

## Rent-to-Own Industry

### Northcoast Research Independent Rent-to-Own Dealer Survey: February 2015

#### Overview

- According to the results of our survey of independent rental purchase dealers, industry-wide demand trends were stronger on a year-over-year basis in February, as evidenced by the fact the Current Sales Index (CSI) finished the month at 69.6. While this performance was 6.5 points lower than the reading recorded in January, it still marked the eighth consecutive close above 50.0, which is something that has not occurred since June 2012.
- Recall that January's results overstated the health of the industry due to a confluence of a few favorable calendar anomalies, including earlier receipt of tax refunds. We think much of the deceleration in the latest period reflects the unwinding of a portion of this favorable tailwind. As such, we are encouraged that trends remained robust in February.
- Our measure of the aggregate optimism among dealers improved in the period, and remained well above the long-term average. The relatively upbeat sentiment can be attributed to: (1) eight consecutive months of sales growth; (2) customer count is higher despite an increase in EPO activity; (3) the belief that the extremely intense promotional environment is moderating; (4) the fact that delinquency rates continue to improve; and (5) commentary suggesting that the macro headwinds faced by the core customer are beginning to moderate, especially with lower gasoline prices providing a nice tailwind.
- A majority of the dealers that we surveyed indicated that they were light on inventory in February due to solid demand trends. Specifically, a net 30.4% of the respondents cited that they were under-inventoried at the end of the month, which is a strong improvement from the net 4.3% that reported being over-inventoried in January and the net 3.8% that noted being under-inventoried in December.

#### Conclusion

According to the results of our survey of independent rental purchase dealers, industry-wide demand trends were stronger on a year-over-year basis in February. Furthermore, commentary from the channel suggests that the headwinds from higher-than-normal delinquency rates are continuing to moderate and inventory levels are becoming light due to very strong demand trends. In short, the results of our survey over the past few months indicate that the industry is starting to get back on its feet. Reiterate BUY rating on shares of Aaron's and NEUTRAL rating on shares of Rent-A-Center.

Symbol:	Price	Target Price	Rating	EPS (\$) Cur Qtr	EPS (\$) Cur Year	EPS (\$) Out Year	Mkt. Cap (M)
AAN	\$28.12	\$36.00	B	\$0.58e	\$2.10e	\$2.42e	\$2,039.6
RCII	\$27.85	NA	N	\$0.49e	\$2.07e	\$2.48e	\$1,476.8

Rating Legend: B=Buy, N=Neutral, S=Sell

Nick Mitchell, CFA, CMT - Managing Director  
216.468.6902  
[nick.mitchell@northcoastresearch.com](mailto:nick.mitchell@northcoastresearch.com)  
Seth Woolf - Research Analyst  
216.468.6927  
[seth.woolf@northcoastresearch.com](mailto:seth.woolf@northcoastresearch.com)

INTEGRITY  
TRUST  
VALUE

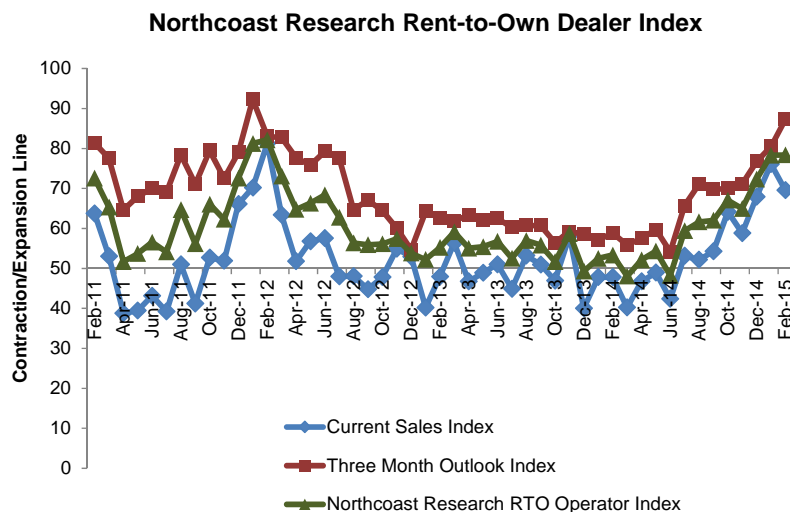
Each month we publish the **Northcoast Research Independent Rent-to-Own Dealer Index** based on the results of our survey, which encompasses a dynamic sample of more than 50 independent rent-to-own retailers throughout the country. We believe that the business trends among the dealers that we speak with are a good proxy for the operating environment in the rent-to-own industry, as independent operators account for approximately 45% to 50% of the traditional stores in the market. The composite index is an equal-weighted average of two sub-indices—**Current Sales Index** and **Three Month Outlook Index**. Levels above and below 50 indicate expansion and contraction, respectively.

The study is designed to capture the following factors in the rent-to-own industry:

- Recent business trends and the corresponding drivers
- Major inflection points in sales trends
- Expectations for demand over the next three months
- Major changes in consumer behavior
- Trends in delinquency rates
- Impact of gasoline prices on demand

#### Northcoast Research Rent-to-Own Dealer Index—February Snapshot

According to the results of our survey of independent rental purchase dealers, industry-wide demand trends were stronger on a year-over-year basis in February, as evidenced by the fact the Current Sales Index (CSI) finished the month at 69.6. While this performance was 6.5 points lower than the reading recorded in January, it still marked the eighth consecutive close above 50.0, which is something that has not occurred since June 2012. Recall that last month we postulated that January's results overstated the health of the industry due to a confluence of a few favorable calendar anomalies, including earlier receipt of tax refunds. We think much of the deceleration in the latest period reflects the unwinding of a portion of this favorable tailwind. As such, we are encouraged that trends remained robust in February despite the calendar headwinds, especially considering that a portion of the operators indicated that weather trends in the period pressured sales trends and traffic slightly (mainly in the Northeast and Midwest).



Source: Northcoast Research

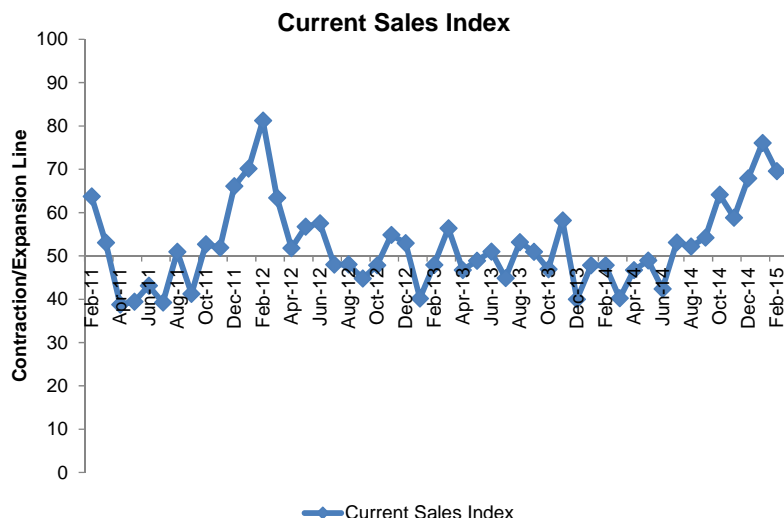
Not surprisingly, eight months of positive sales trends and a strong start to March combined with continued improvement in inventory levels and delinquency rates have left the majority of dealers feeling more confident about future sales trends. These positives are being bolstered by an improving macroeconomic backdrop for lower-income

households, including lower energy prices, improved job growth among low-skilled workers, and the cycling of headwinds related to the reduction in SNAP benefits and the curtailment in extended unemployment benefits. The more upbeat outlook is clearly visible in the Three Month Outlook Index, which finished the period at 87.2. This reading was 6.7 points higher than the reading recorded in January, and solidly above the long-term average of 68.5. We provide additional details on the drivers of the two sub-indices in the sections that follow.

### **Eight Straight Months of Sales Gains**

Our research suggests that sales trends in the rent-to-own industry increased on a year-over-year basis in February, as evidenced by the fact that the Current Sales Index (CSI) closed the period at 69.6. Recall that a reading above 50.0 implies that industry-wide comp trends were positive during the period. Results were strong despite the fact that operators faced headwinds related to earlier receipt of tax funds in 2015 relative to the previous year, which pulled forward some demand, especially early payment option activity. Despite this headwind, most dealers noted that cash sales, including early payment activity, increased relative to the prior year's period.

We were encouraged by the fact that traffic and ticket both contributed to the positive comps in the period. Recall that last month we speculated that the aforementioned shift in tax refunds weighed on agreement growth, as this metric was negative for the first time since August 2014. Needless to say, we were very encouraged to see customer growth rebound in February. In fact, this metric was at the highest that we have seen since November of 2012. Anecdotally, operators noted that it was much easier this year to convince customers that took advantage of the early payment options embedded in their contracts to rent new items.



Source: Northcoast Research

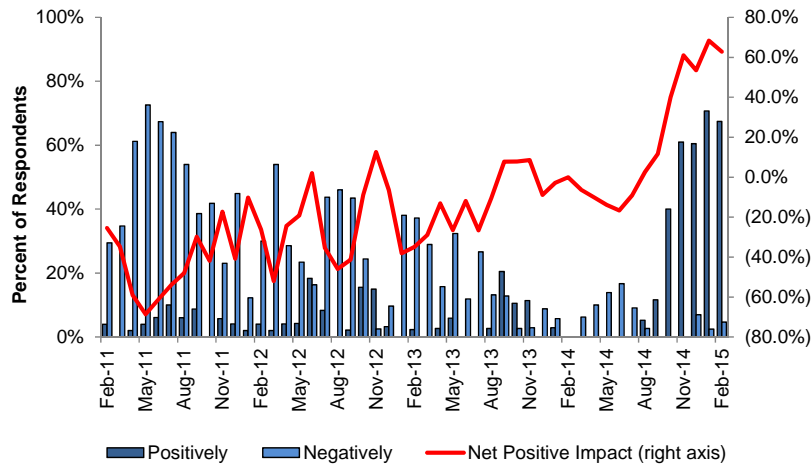
### **Lower Gas Prices are Providing Relief to Renters**

Gasoline prices declined 33.0% on a year-over-year basis in February, which marked the seventh straight month that prices were lower than in the prior year's period. In light of the ongoing relief that consumers are experiencing at the pumps, we were not surprised to see that a net 62.8% of the dealers in our survey cited gasoline prices as a tailwind to demand trends in the period. This reading compared to the net 68.3%, 53.5%, and 61.0% of dealers that reported a benefit from lower gas prices in January, December, and November, respectively. That said, falling petroleum prices are



not a universal positive as some dealers located in regions that have outsized employment exposure to the oil and gas industry noted a negative impact, or at least a reduced tailwind, from the lower oil prices as several customers have been laid off due to the correction in energy prices. This issue seems to be more prevalent in the fracking regions, as transient workers that have been laid off are opting to return their merchandise and return home. Looking ahead, fuel prices will likely remain a net tailwind to demand trends given the favorable outlook for gasoline and oil prices.

### Impact on Sales from Gasoline Prices

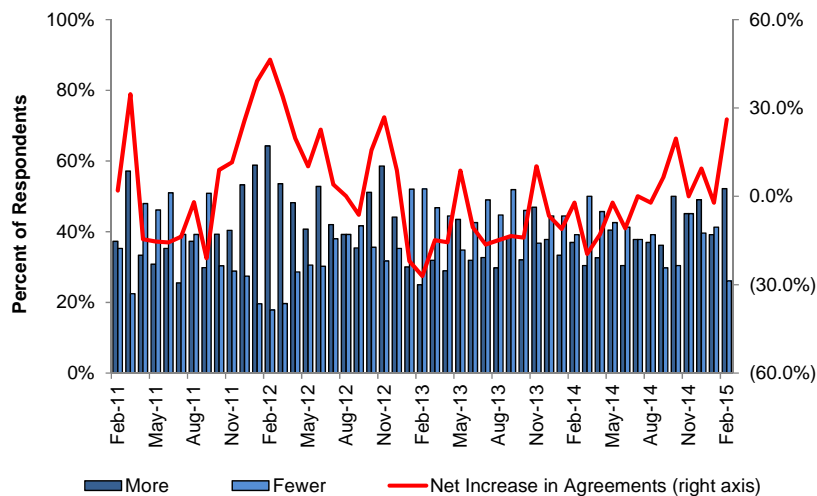


Source: Northcoast Research

### Rental Portfolios Are Expanding Again

Dealers reported that their customer portfolios started to expand again on a year-over-year basis in February after the early receipt of tax refunds created a minor setback in January. Specifically, a net 26.1% of the operators that we surveyed indicated that the number of rental agreements outstanding were up on a year-over-year basis at the end of the month. In comparison, a net 2.2% reported a decline in January. Prior to this decline, this metric was flat to up for four consecutive months, including December when a net 9.4% of the dealers reported growing their customer base.

### Number of Agreements Outstanding versus Last Year



Source: Northcoast Research

As we have said in the past, we view the size the dealers' rental portfolios as the single most important barometer of the strength of industry demand. Based on our conversations with industry contacts and the survey responses collected over the past several months, we remain confident that traffic in the core rent-to-own business is improving among independent operators. We believe the improving trend can be traced to a handful of factors: (1) agreements that have been originated in the past few months appear to be somewhat stickier than what we have witnessed in the previous 12 months, partially due to less aggressive promotions; (2) the industry is cycling some very easy comps; (3) gas prices are trending favorably; and (4) the introduction of 4K televisions and smartphones are adding incremental demand.

Notwithstanding the sequential improvement in same-store sales trends at Rent-A-Center in 4Q14, which benefited from strong adoption rates in the smartphone category, we are surprised that the publicly traded giants (Aaron's and Rent-A-Center) have not seen a similar uptick in traffic based on their respective outlooks for 2015. We are somewhat optimistic that the performance gap is merely a timing issue due recent execution hiccups as opposed to a permanent shift in market share to the independent channel; however, we will be watching this dichotomy closely in the coming quarters.

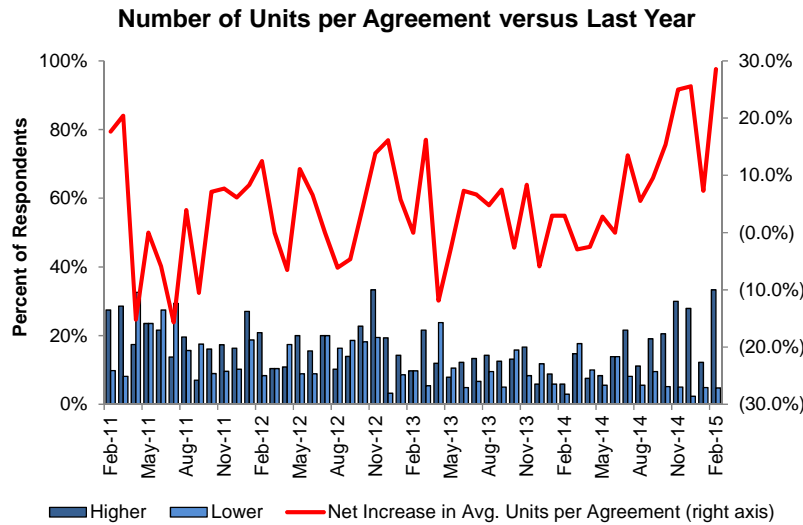
It is worth noting that many attendees of a recent industry trade show speculated that the independents are outperforming their national peers because they are more motivated to go out and find business since they have their own capital tied up in the businesses. We are confident that Aaron's and Rent-A-Center can jumpstart a similar trend by reengaging the store associates through enhanced training efforts and more efficient incentive compensation programs. For more commentary on the opportunities Aaron's and Rent-A-Center have to turnaround their legacy operations see the note entitled [AAN & RCII: A Closer Look at Drivers of Lost Earnings Power in Legacy Formats](#).

#### **Promotional Environment Still Fairly Stable**

The competitive environment has become generally more favorable as of late, which is certainly a positive for dealers who have struggled to maintain historical profitability metrics and grow customer counts over the past two years. In February, a net 4.7% of the dealers noted investing in price on a year-over-year basis. While this is a minor setback compared to January and December when a net 2.4% and a net 2.3% of the dealers noted higher prices, the overall environment is much more rational than what we saw from 2H12 through 1H14. In fact, only a net 3.7% of the dealers have on average reported lowering prices over the past 8 months, which is a material improvement from the average monthly reading of net 12.0% during the aforementioned 2-year window of more aggressive competitive tactics. We will continue to monitor this trend for a reversal going forward to be sure that the industry is not making a fundamental promotional shift.

#### **Traction with Bundling Efforts and the Benefits of Lower Gasoline Prices Lead to Gains in Units per Agreement**

The dealers that we spoke with reported that the average number of items per rental agreement increased in February compared to the same period in the prior year. Specifically, a net 28.6% of the dealers saw their customer base rent more units per agreement in the period relative to the prior year's period. More importantly, we have now seen growth in, or a sustained number of units per agreement relative to the previous year for 10 consecutive months. It is worth mentioning that the average reading in 2H14 was a net 15.8%, which was a material improvement from 1H14 when the average was a net 0.5%. February's reading is more in-line with what we witnessed at the end of 2014, and we are encouraged by the fact that the dip that this metric took in January was reversed. In our view, the trend over the past few months indicates that customers are responding to dealers' bundling strategies, as well as finally starting to loosen their purse strings, which is being aided by the favorable move in fuel prices and stronger employment trends for low-skilled workers.

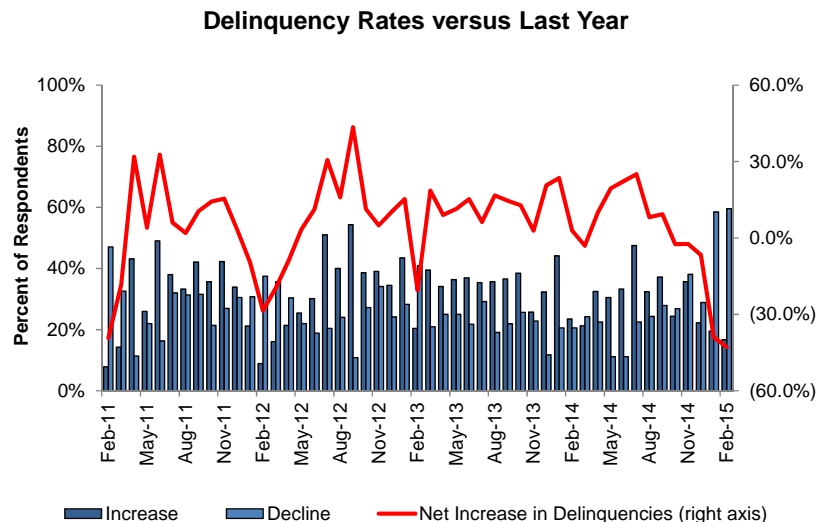


Source: Northcoast Research

### Delinquency Rates Continue to Improve

We were very encouraged by the fact that the majority of the dealers indicated that delinquency rates improved on a year-over-year basis for the fifth consecutive month. Specifically, a net 42.9% of the dealers indicated that delinquencies decreased on a year-over-year basis in February. More importantly, the three month average has shown a net tailwind to cash collection trends for three consecutive months. Prior to this, we had not seen a favorable reading on cash collection trends since May 2012. This trend is consistent with the sequential improvement Aaron's and Rent-A-Center witnessed in the brick-and-mortar stores during 4Q14, excluding the impact of smartphones.

In our opinion, the improving trend is a function of a stronger customer, a reduction in poorly-designed promotional activity, and more dealers adhering to their historical collection standards. The use of promotions requiring little (or no) money down is not as prevalent as it was in prior quarters; however, these promotions have not disappeared completely, and the operators that are still employing these tactics are continuing to suffer from elevated delinquency rates.



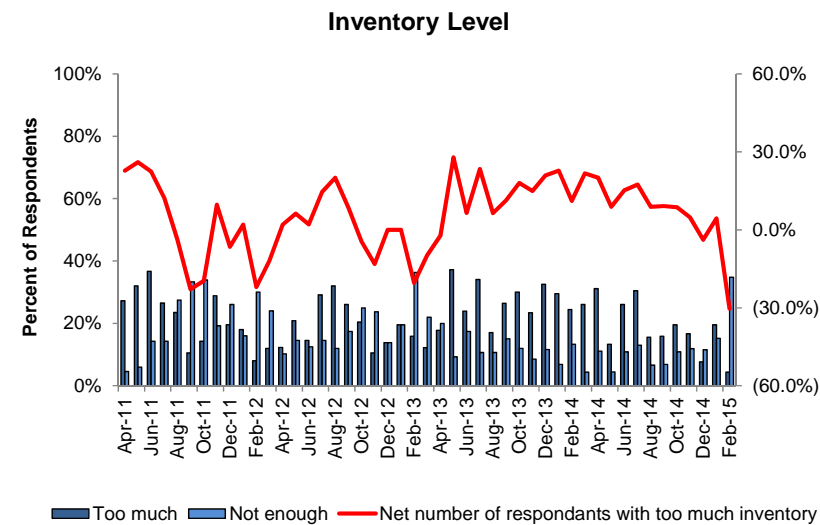
Source: Northcoast Research

## Inventory Levels Light Amid Improving Demand Trends

Although we heard some chatter regarding delays in the receipt of inventory due to the previous disruptions at the west coast ports, a majority of the dealers that we surveyed indicated that they were light on inventory in February due to solid demand trends. Specifically, a net 30.4% of the respondents cited that they were under-inventoried at the end of the month, which is a strong improvement from the net 4.3% that reported being over-inventoried in January and the net 3.8% that noted being under-inventoried in December.

It is worth noting that this metric improved significantly throughout 2014. In fact, the three-month moving average for this metric stood at a net 10.0% of respondents reporting being under-inventoried at the end of February 2015 (April 2013 was the last time the dealers were under-inventoried on a three-month moving average basis), which compares to a net 3.2%, 11.8%, 14.7%, and 18.5% of respondents reporting elevated inventories at the end of December, September, June, and March, respectively.

While being under-inventoried can spell trouble for sales trends in the short run due to lost sales from out-of-stocks, it is a much better position to be in than the alternative. Needless to say, excess inventory, including an abundance of pre-leased items can force dealers to increase promotional activity and hurt new deliveries (i.e. it is easier to rent new merchandise than previously rented goods). In short, while some of the inventory issues have been caused by delays at the west coast ports that may persist for the next month or so, in general, unexpectedly strong demand trends were the primary reason for lower inventory levels in February, which is a sign that demand trends are improving faster than the dealers anticipated.



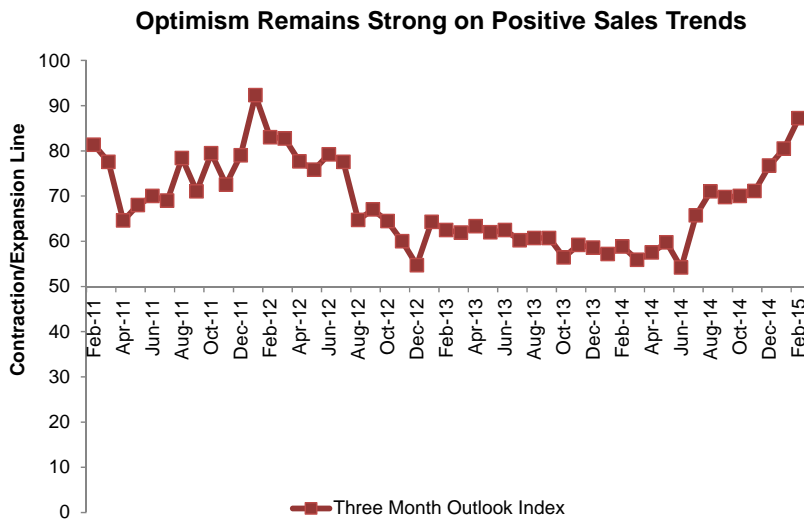
Source: Northcoast Research

## Dealers' Sentiment Remains Strong

The aggregate optimism among the dealers that participated in our survey improved in February, as evidenced by the fact that the Three Month Outlook index increased 6.7 points sequentially to 87.2. Furthermore, the collective sentiment remained much stronger than the average reading of 70.7 that we recorded in 2H14, as well as the average reading since inception of 68.5. In fact, the reading in January marked the highest level that we have recorded since January 2012.

The factors that continue to contribute to the relatively upbeat outlook in the dealer community are: (1) eight consecutive months of sales growth (first time since June of 2012); (2) customer count is higher despite an increase in

early payment option activity; (3) the belief that the extremely intense promotional environment is moderating; (4) the fact that delinquency rates continue to improve; and (5) commentary suggesting that the macro headwinds faced by the core customer are beginning to moderate, especially with lower gasoline prices acting as a progressive tax cut for lower-income households.



Source: Northcoast Research

The dealers that we spoke with still expect the industry will benefit longer term from the relatively tight credit environment being experienced by many individuals with subprime credit scores (below 650—680); however, the rapidly expanding kiosk channel is expected to capture the lion's share of this opportunity. As always, dealers were quick to point out that the ideal development for future sales growth would consist of a sustainable uptick in the labor markets among their core demographic buckets and somewhat tight consumer credit standards.

In our opinion, the fact that the operators' sales outlook remained strong in February is a key takeaway from the survey results, as it suggests that the dealers believe that the market will continue to improve. Notwithstanding the recent sales benefit from the introduction of smartphones at Rent-A-Center and strategic price hikes at Aaron's, sales trends at the publicly traded giants have lagged that of their private peers. We are somewhat optimistic that the performance gap is merely a timing issue due recent execution hiccups as opposed to a permanent shift in market share to the independent channel; however, we will be watching this dichotomy closely in the coming quarters.



## Conclusion

According to the results of our survey of independent rental purchase dealers, industry-wide demand trends were stronger on a year-over-year basis in February. This is evidenced by the fact that the Current Sales Index finished the month at 69.6, which marked the eighth consecutive close in expansionary territory. More importantly, our measure of the aggregate optimism among dealers improved in the period, and remained well above the long-term average. The relatively upbeat sentiment can be attributed to: (1) eight consecutive months of sales growth (first time since June of 2012); (2) customer count is higher despite an increase in EPO activity; (3) the belief that the extremely intense promotional environment is moderating; (4) the fact that delinquency rates continue to improve; and (5) commentary suggesting that the macro headwinds faced by the core customer are beginning to moderate, especially with lower gasoline prices providing a nice tailwind. In short, the results of our survey over the past few months indicate that the industry is getting back on its feet, and we are optimistic that Aaron's and Rent-A-Center can narrow the performance gap in the coming quarters.

## Aaron's – Investment Thesis

We think the opportunity Aaron's has to claim a meaningful portion of the non-traditional rent-to-own market via the recent acquisition of Progressive, combined with the projected benefits from strategic price hikes, cost cutting, and store optimization efforts offset the fact that the retailer's core market may remain soft in the near-term, and the potential risk that management will continue to struggle on the execution front. That said, we think these risks are diminishing somewhat given the fact that industry fundamentals appear to be improving based on the latest feedback from the independent dealers that participate in our monthly survey, and the fact that Aaron's Board of Directors recently elected John Robinson Chief Executive Officer, which, in our opinion, is a positive development. As such, we are reiterating our BUY rating and \$36 price target. Please refer to our notes entitled: [AAN: Moving to BUY with \\$36 PT on Progressive Deal, Margin Enhancing Moves](#) & [AAN: Strategic Price Hikes Are Key to Unlocking Significant Earnings Potential](#) for further color on our thesis. Additionally, the notes entitled [AAN: High Confidence that the Omni-Channel Bet Will Pay Off](#) & [AAN: "All Hands On Deck" at Management Access Day](#) provide further color on our confidence in the omni-channel strategy and newly refreshed management team.

## Rent-A-Center – Investment Thesis

While we continue to believe that several of the strategic initiatives that led to our upgrade of Rent-A-Center shares should help improve earnings over the intermediate term, and help management achieve 400 bps of operating margin gains by 2017, execution risk is much greater than we had anticipated. Therefore, we recently downgraded shares of Rent-A-Center to NEUTRAL for the following reasons: (1) smartphones have a higher loss rate, lower gross margin due to higher 90-day option activity, and a higher cannibalization factor; (2) increased competition is forcing Acceptance Now to increase its value proposition to consumers quicker than we expected, including greater use of the 90-day option pricing, which is weighing on the margin structure and EBIT performance (i.e. sales lift not enough to offset the margin drag); (3) and management is having a harder time stabilizing comp trends in the Core U.S. segment despite new merchandising initiatives and an improving macro backdrop. For further thoughts on our thesis, please refer to our recent downgrade note entitled: [4Q14 Results Weak; Risks Greater Than Perceived; Downgrading to NEUTRAL](#). The note entitled [RCII: Trip to Boston Reveals Key Initiatives Remain on Track](#) provides additional insight into near-term headwinds to sales and margin trends, as well as color on the long-term opportunities to improve the cost structure and improve operating efficiency.

## DISCLOSURES

Research is produced by Northcoast Research Partners, LLC Member FINRA ([www.finra.org](http://www.finra.org)) and SIPC ([www.sipc.org](http://www.sipc.org)). Research is for institutional investor use only. Although we believe this information has been obtained from reliable sources, we don't guarantee its accuracy, and it may be incomplete or condensed. Past performance is not indicative of future results. A change in any assumptions may have a material effect on the projected results.

Securities are offered through America Northcoast Securities, Inc. Member FINRA ([www.finra.org](http://www.finra.org)) and SIPC ([www.sipc.org](http://www.sipc.org)).

## Ratings

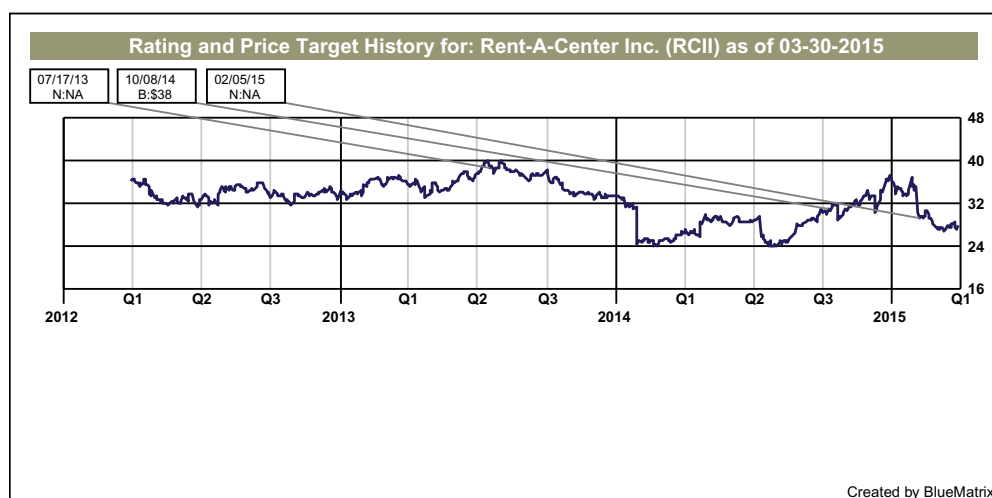
**BUY** – The stock is expected to outperform the S&P 500 index over a twelve-month period.

**NEUTRAL** – The stock is expected to perform in-line with the S&P 500 index over a twelve-month period.

**SELL** – The stock is expected underperform the S&P 500 index over a twelve-month period.

## Valuation and Risks

Our price target as well as our recommendation is based on a 12-month time horizon; however, we cannot guarantee an investor will achieve these results. We use a variety of methods to determine the price target of individual securities including fundamental analysis. In addition, we employ numerous valuation methodologies which include, but are not limited to, price to earnings multiples, enterprise value to earnings before interest taxes, and depreciation (EBITDA), book value, free cash flow yield, discounted cash flow, and relative valuation. All securities are subject to various risk factors. Please reference the above text and our most recent report for specific company valuation and price target.



**Rating Summary**

Distribution of Ratings Table		
Rating	Count	Percent
BUY(B)	56	39.72%
NEUTRAL(N)	83	58.87%
SELL(S)	2	1.42%
Total	141	

**Analyst Certification**

I, Nick Mitchell and Seth Woolf, certify that the views and opinions expressed in the research report accurately reflect my personal views about the securities and issuers mentioned in this report. Further, I certify that no part of my compensation was, is or will be directly or indirectly related to the specific recommendations or views contained in this report.

Copyright © Northcoast Research Partners, LLC