Management CV

Research Note:
Rent-A-Center, Inc. (RCII)
October 29, 2014

RCII: Mostly Same Team-Different Seats-Same Results

In the midst of a business slowdown and changes to the core model, Rent-A-Center's founder and CEO Mark Speese (56) announced his retirement and the promotion of long-time CFO Robert Davis (42) to CEO in January. It has been a challenging few years for the team as growth in its core U.S. business has slowed and it has been forced to rethink its business model and rapidly expand into new areas. In response to the slowdown in sales, management has closed 150 of its 3,000 locations and is working to improve the profitability of its core business by implementing a new labor optimization program, changing its pricing strategy, and optimizing its supply chain. The team is struggling to stabilize the core business and has recently added smartphones to its stores in the hopes of attracting new customers. Strength in new businesses, such as Acceptance Now, and its expansion into Mexico have somewhat offset top-line weakness, but these businesses are lower margin and require a large upfront investment. We like the long tenure of the team, many of whom have worked their way up through the organization; however, their experience has primarily been in growing RCII through M&A and new store openings. They now face a number of challenges in this mature space and we do not think they have the right background to handle them. We note, positively, that Davis did bring in an experienced CFO, Guy Constant (49), and we like his operational background. We don't think that management has the right pay incentives in place or enough skin-in-the-game to align them properly with shareholders. We are cautious on the team given the challenges they face and the recent significant changes.

EXECUTIVE TEAM SKILLS FIT While the majority of the team has had long tenures with RCII, 7 of the 8 key executives were promoted into new roles in 2014, which we think creates transition risk and uncertainty given the challenges in the rent-to-own market and at RCII. Chairman Speese may have recognized that the business had outgrown him and decided it was the right time to step aside in 2013. Instead of bringing in an outsider with turnaround experience, long-time CFO Davis was promoted to CEO. Davis has been with the Company for over 20 years and served as CFO for 15 years. We think he did a reasonable job as CFO in overseeing the growth of the Company and successfully integrating new businesses into the firm. We note, however, that we rank management in the 2nd to the bottom or bottom quintile vs. similar-sized peers on 7 of the 9 key operating metrics that we look at to evaluate performance. We blame Davis for some of that performance and note that the metrics were mostly in decline during his last 2 years as CFO. We also don't think that he has the right skillset to navigate the Company through this challenging time. Davis is known as a hard working CEO who was the first person in his family to graduate from college and worked full-time through college to pay his tuition. His leadership style is to bring more people into the decision making process than has been done in the past. CFO Constant joined RCII in June. He was previously the CFO of Brinker International for 10 years, where he successfully drove operational improvements. Prior to Brinker, he spent 9 years at American Airlines in various finance roles. CFO Constant brings significant operational experience. We think his skills will be important as management tries to better manage its workforce and begins to add part-time employees to its staff to allow it the flexibility to allocate labor based on demand levels. President & COO Mitchell Fadel (56) has been with the Company for a total of 14 years and began his career in RCII's store management training program. He has served as President since 2000 and as COO since 2002. Prior to that, he spent 8 years as CEO of a subsidiary, Colortyme. EVP, CAO & General Counsel Christopher Korst (54) has also been with the Company for 14 years, taking over as CAO this year. He had previously been EVP Operations since 2008. We note that General Counsel Ron DeMoss resigned in July and Korst took over his duties. Management has said that international is an important area of growth and in January named Ricardo Cordon (66) EVP - Mexico to take on this job. We think he is a weak choice to run this important unit as he has previously served in a number of roles in the Tax department of the Company, starting in 2007. Most recently he was SVP, Tax from 2011 to 2013.

COMPENSATION & ALIGNMENT ANALYSIS We like that the Board's compensation plan is linked to good financial metrics, however, we think that management's compensation was *(continued on next page)*

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dominated by former CEO and now Chairman Speese. Overall the team's 2013 total cash compensation is reasonable at 1.3% of EBIT compared to 3.2% for similar-sized peers. We are concerned, however, that Speese took 58% of the team's total cash pay and about 60% of the team's total incentive pay. Total compensation is comprised of base salary, cash bonus, and long term incentive pay (LTIP), which includes 35% in options, 25% in time-based restricted stock units (RSUs) and 40% in performance-based restricted stock (PRSUs). Chairman Speese's total 2013 compensation (when he was still CEO) was $3.8 million, including: $984k in salary, a $511k cash bonus, and $2.2 million in LTIP. Davis' total compensation in FY13, when he was still CFO, was $996k, with $469k in salary, $26k in cash bonus and $490k in LTIP last year. In FY14, CEO Davis' salary will be $750k, his annual cash compensation target is 100% of salary and his target LTIP is 200% of salary. COO Fadel's total compensation was $1.7 million, including: $624k in salary, $47k in cash bonus and $768k in LTIP. We like that the Board targets total compensation at the 50th percentile of similar-situated public companies and that the cash bonus is based on good financial metrics, including: pre-tax net profit (65% weighting) and revenue (25%). We note, negatively, that there is also a subjective component tied to leadership values, but it is small at 10%. In FY13, management did not achieve its pre-tax income target; therefore, it did not pay out bonuses attributable to pre-tax net income or revenue. However, it did pay out 10% target bonuses. Options vest ratably over 4 years, RSUs cliff vest after 3 years, and PRSUs vest based on achievement of a 3-year EBITDA target.

EQUITY OWNERSHIP ANALYSIS We think Officers and Directors have reasonable beneficial ownership at 1.9 million shares or 3.7% of RCII. The majority of the shares, however, are held by Chairmen Speese (with beneficial ownership of 1.5 million shares, or 2.8% of shares outstanding). Nearly 21% of the total beneficial ownership is in the form of vested options. Outstanding options are 20% in-the-money at a weighted average strike price of $25.38, providing good alignment with shareholders. Over the past 18 months, there has been minimal selling among the team, except for COO Fadel, who sold 77k shares (51% of his beneficial stake). We note, positively, that CFO Constant purchased 10k shares shortly after he joined the Company and CEO Davis bought 4k shares when he took over as CEO, increasing his beneficial ownership to 83k shares.

CAPITAL ALLOCATION PRACTICES We think management has been consistent with its capital allocation strategy but has overly focused on returning cash to shareholders at the expense of the balance sheet and reinvesting in the business. The team has consistently repurchased shares as part of the Board's substantial $1.25 billion buyback authorization. In FY13, management repurchased 37 million shares for $995 million and in FY12 repurchased 31 million shares for $777 million. In addition to that, the team completed a $200 million accelerated share repurchase in FY13. The Board also pays a good dividend of $0.92 per share, yielding 3.1%. We are concerned that this significant return of cash to shareholders has been at the expense of the balance sheet and basic reinvesting in the core offering. The Company is highly leveraged, with $975 million in debt and $62 million in cash at the end of Q3'14. We also question how effective Davis can be in his relatively new role as CEO when he was at least partially responsible for the recent poor results. We note that EBIT was down 38% over the past 3 years and ROA dropped over 35% to 4.7% in that timeframe. We are also concerned that management hasn't reinvested properly in the business. We note that CapEx has been trending substantially lower over the past several years, from $133 million in FY11 to $109 million in FY13 and an expected $95 million in FY14.

OTHER FIDUCIARY ISSUES We note, negatively, that a Change-in-Control is triggered at a too low 35% voting rights acquisition. In 2007, the Company paid $100 million to settle a lawsuit regarding rent-to-own contracts that imposed a time-price differential greater than 30%. *End*