

BY ROBERT STRAUS

MAPPING OUT RENT-TO-OWN ON

Wall Street

EDITOR'S NOTE:
FINANCIAL ANALYST
ROBERT STRAUS WILL
PRESENT A SEMINAR,
"WHAT WALL STREET
ANALYSTS ARE
SAYING ABOUT RTO,"
DURING THE 2004
APRO CONVENTION
AND BUYING SHOW,
9-10:30 A.M.,
AUGUST 6 AT THE
TAMPA CONVENTION
CENTER.

Rent-to-own operators are benefiting from strong fundamentals in the rental industry. The industry generates annual revenue of approximately \$6 billion and has grown 5 percent, on average, over the past five years. RTO operators are becoming a more visible group as indicated by a 23 percent increase in the Association of Progressive Rental Organizations' member stores in 2003 versus 2002. (This percentage excludes the stores of Aaron Rents, the industry's second-largest operator, which only joined APRO in November 2003.) ✧ RTO continues to provide opportunities that are especially attractive for entrepreneurs. Unlike many traditional retail businesses, RTO operators tend to generate comparatively strong cash flow, which has resulted in a fragmented industry composed of profitable small operators.





As a senior equity analyst covering the consumer and retail sectors for Independent Research Group—a wholly owned subsidiary of TheStreet.com—there are certain responsibilities required to represent an industry. In my research of the RTO industry, I would like to share an overview of the industry, as well as discuss the industry's leading operators—Aaron Rents, Rent-A-Center and RentWay—and the overall industry outlook. Independent Research Group maintains research coverage of all three stocks, with Buy ratings.

My job is to search for compelling investment ideas that I consider under- or over-valued—often because a company or industry is misunderstood or less visible. To build an investment case, I conduct in-depth industry interviews, read up on my subject company and its competitors, aggregate industry data and seek stock-specific catalysts.

In general, I favor companies with strong competitive positions and solid management that operate in niche markets. As a screening tool in the search for investment opportunities, I use a proprietary database with more than 900 consumer and retail companies. Also, I emphasize the analysis of cash flows and valuation parameters—how is my subject company valued on various financial measures, on an absolute basis and relative to its publicly traded peers.

PLENTY OF ROOM FOR GROWTH

Based on my discussions with public and private RTO operators, I believe industry growth trends remain solid. My industry checks suggest that the number of RTO operators is on the rise, which is an encouraging sign. Independent operators appear to be attracted to RTO's cash flow potential and the industry's view that customers can be served better by a smaller-scale operation. At present, the RTO industry has 3 million U.S. clients. By my estimate, this represents only 7 percent of the industry's addressable market—based on the most recent U.S. Census indicating that there are roughly 44.5 million U.S. households that generate annual income of \$15,000 to \$50,000, the RTO-opportunity sweet spot. These strong macro industry fundamentals should support the efforts of large and small operators.

The RTO industry serves the needs of a specific consumer segment that is not met by traditional retailers. It's a niche segment of retail. The RTO operator provides an alternative for consumers who lack the credit or available cash to purchase goods such as major appliances, furniture and electronics.

There are three types of RTO customer: 1) con-

sumers who lack credit or the available cash to purchase goods at typical retailers; 2) consumers and businesses that have temporary needs; and 3) customers who have the credit or cash availability, but have an interest in trying out a particular brand or model before making a final purchase. In my estimation, more than 90 percent of RTO customers are those who lack credit or the available cash to purchase merchandise at traditional retail stores. These customers are drawn to the flexibility of RTO agreements, which offer an option to purchase merchandise, yet allow the customer to be free from obligation beyond a weekly or monthly commitment.

THE RTO GROWTH, CASH FLOW AND TURNAROUND STORIES

The top-three publicly traded companies offer three distinct investment opportunities: Aaron Rents as the growth play, Rent-A-Center as the cash flow story and RentWay as the turnaround story. As a result of these different perspectives, there is opportunity in the RTO sector for many different types of investors. Risks that may affect these companies include uncertainty regarding federal regulation, pressure from consumer advocacy groups, acquisition-related integration risk and failure to implement key strategies and growth plans.

Aaron Rents is an industry leader that is generating record growth. Aaron's primary business is the operation of RTO stores in its Sales and Lease Ownership division. If we apply the "same-store sales" metric to SLO (same-store sales is used to measure the growth of existing operations), we find that Aaron stores are currently increasing at a low double-digit pace year-over-year.

The company reported outstanding financial results in the first quarter ending March 2004. Its rental agreement growth drove a first-quarter same-store sales increase of 13.7 percent, especially impressive following year-ago growth of 14.1 percent. The company's store-expansion plans appear to be on track. In 2004, Aaron's primary growth driver will be roughly 70 new company-owned and 70 new franchise locations. Further, its franchisee success has resulted in strong demand for its franchise license rights and has allowed the company to raise its initial franchise fee and franchise royalty fee. The company purchased approximately 25 stores year-to-date and could acquire a total of 50 stores by year-end. In my view, execution of new-store openings will be the key to this story.

Rent-A-Center is the largest RTO operator with approximately 3,000 locations. The company generates significant free cash flow (cash flow from operations minus purchases of property assets), which has been used to fund new store openings, acquisitions and share repurchases over the past three years.

Rent-A-Center's new store operations are outpacing the company's internal expectations. The company is expected to continue to increase its store base through a combination of acquisitions and new store openings. In 2004, I expect Rent-A-Center to open approximately 100 new locations. The company has made two sizeable acquisitions already this year: Rainbow Rentals, which operated 124 stores in 15 states, and Rent-Rite, which operated 90 stores in 11 states. The key to success for RAC will be to reinvigorate revenue growth.

Last but not least, RentWay is a turnaround story returning to rental basics. The company emerged from financial and legal troubles approximately 12 months ago and has not looked back. In June 2003, a refinancing significantly strengthened RentWay's balance sheet. Management has been able to return its focus to store operations. The company has restored rental revenue momentum with a same-stores sales increase of 2.5 percent in the fourth quarter of its fiscal 2003 (the fiscal period ended September 2003), 6.6 percent in the first quarter of its fiscal 2004 (ended December 2003) and 6.9 percent in the second quarter of fiscal 2004 (ended March 2004).

RentWay's rental collections also are showing improvement, with on-time receipts increasing to slightly over 92 percent as of its fiscal second quarter ended March 2004; this compares to 91 percent in the year-ago period and 89.7 percent in the first quarter ending December 2003. RentWay remains well positioned in the RTO market and look for the company to start expanding its store base—something it has not done in about four years.

EXPANSION OPPORTUNITIES IN THE WEST, CANADA AND MEXICO

In 2003, Rent-A-Center Chairman and CEO Mark Speese said he believed "the industry can add another 6,000-plus stores before it is saturated"—to 14,000 locations from the current 8,000. My discussions with industry contacts suggest that expansion throughout the western United States is likely to be a focus over the next several years. International markets—specifi-

cally Canada and Mexico—should provide additional growth opportunities for RTO operators. Other international markets may be of interest to U.S. RTO operators on a franchise basis, including New Zealand and Australia.

Canada is a promising near-term market for U.S. RTO operators. In 2003, Aaron Rents became the first U.S. operator to enter Canada with six franchise stores in southwestern Ontario. In March 2004, Rent-A-Center entered Canada with the purchase of five stores in Edmonton and Calgary. Our industry checks suggest that there are about

200 RTO stores in Canada at present. Easyhome is Canada's largest RTO operator, with 133 locations. Rent Cash, whose primary business is payday loans, is currently the second-largest Canadian RTO operator, with five locations.

The Canadian RTO industry shares several similarities with the U.S. industry, including: merchandise remains in the system for approximately two years, the average rental length is about 18 months and the total cost of merchandise ownership for the client is roughly four times the RTO operator's cost to buy it. I believe RTO in Canada is in the early stage of its development and in some ways is similar to the U.S. market 20 years ago. For example, there are currently no laws regulating RTO in Canada.

Canada also has a more rural topography. To date, this has translated into solid profits for RTO stores despite lower volumes.

In a final note, investment interest in the RTO community is strong due to its positive outlook and continued growth potential, both here and abroad. I look for the industry to continue to garner investment interest in the coming years, especially in light of the possibility of the passage of federal legislation. ■

Robert D. Straus has eight years of Wall Street experience and covers the consumer and retail sector as a senior analyst for Independent Research Group. He has appeared on CNBC and Bloomberg Television. Straus also has been interviewed by The Wall Street Transcript and national publications, including The Wall Street Journal, Business Week, Investor's Business Daily and The New York Times. IRG Research is a registered broker-dealer providing hedge funds and institutional money managers with unbiased and differentiated equity research. IRG Research is headquartered in New York City.

THE TOP PUBLICLY TRADED COMPANIES OFFER THREE DISTINCT INVESTMENT OPPORTUNITIES: AARON RENTS AS THE GROWTH PLAY, RENT-A-CENTER AS THE CASH FLOW STORY AND RENTWAY AS THE TURNAROUND STORY.