RTO AND THE FINANCIAL CRISIS

A review of economic calamities past and how they affected the rent-to-own industry

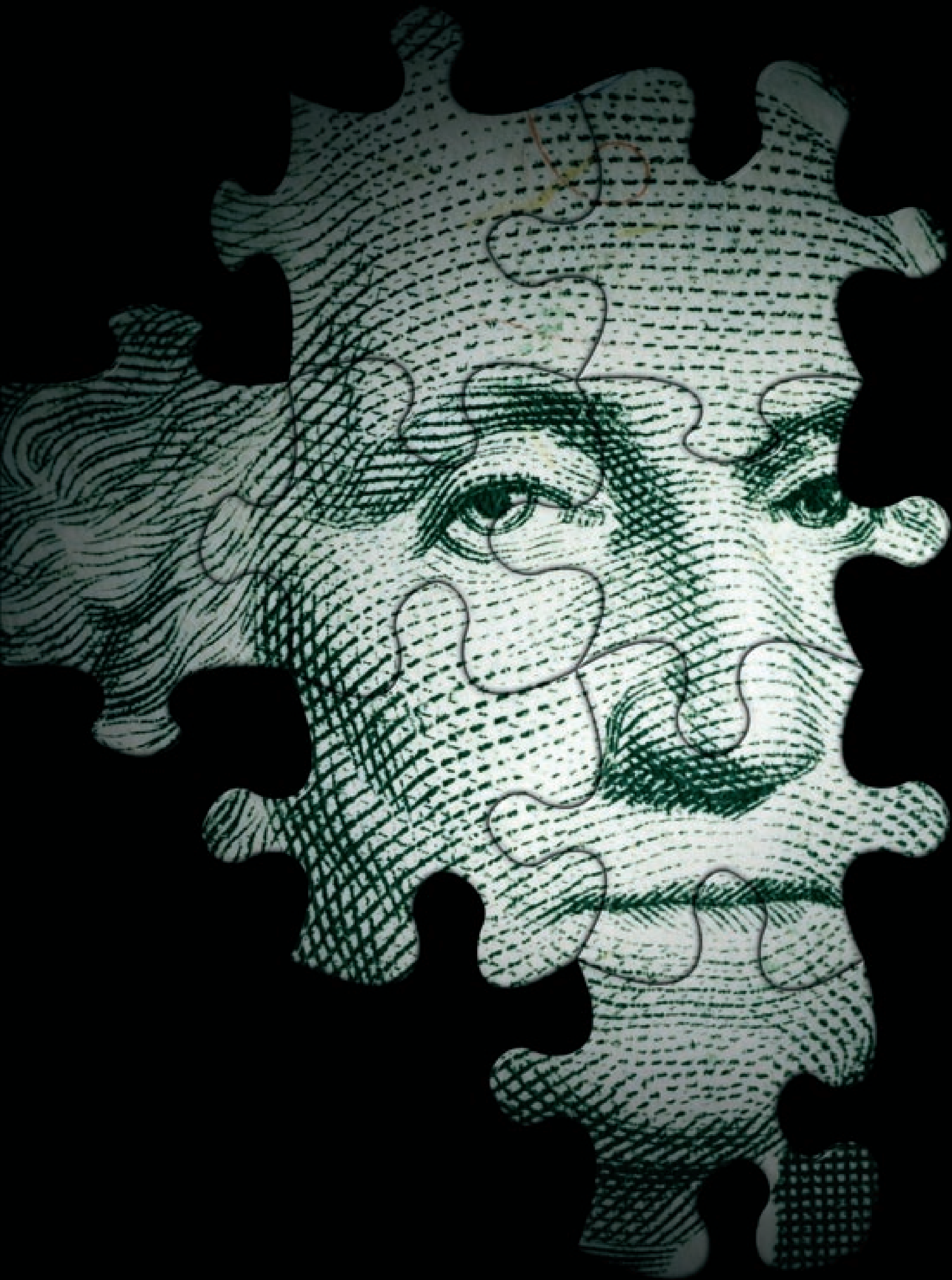
By Ed Winn III

The current worldwide financial crisis has rental dealers fretting about their futures and rightly so. There is concern over whether the industry's lenders—mostly banks these days—will continue to exist and whether they will continue to lend to the industry. Then there is concern over whether consumers will continue to rent.

A business that buys a piece of inventory for $750 and then rents it out for $25 a week needs a steady supply of credit in order to keep buying inventory. Some dealers are salivating over what they are sure will be an influx of new customers whose suddenly perilous financial circumstances will require them to take a hard look at rent-to-own for the first time. Other dealers' mouths are dry from the fear that times will get so tough that American consumers will become too poor even to rent. No one—alas, not even the Harvard MBAs and economic advisors and their political bosses who drove the country into this mess—can predict the future with any accuracy.

This is not, however, the first economic crisis that the rent-to-own industry has faced, although it threatens to be the most severe and longest lasting. A quick look back at some previous hard times may provide insights into what widespread economic calamity does to RTO.

KUZMA | DREAMSTIME.COM



While the rent-to-own transaction may have first surfaced in the 1960s, the industry did not really get going until the late 1970s/early 1980s. This was at the height of President Jimmy Carter's economic "malaise" of high interest rates, high gas prices and rampant inflation.

Most rental dealers at that time, and there were not very many, got their financing from one source, the commercial finance company Borg Warner Acceptance Corp. The lending was disciplined, with small lines that required dealers to pay off purchases in 18 months. These lending terms were the origin of the 18-month/78-week rent-to-own term in rental agreements. Dealers paid Borg Warner prime plus 6 percent. When the prime interest rate hit 20 percent briefly in the early 1980s, rental dealers were paying 26 percent interest on their credit lines—and were grateful to have access to the funds. Savvy rental dealers borrowed all they could, because in some states, the prime interest rate was higher than the usury rate and higher than the finance charge limits in retail installment sales acts, thus cutting off virtually all consumer credit. The RTO industry got a huge bump during this hard time with overall growth as much as 25 percent a year. Rent-to-own got an early reputation as being counter-cyclical and a recession-proof industry. Tom Devlin took Rent-A-Center public in 1983 because he saw the vast potential for the growth of rent-to-own and wanted access to public money to finance that growth.

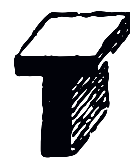
On the consumer side, the "misery index" (unemployment rate plus inflation rate) reached its all-time high in June 1980: 22 percent. (The misery index was first calculated by economist Arthur Okun, an advisor to President Lyndon Johnson, in the 1960s.) It was 1986 before the index fell below 10 percent.

This era saw not merely a deep recession, but "stagflation": rising unemployment, negative growth in GDP and high inflation. In an ordinary recession, there is rising unemployment, negative GDP growth and falling prices. Even during this period of stagflation, the rent-to-own industry came into its own and grew at rates not seen before or since. Consumer credit was very tight and the demand for consumer goods was very high—the demand contributed to the inflationary pressure. These were ideal circumstances for RTO growth.

The next time the country fell on hard economic times was the recession of 1990–91. This recession allowed Bill Clinton to run and get elected president in 1992 using the slogan, "It's the economy, stupid." By this time, rent-to-own was well established in most markets. Rent-A-Center's startling growth, including its acquisition by Thorn EMI in 1986 for a whopping 34 times monthly revenues—a nearly $600 million purchase—attracted a lot of interest and a lot of money to RTO. Major finance companies, rather than banks, courted dealers and Transamerica Commercial, Chrysler Financial, GE Capital, McDonnell Douglas and others had large rent-to-own portfolios. It was not unusual for a dealer to have a line of credit equal to eight or even ten times monthly revenues on a revolving line, paying interest only, and dealers borrowed all they could for reasons good and bad.

The recession in the early 1990s was not as broad or as deep as the previous one and did not drive hordes of new customers to rent-to-own doors. Many dealers were overextended because credit was so loose; when economic growth slowed and RTO growth along with it, a lot of dealers went under. The industry proved that it was not recession-proof after all. In 1991, Transamerica wrote off $137 million in bad rent-to-own loans. The period saw the creation of Magic Rent-to-Own, a lender-created entity designed to operate some 350 RTO stores that had been repossessed. If rent-to-own lending was loose, consumer credit was even looser. The credit card age was born in the 1980s and consumer credit card debt has continued to grow exponentially until today (www.federalreserve.gov/historicaldata).

The rent-to-own industry that came out of this recession—a recession that saw the misery index creep over 10 percent for the first time since the early 1980s—was more disciplined, more professionally run and eventually more consolidated. The weak operators were driven out and the surviving companies saw opportunities to expand rapidly via acquisitions, which they exploited.



Today, on the lending side, the finance companies have been replaced by local banks and the public's investment in Rent-A-Center and Aaron's, which together operate more than half of the rent-to-own stores in the country. Lending is disciplined and growth has been modest and steady. For example, banks typically cap lending lines at two to four times monthly revenues, with a host of other negative covenants to control the loan. Conditions on the lending side of the industry are very different from conditions during the last recession. Still, this is not the time to be fussy with your lender. In fact, you want to buy *him* lunch, instead of the other way around.

On the consumer side, the misery index has not topped 10 percent, although it is trending up so far in 2008 and is a far cry from the early 1980s when it was twice as high. Consumer credit is tightening to a greater extent than perhaps ever before. By the time they get washed through the system, all of the mortgage defaults will increase the number of

FOTKO | DREAMSTIME.COM

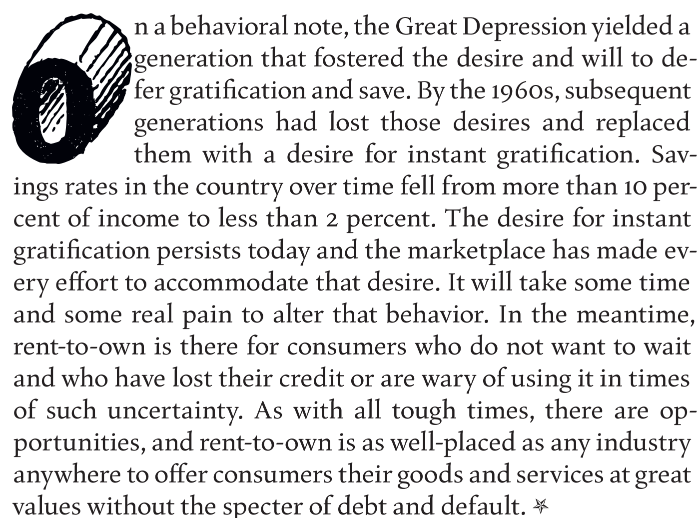
consumers with bad credit by millions. Credit card defaults are on the rise and some predict that the next spectacular financial failures will be some of the credit card companies. Consumer credit is tightening and that situation is akin to the early 1980s. An open question is whether the current situation—bleak and uncertain as it is—will also stifle consumer demand. If demand falls, then all consumer businesses, including rent-to-own, will suffer.

Lately, there has been a rise in layaway plans, according to the *The Wall Street Journal* (October 21, 2008). One Internet layaway company reported that sales have increased 91 percent over the previous year. This is some indication that, for the moment at least, consumer demand is being sustained—and that bodes well for rent-to-own.

Some dealers report anecdotally that as the bottom tier of customers has fallen away due to economic uncertainty, job loss, high gas prices and general belt-tightening, it has been replaced by new, higher-income customers. These customers are more demanding and less grateful to have a place to do business, but they are still paying customers, so far.

One might suppose that if the economy truly melts down into a worldwide depression with soup lines and former executives selling apples on street corners, then rent-to-own will melt down along with the rest of U.S. commerce, but that has not happened yet. There is no reason to predict or suppose that things will get *that* bad. There are checks and balances in place and at play that did not exist during the Great Depression to minimize economic crises.

One might suppose that if the economy truly melts down into a worldwide depression with soup lines and former executives selling apples on street corners, then rent-to-own will melt down along with the rest of U.S. commerce, but that has not happened yet. There is no reason to predict or suppose that things will get *that* bad.



On a behavioral note, the Great Depression yielded a generation that fostered the desire and will to defer gratification and save. By the 1960s, subsequent generations had lost those desires and replaced them with a desire for instant gratification. Savings rates in the country over time fell from more than 10 percent of income to less than 2 percent. The desire for instant gratification persists today and the marketplace has made every effort to accommodate that desire. It will take some time and some real pain to alter that behavior. In the meantime, rent-to-own is there for consumers who do not want to wait and who have lost their credit or are wary of using it in times of such uncertainty. As with all tough times, there are opportunities, and rent-to-own is as well-placed as any industry anywhere to offer consumers their goods and services at great values without the specter of debt and default. ✴

Ed Winn III is APRO's general counsel and has been involved with the association since its inception in 1980. His e-mail address is edwinn@mwvmlaw.com.