Sears Hometown and Outlet Stores, Inc. (SHOS)

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Disclaimers

- I am not a registered investment advisor and I do not offer any investment advise
- No parts of this talk are suggestions to invest, not invest, buy or sell any kind of securities or other financial instruments

Sears Hometown and Outlet Stores - business

- Sears Hometown and Hardware:
  - Sears Hometown Stores (941) - home appliances, consumer electronics, lawn and garden equipment, sporting goods, tools, and household goods
  - Sears Hardware Stores (90) - tools, lawn and garden equipment, home appliances, other home improvement products, fasteners, electrical supplies, and plumbing supplies, as well as proprietary in-store services consisting of blade sharpening, key cutting, and screen repair
  - Sears Home Appliance Showrooms (80) - home appliances and related services in stores primarily located in strip malls and lifestyle centers of metropolitan areas
- Sears Outlet (126) - in-store and online access to purchase outlet-value products across an assortment of merchandise categories, including home appliances, consumer electronics, lawn and garden equipment, apparel, sporting goods, tools, and household goods

Sears Hometown and Outlet Stores- business (cont’d)

- Hometown: 75% sales, 56% op income – 60% appliances, 22% lawn&garden, 10% tools and paint
  - 22% op income last Q
  - 942 dealer operated stores, 110 franchise, 59 company
- Outlet: 25% sales, 44% op income – 80% appliances, rest – apparel?

Sears Hometown and Outlet Stores - Misc thoughts

- What can go wrong?
  - Competition from Sears mothership stores
  - Bad franchising of Hometown: lack of franchisees, bad quality franchisees, etc.
  - Competition from other hardware stores
  - Subpar merchandise selection

Sears Hometown and Outlet Stores - Misc thoughts

- Opportunities:
  - Franchise growth (especially with Sears mothership stores closing)
  - Less competition in smaller towns with a positive Sears brand image in hardware
  - RE recovery

Strategic considerations

- Moat (*switching costs*, *habit*, *low cost*):
  - What are the moats? Brand name, some HW brands have cachet
  - What does it take to sustain the moats? Continued brand cachet
  - Bargaining power of suppliers/customers? Not much
- Is it a low risk business? Medium risk.
- Is there high uncertainty? Medium uncertainty.
- How capital intensive is the business? Not really.
- Future growth – Unknown
- Are the revenues and cash flows of the business sustainable or overstated / understated due to boom or bust conditions? Perhaps understated due to past recession

Checklist

- 1. Can I in one sentence say exactly what the company does?
- 2. Operating cash flow higher than earnings per share?
- 3. Free Cash Flow per share higher than dividends paid?
- 4. Debt to equity below 35%?
- 5. Debt less than book value?
- 6. Long Term debt less than 2 times working capital?
- 7. Is the debt to EBITDA ratio less than 5?
- 8. What are the debt covenants?
- 9. When is the debt due? All at the same time?
- 10. Are pre-tax margins higher than 15%?
- 11. Free cash flow margin higher than 10%?
- 12. Does the cash belong to the company?
- 13. Current asset ratio greater than 1.5?
- 14. Quick ratio greater than 1?
- 15. Growth in Earnings Per Share?
- 16. EBIT / Assets > 20%
- 17. Management shareholding > 10%?
- 18. Altman Z score > 3?
- 19. Piotroski F-Score of more than 7?
- 20. Is there substantial dilution?
- 21. What is the Flow ratio (Good < 1.25, Bad > 3)

Management

- I don't usually do management analysis. Included for template completeness
- No information on dilution - spinoff
- Can I trust management?
- Management shareholding (> 10%)
- Management incentives?
- Are the salaries too high?
- Is there heavy insider buying?
- Is there heavy insider selling?
- Do I like the management? (Operators, capital allocators, integrity)
- Profitable reinvestment
- What has management done with the cash?
- Where is Free Cash Flow invested? Share buybacks, dividends, reinvested, ROE & ROCE, incremental BV

Piotroski Score

Only applicable to Graham Cos – N/A to SHOS

1. Net Income: Bottom line. Score 1 if last year net income is positive.
2. Operating Cash Flow: Better earnings gauge. Score 1 if last year cash flow is positive.
3. Return On Assets: Measures Profitability. Score 1 if last year ROA exceeds prior-year ROA.
4. Quality of Earnings: Warns of Accounting Tricks. Score 1 if last year operating cash flow exceeds net income.
5. Long-Term Debt vs. Assets: Is Debt decreasing? Score 1 if the ratio of long-term debt to assets is down from the year-ago value. (If LTD is zero but assets are increasing, score 1 anyway.)
6. Current Ratio: Measures increasing working capital. Score 1 if CR has increased from the prior year.
7. Shares Outstanding: A Measure of potential dilution. Score 1 if the number of shares outstanding is no greater than the year-ago figure.
8. Gross Margin: A measure of improving competitive position. Score 1 if full-year GM exceeds the prior-year GM.
9. Asset Turnover: Measures productivity. Score 1 if the percentage increase in sales exceeds the percentage increase in total assets.

- Total: / 9

Is it a good business?

- No history - spinoff
- ROE:
  - 2010: 2011: 2012: 12
- Margins
  - 2010: 2011:1 2012: 3
- 3 year sales growth ?%, earnings growth ?%
- No dilution information
- Strong balance sheet
  - Cash ~= debt
  - Capital lease obligations
- ROIC = Earnings / (Equity + Debt – Cash) = Earnings / (Assets – non-debt liabilities - Cash)
  - ~= ROE

Is it a good business? Cash flow

- Good 2012 cash flow:
  - 2012 9 mo 50M earnings, 93M operating cash flow, 85M FCF (FCF = OCF – capital expenditures)
  - Free Cash Flow/Share higher than dividends paid

Is business cheap? - Buffettology calculations

- ROE 12%
- Earnings in 10 years = ROE*Equity*$(1+\text{ROE})^9$ = $185M
- Equity in 10 years = Equity*$(1+\text{ROE})^9$ = $1542M
- Market cap = 185M x P/E (15) = $2775M
- Rate of return = 10% after tax (calculations omitted)

- 9 year earnings growth: N/A%. Assuming N/A% earnings growth: N/A% share price growth.

Is business cheap? DCF

- Discounted cash flow
  - Current earnings of 67M (FCF ~100M)
  - 10% growth for 5 years, leveling after that
    - 15% discount -> $653M current valuation
  - 5% growth for 5 years, leveling after that
    - 15% discount -> $542M current valuation
  - 10% growth for 10 years, leveling after that
    - 15% discount -> $818M current valuation
- Owner's yield = earnings / (market cap + debt - cash) = earnings/EV
  - 67M / (920M+280M) = 5%
- What makes up the margin of safety? Potential growth
- Is there a sufficient margin of safety? No.

Is business cheap? - Graham investment considerations

- N/A for SHOS – included for completeness
- 1.6 P/Book – not a net net
- Altman Z score (http://en.wikipedia.org/wiki/Altman_Z-score)