Sears Hometown and Outlet Stores, Inc. (SHOS)

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• 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? - Buffetttology calculations

• ROE 12%
• Earnings in 10 years = ROE*Equity*(1+ROE)^9 = $185M
• Equity in 10 years = Equity*(1+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