center, Inc.

A

Yeah. On the Preferred Lease side, we've actually gone and we've made the rounds with our largest partners over the past few weeks. And in a very similar sense, they have proactive game plans to work through backlog over the course of the next several months and get back on to their normal delivery time and their normal reserve inventories. So, there's really sort of a digging out that's actively taking place. And now, as compared to maybe several months ago, we have more clear line of sight with very specific game plans coming off of our key large partnerships.

Andrew Efimoff
Analyst, KeyBanc Capital Markets, Inc.

Q

Understood. That's very helpful. My last question is on the customer payment activity. I was wondering if you could talk a little bit more about the drivers of that strong customer payment activity that you saw during the quarter and how you expect this to evolve in 4Q and perhaps even in 2021.

Anthony Blasquez
Executive Vice President, Rent-A-Center Business, Rent-A-Center, Inc.

A

Yeah. This is Anthony again. So customer payments have been strong. Our customers have migrated towards more digital payments, which obviously is enabling some lower delinquencies. And as I've stated earlier, it's on pace to double versus last year. And we're very intentional in our approach to pricing and the value proposition; so it's resulting in more ownership.

And then the other thing that I would say is, is we've really invested in communication with our customers and making it much more efficient, especially through texting. We surveyed them a bunch and they've obviously told us their preference for communication. So that's improving the customer payments. And then directionally, we look at leading indicators every single day. And considering the health of the portfolio, we feel very confident going forward as well.

Andrew Efimoff
Analyst, KeyBanc Capital Markets, Inc.

Q

Okay. Thank you.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Thanks, Andrew.

Operator: [Operator Instructions] Your next question comes from the line of John Rowan from Janney. Your line is open.

John Rowan
Analyst, Janney Montgomery Scott LLC

Q

Good morning, guys.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

A

Good morning, John.

John Rowan
Analyst, Janney Montgomery Scott LLC

Q

So, first I'll – the decision to exit California, is that – I mean, I understand there were certain franchisees that you were targeting to hand stores off to. But is that driven in any way by the new DFPI and looking to sidestep a new regulator in the state?

Jason J. Hogg
Executive Vice President-Preferred Lease, Rent-A-Center, Inc.

A

It's a combination of things. Certainly the lease-to-own line out there from a margin standpoint is different than the rest of the country. There's a lot of – one of the reasons we think it's better for a franchisee to operate a market like California is all the laws that are specific to California that we don't deal with nationally. So it's a multitude of reasons. It's not just sidestepping with any particular regulation. Multiple reasons that we felt like that was a better situation for a franchisee.

John Rowan
Analyst, Janney Montgomery Scott LLC

Q

Okay. Did you guys address the increase in the – for at least skip/stolen losses year-over-year?

Jason J. Hogg
Executive Vice President-Preferred Lease, Rent-A-Center, Inc.

A

No. Sequentially, it's way down. It is a little higher year-over-year.

Maureen B. Short
Executive Vice President & Chief Financial Officer, Rent-A-Center, Inc.

A

Yeah, John.

Jason J. Hogg
Executive Vice President-Preferred Lease, Rent-A-Center, Inc.

A

Maureen's got an answer.

Maureen B. Short
Executive Vice President & Chief Financial Officer, Rent-A-Center, Inc.

A

Yeah. The year-over-year change is mainly driven by the mix shifts of increasing the virtual business. We do have slightly higher loss rates in that virtual business. And as we grow the business and it's going to put some pressure on loss rates in the Preferred Lease business. We do like that model a lot, though, because the EBITDA margins are actually fairly similar. There's higher loss rates, but lower expenses, of course, because we don't have to have labor in the stores to help generate sales. And so the EBITDA margins are favorable. But year-over-year it does put some pressure on margins.

But if you look sequentially, it's up significant – or sorry, down significantly, 11% versus about 18% in the second quarter. And we're expecting those favorable loss trends to continue into the fourth quarter. And then as we grow the virtual business, like I said, there will be pressure, but we will overall grow the EBITDA percent because it's a more efficient model, if you will.

John Rowan
Analyst, Janney Montgomery Scott LLC

Q

Okay. Staying on Preferred Lease for a moment, you talk a lot about new national partners. Is there any difference in the product that you're offering? Are we looking at – just in your conversations with them, are you looking at anything that would be a second look opportunity or are these all third look or are we thinking about products that would potentially be outside of the typical [indiscernible] (00:51:29) that you have at other retailers?

Jason J. Hogg
Executive Vice President-Preferred Lease, Rent-A-Center, Inc.

A

There's a number of different opportunities that we're in active discussion with. Obviously, the third look is still a critical component of what we do and how we participate when we're in a waterfall situation. But one of the other advantages that we have by launching the Preferred Digital platform and having now Version 1.0 of our mobile app in the marketplace is the ability to increase our addressable market and to also kind of get a first look at customers and be able to drive those customers into our retail partner locations proactively. So that enables us to target into kind of optimal consumer segments as well as be able to drive them into optimal verticals for us. So taking this platform approach really is going to be transformative over the course of the next several quarters as we begin to roll it out at scale.

John Rowan
Analyst, Janney Montgomery Scott LLC

Q

When you talk about waterfall, would you be a third look possibly behind a second look program for another lease-to-own operator or would you be the only lease-to-own operator in a waterfall?

Jason J. Hogg
Executive Vice President-Preferred Lease, Rent-A-Center, Inc.

A

Yeah. No. There are a number of different scenarios that unfold. And so the answer to your question directly is yes. In some situations, yes; in other situations, we're third; and in other situations, we're actually first depending on whether or not we're originating and where the customer is coming from. So it's a blend when we look at it. To the point that we were talking about earlier with regard to credit tightening and some of the benefit that we have, when we are in that second look or that third look scenario, what we are seeing is as people have tightened up, we're actually getting segment expansion, which is enabling us to be more selective with regard to our decision engine. And we actually end up seeing to the point that Mitch made earlier, an increase in average risk score is the way that we look at it.

John Rowan
Analyst, Janney Montgomery Scott LLC

Q

Okay. And then just last question for Maureen. Is there any tax rate guidance that we should use going forward?

Maureen B. Short
Executive Vice President & Chief Financial Officer, Rent-A-Center, Inc.

A

The tax rate going forward will still be around that 24%. We benefited quite a bit this year from the CARES Act and some NOL carryback favorability that we were able to take advantage of. But the go-forward rate will be around 24%.

John Rowan
Analyst, Janney Montgomery Scott LLC

Q

All right. Thank you very much.

Maureen B. Short
Executive Vice President & Chief Financial Officer, Rent-A-Center, Inc.

A

Thanks, John.

Operator: There are no further questions at this time. I turn the call back to Chief Executive Officer of Rent-A-Center, Mitch Fadel, for closing remarks.

Mitchell E. Fadel
Chief Executive Officer & Director, Rent-A-Center, Inc.

Thank you, Jay, and thank you, everyone for your support and for taking the time this morning to listen to our update. Things are very positive here and we're really excited about our future only getting better. And obviously, any follow-up questions, we're certainly more than prepared to spend time answering them. Hopefully, the audio was better on your end than it was on our end. If it was a little choppy, we apologize. We had some audio problems on our end in the middle of the call, but hopefully it was only on our end. And we apologize if it was choppy on your end and if there was anything you couldn't hear, certainly we're more than happy to get on the line with each and every one of you to answer your question. So, thanks again and have a great day, everyone.

Operator: That concludes today's conference call. You may now disconnect.