SEARS HOLDINGS

Sears Holdings' First Quarter 2014 Results
Pre-Recorded Conference Call Transcript
May 22, 2014

Operator:

Good day, ladies and gentlemen, and welcome to the Sears Holdings Q1 2014 earnings conference call. At this time, all participants are in a listen-only mode. [Operator Instructions] As a reminder, this conference call is being recorded.

I would now like to introduce your host for today's conference, Mr. Rob Schriesheim. Sir, you may begin.

Rob Schriesheim:

Thank you, Operator.

Ladies and gentlemen, welcome to Sears Holdings' earnings call. I am Rob Schriesheim, EVP and CFO. Please note that this morning we released our first quarter earnings results, which are now available on our website.

Joining me today is Eddie Lampert, our Chairman and Chief Executive Officer. For our call today, you may access the accompanying slide presentation which is available on the investors section of our website under events and presentations.

Before we begin, on slide one, I would like to remind you that today's discussion will contain forward-looking statements relating to future events and expectations. These statements are based on current expectations and the current economic environment, and actual results may differ materially from those expressed or implied in the forward-looking statements.

You can find factors that could cause the company's actual results to differ materially listed in today's press release, in the presentation for today's call that is posted at the Investor Information section of searsholdings.com, and in our most recent SEC filings.

In addition, on slide two, our discussion will include certain non-GAAP financial measures. Reconciliations to the most directly comparable GAAP financial measures can be found in the presentation and today's earnings release. Any reference in our discussion today to EBITDA means adjusted EBITDA, as defined in the earnings release and presentation.

Finally, we assume no obligation to update the information presented on this call, except as required by law.

I would now like to turn to slide three and turn the call over to Eddie Lampert.

Eddie Lampert:

Thanks Rob. I also would like to thank all of you for joining us today.

Beginning on slide three, I will provide an update on the progress we are making in our transformation, review some highlights from the past quarter, and briefly review some of the actions we are continuing to take to simplify and focus our company, while creating long-term value for our shareholders. Rob will then review our financial results for the quarter and update you on our asset redeployment efforts in more detail.

Following Rob's remarks, I will outline a framework we have been working on with the intent to restore profitability to our company.

Over the past year, we have successfully educated our various constituents on the strong asset base of Sears Holdings and the significant financial flexibility we have to fund our business operations and transformation. Today we will share a framework which we have developed outlining our intent to restore our company to profitability. We've already executed on certain aspects of that framework, but it is not meant to or designed to give guidance as to our future results, but rather to highlight some of the different levers we have at our disposal to restore profitability to a company of our size and scope.

Slide five depicts our transformation from a traditional retail business model to our member-centric business, leveraging Shop Your Way and Integrated Retail. Our traditional business focused almost exclusively on managing an asset-intensive store-based network, selling products through that network, and employing mass marketing and promotional programs with a high fixed-cost component. In our transformation, we are moving towards a model that is focused on providing benefits to our members by forming individual relationships using our technology and platforms. Our new business model is less asset-intensive and variable in nature.

On slide six, we outline the strategic pillars of our transformation. Our two key platforms -- Shop Your Way and Integrated Retail -- continue to become more prominent both in how we run the company and in how we serve our members.

In reviewing the first quarter, let's move to slide seven, where we provide an update on our transformation progress. As you can see in the charts at the top, we generated a significant change in our same-store sales trends.

Sears Domestic experienced positive comparable store sales growth of 0.2% as compared to a 2.4% decline last year, despite the continuing impact of consumer electronics industry trends. We regained sales momentum in our appliances business, but overall profitability still remains challenged, highlighting a few of the issues that are inevitable in a transformation of this scale.

The biggest negative contributor to sales has been from our consumer electronics business at both Sears and Kmart. To address this decline, we are moving this business from a focus on selling televisions to a company empowering Connected Living, which will bring together our capabilities in fitness equipment, electronics, appliances, home services, and auto services.

Specifically, our Sears Domestic comparable store sales would have been roughly 60 basis points higher if it were not for the poor performance of the consumer electronics business.

Another business that struggled in the first quarter was our Sears fitness equipment business. Sears is the leader in fitness equipment in the United States, and we intend to leverage and network this business also as part of Connected Living to develop capabilities that go beyond just selling treadmills, ellipticals, and other fitness equipment.

As one step, in the first quarter, we rolled out the integration of Shop Your Way, with several third-party fitness activity tracking clouds, permitting us to reward members for activities monitored via Fitbit, Jawbone Up, iFit-enabled cardio equipment, and a host of smartphone apps.

Kmart's comparable store sales were down 2.2%, as compared to a 4.6% decline last year, also despite the continuing impact of consumer electronics industry trends. In fact, the poor consumer electronics sales contributed to over a 1% drop in comparable store sales. Our grocery and household business also continued its poor performance, which has persisted for over a year and which we intend to address going forward. Excluding the impact of these two categories, the comparable store sales performance at Kmart would have declined 0.4%.

As you can see in the chart on the lower left, our online and multi-channel sales grew 26% over the prior year first quarter. We continue to make our online capabilities more robust and appealing for our members. We are also expanding our marketplace assortment and increasing the number of stores with tablet capabilities.

Finally, as shown on the chart on the lower right, we continue to invest heavily in driving our Shop Your Way platform. Member sales for the first quarter represented their highest level ever, reaching over 74% of eligible sales, up from 68% in the first quarter of 2013. Points redeemed increased by over 30%, demonstrating that our members are becoming even more engaged with the program and taking advantage of the points that they are earning and the points that they are being awarded.

Moving to slide eight, during the first quarter, we completed the spin-off of Lands' End, from which we received gross proceeds of $500 million, while also creating an opportunity for all of our shareholders to participate equally, based on their pro rata ownership, in any value created by a standalone Lands' End.

Most recently, we announced we are exploring strategic alternatives for Sears Canada, including a potential sale of our interest, currently valued at $730 million, or Sears Canada as a whole. We believe that the monetization of our stake in Sears Canada will improve our financial position and our ability to execute on our strategic transformation.

As we have previously disclosed, we are continuing to evaluate strategic alternatives for our Sears Auto Center business. We have had discussions with third parties regarding a variety of opportunities, including partnerships. We are focused on either receiving adequate value from a third party or otherwise positioning the business to allow Sears Holdings shareholders to participate in an improvement in the performance of this business.

We are continuing these transformation efforts across our enterprise. We have closed, or are in the process of closing, 80 stores and may close additional stores over the course of this year. As of the end of the first quarter, we had about 1,900 Sears and Kmart big box stores, representing about 200 million square feet throughout the United States to serve our members. Few companies have this scale and reach.

Also, please note that, as we continue to grow our online business, we intend to continue to increase the services and products provided to our members through our online channels. As an example, we now have data and experience in retaining our actively engaged members following store closings since June of last year.

Given this experience, we believe that we can partially offset the impact of store closures, and, if successful with our integrated retail initiatives, grow our overall ecosystem in line with changes in consumer behavior and technology.

The store actions, together with our expected reduction in inventory needs during the regular selling seasons and the holiday peak season, will further de-risk our business model and that of the vendors who sell to us. We also expect that these actions should decrease our working capital needs and mitigate our losses going forward from these stores.

With regards to our inventory, we have focused on improving productivity, and this has resulted in our domestic net inventory being down $511 million year over year, excluding the impact of Lands' End.

To this end, we have been reducing slower selling inventory and focusing on keeping our overall inventory position fresh and relevant. This initiative has hurt our overall gross margin in the near term, but we believe that a fresher and more productive inventory assortment should drive better sales, profit, and inventory productivity going forward. This is a reflection of our business model transformation, which leverages integrated retail capabilities to move more of our sales online, requiring us to employ less inventory in the stores. We intend to remain vigilant on our overall inventory management going forward.

While Rob will cover our financial position and results in more detail, I want to highlight the fact that our net debt year over year is down substantially, when including our unfunded pension obligation, as is our net domestic short-term debt.

In addition, we have increased our cash on hand, which when combined with our revolver availability and our net domestic inventory, provides with $5 billion of domestic liquid assets and net inventory, affording us strong financial flexibility, especially when considering our asset-rich portfolio and all the levers at our disposal to create further financial flexibility.

I also want to discuss our pension funding obligations, which we always have met. The pension obligations have been a constraint on our transformation. This year should mark the peak of our pension needs, with approximately $500 million of funding required, and over the next five years, we expect funding requirements to be materially lower. We anticipate that our pension will be fully funded by 2019, based on current interest rates and regulations, and potentially sooner, if interest rates increase.

We will continue to take actions that create value and flexibility to invest in the strategic priorities of our company. After Rob covers our Q1 results and financial position in more detail, I will talk about a framework that outlines for illustrative purposes the levers that we believe we have to restore our company to profitability.

Due in part to our historical performance challenges, we have taken various actions to re-deploy our capital both to invest in our Shop Your Way and Integrated Retail platforms, as well as to meet our financial obligations, including our legacy pension obligations.

As legacy obligations decline, we expect to have more freedom to invest in and accelerate our transformation. As changes occur in and around retail, we intend to be in the mix, focused on investments and acquisitions that accelerate and improve our transformation. The framework we have laid out focuses on the levers we have in light of our scale to drive profitability, and I'll review that with you following Rob's presentation.

Rob?

Rob Schriesheim:

Thanks, Eddie.

Slide 10 is a summary of our first quarter consolidated results. As we continue to invest in Shop Your Way and Integrated Retail as part of our business model transformation, we are seeking to improve member engagement and enhance margins as we transition to a more variable-based promotional cost model.

In the near term, we incur the cost of two promotional programs while also reducing our slow-moving, unproductive inventory levels, both of which impact our gross margins. Longer term, if successful, we would expect our fixed promotional costs and selling and administrative expenses to decline and our variable promotional costs to result in higher margins, which we will discuss in more detail later in this presentation.

We have significant revenue scale, which provides us with substantial operating leverage such that small improvements in margin can lead to substantial improvements in EBITDA. Let me now take you through some of the year-over-year changes underlying our results.

Slide 11 is a "waterfall" chart providing components of the decline in revenues from $8.5 billion in the first quarter of last year to $7.9 billion in the current year quarter. As you can note in the box on the upper-right-hand corner of Slide 11, about 90% of the $573 million year-over-year decline was due to factors other than domestic comp store sales performance.

The primary drivers of the year-over-year revenue decline include closed stores, which account for about 32% of the decline, or $185 million. As Eddie indicated earlier, we have announced that we will be closing 80 stores and may consider closing additional stores in 2014. As we have invested heavily in our Shop Your Way program and Integrated Retail capabilities, we now have the ability to retain a portion of members who shopped the closed stores, thereby reducing the revenue impact of store closures.

Next, the separation of Lands' End, accounting for 16% of the decline, or $91 million; $58 million for domestic comparable store sales, about 10% of the decline; and, finally, Sears Canada for 25%, or $145 million of the decline, which consisted of $45 million due to a decline in comparable store sales, $25 million due to having fewer stores in operations, and $59 million due to unfavorable foreign currency exchange rates.

As indicated on slide 12, for the quarter, our domestic comparable store sales declined by 1.0%, as Kmart experienced a 2.2% decline, which was partially offset by an increase in the Sears Domestic format of 0.2%.

The decline at Kmart was driven primarily by declines in the consumer electronics and grocery and household categories. Excluding the impact of these two categories, Kmart would have experienced a same-store decline of about 0.4%.

The comp store sales increase at Sears was driven primarily by increases in the appliances and home categories, partially offset by declines in the consumer electronics, lawn and garden, and fitness categories. Had it not been for the poor performance of consumer electronics, the Sears domestic comparable store sales would have been approximately 60 basis points higher.

Slide 13 shows that for the quarter, our gross margin decreased about $328 million to $1.8 billion in 2014. As shown in the table on the upper-right-hand side, about 40% of the year-over-year decline was due to a combination of comparable store sales and rate, with the remaining change of 60% due to other factors.

More specifically, the year-over-year impact of closed stores accounted for approximately $37 million, or about 11% of the change. The impact of the Lands' End separation represents about $45 million, or about 14% of the change.

The set of bars labeled "Domestic Operating Performance" is a net amount of $135 million, or about 40% of the total margin decline. The first bar in this set represents the margin impact of $17 million related to our comp store sales decline. The next bar in the set represents the impact of margin rate, accounting for $118 million of the margin decline, which was driven by higher promotional markdowns, most notably in home appliances, as well as in apparel.

Next, as indicated, we increased our year-over-year investment in Shop Your Way points by $38 million. The higher cost of points demonstrates increased member engagement and is an indicator of the progress that we are making in our transformation to be a member-centric integrated retailer.

Furthermore, it is important to understand that we recognize the points expense when points are issued to our members. We expect to see additional revenue and margin benefit from the points that were issued in the first quarter throughout the remainder of 2014, as the points will continue to be redeemed in the future.

Also, as previously noted, we have continued with our traditional promotional programs at historical levels, as we are intending to move through the transformation in a thoughtful and deliberate manner. As a result, we are carrying the costs of two promotional programs.

Finally, Sears Canada's gross margin declined by $73 million in the first quarter, accounting for approximately 22% of the total year-over-year margin decline.

While not shown on the slides, we were also negatively impacted by significantly higher utilities expenses. For the full year, these expenses could run $30 million to $50 million or more higher than last year as electricity rates have increased by over 10%.

Slide 14 summarizes some of what we believe are our substantial financial resources. We had $842 million of cash at quarter end on a consolidated basis. In addition, we had immediate availability to borrow about $1.2 billion on our credit facilities, which reflects the effect of both the springing fixed charge coverage ratio covenant and borrowing base requirement of our domestic credit facility.

We also had $4.1 billion of equity in inventory. Inventory is a current asset which can be converted to cash very quickly, or on average in 90 days in the normal course. Taken together, we had about $6.1 billion of liquidity or assets on a consolidated basis which could be converted into cash in the near term.

In addition, we have up to $500 million in an uncommitted commercial paper program, $159 million of which was outstanding at the end of the first quarter. In addition, we potentially have $760 million of second lien debt capacity available, subject to borrowing base requirements.

Also note that, should we be successful in monetizing our 51% stake in Sears Canada, this would result in cash proceeds of approximately $730 million at current market values. As indicated on the slide, this affords us the option, should we decide to do so, to apply those proceeds to our domestic revolver. I would note that under the terms of our domestic revolver agreement, we have flexibility in how we use those proceeds. We are not required to apply these proceeds to the outstanding revolver balance. If we have received these proceeds and decided to apply them to the domestic revolver outstanding balance, then availability under our domestic revolver would have been $1.5 billion had the transaction taken place as of the end of our fiscal first quarter.

Slide 15 presents our inventory, payable and net inventory balances for the past three years on a consolidated basis. We have had success reducing the capital required to run our business, as we have reduced our net inventory investments by about $1.4 billion over the past three years. By reducing our net inventory investment and our payables, we have decreased the level of vendor support needed to run our business, de-risking our business model in a way that benefits both us and our vendor partners.

On Slide 16, we show that over the past five years, as part of our transformation, we have honored all of our legacy pension obligations. While the pension plan remained unfunded by about $1.5 billion at fiscal year end 2013, it was down by about $600 million from the prior year, and based on current assumptions and estimates, as indicated on the slide, we currently expect the unfunded obligation to decline to about $900 million at fiscal year end 2014.

The pension funding is highly sensitive to both the regulatory environment and interest rates. Note that a 100 basis point increase in the discount rate would reduce the pension liability by about $460 million.

On slide 17, you can see that our domestic pension contributions over the past nine years, including 2014, will have totaled $2.9 billion. This year should mark the peak of our pension funding needs going forward with about $485 million of funding required. Our pension funding should decline to around $300 million or less beginning in 2015 and decline to $75 million in 2019.

As you can see, our aggregate pension funding requirements over the five-year period ending 2019 are expected to be about $1.2 billion, at which point we expect our pension to be fully funded based on current interest rates and regulations, and possibly sooner, should interest rates increase.

As Eddie indicated, this should provide relief to the funding pressure we have felt as we have honored our legacy pension obligations and allow us to devote funding into our transformation.

Slide 18 itemizes our debt balances as of the end of the year, and after making some adjustments, provides our adjusted consolidated net debt position. Let me offer a few comments.

First, as the call-out box on the upper right notes, our revolver borrowings are down by about $306 million, our commercial paper outstanding is down by about $218 million, with our short-term borrowings down by $524 million. Our domestic cash is up by $218 million, meaning that our net short-term borrowings are down by $742 million on a year-over-year basis.

Second, note that while our total debt has increased by about $426 million, our adjusted net debt position, when including the effect of our unfunded pension obligation, is down almost $400 million year over year. Note that the company's legacy pension obligation is essentially a form of debt and has influenced revolver usage.

The contributions of $516 million in 2012, $360 million in 2013, and $98 million in the first quarter of 2014 have been funded by revolver borrowings. On a pro forma basis, the revolver balance would be $97 million absent these contributions. In essence, we have used one form of debt -- namely, our revolver -- to fund another form of debt, the pension. Since 2012, almost $975 million of the first quarter revolver balance of $1.1 billion was driven by pension contributions which should be distinguished from funding operating expenses.

Once again, note that should we be successful in monetizing our 51% stake in Sears Canada, this would result in cash proceeds of $730 million at current market values. As indicated on the slide, this affords us the option, should we decide to do so, to apply those proceeds to our domestic revolver.

I would note that under the terms of our domestic revolver agreement, we have flexibility in how we use those proceeds. Again, we are not required to apply such proceeds to the outstanding revolver balance. If we had received those proceeds and decided to apply them to the domestic revolver outstanding balance, this would have resulted both in usage of our revolver and our adjusted net debt being lower by $730 million.

In the box on the upper-left-hand side of slide 19, we show our domestic net short term debt position of $634 million. We had $1.1 billion in borrowings under our domestic credit facility, versus $1.4 billion last year. We had less commercial paper at $159 million this year versus $377 million last year, which impacts the level of credit facility borrowings. We ended the quarter with cash of $596 million, up about $218 million from last year. By taking these changes into account, net short term debt is down about $740 million versus last year, or 54%.

Next, we show availability on our committed domestic credit facility in the box on the lower-left-hand side of the slide. I'd like to make two points about the year-over-year change, both of which are primarily driven by our more efficient management of inventory.

First, our capacity at the end of the first quarter was $2.5 billion. Although the credit facility provides for up to $3.275 billion of revolver commitments, our ability to use the entire facility was limited at quarter's end by our borrowing base, which is determined relative to the value of eligible inventory and other collateral. Also, just as last year, we did not have access to about 10% of the total commitments because we would not have met the springing fixed charge coverage ratio covenant.

Second, as we have managed our inventory more efficiently, we have less need to borrow, and our resulting borrowing capacity is about $470 million lower than this time last year. At seasonal highs during the 2014 holiday season, we currently anticipate that our domestic inventory will be at a level that the borrowing base will not limit access to the credit facility.

After deducting quarter end borrowings and outstanding letters of credit, and factoring in the impact of the springing fixed charge coverage ratio covenant and borrowing base requirement, availability to borrow at the end of the first quarter was $752 million, down from $823 million at the end of the first quarter last year.

However, as with net short term debt, that does not tell the whole story. Cash was about $218 million greater than last year, and incremental capacity under our $500 million uncommitted commercial paper program was also $218 million greater than last year. After including the impact of cash and incremental commercial paper capacity, we had nearly $1.7 billion of potential liquidity compared with $1.3 billion last year.

Note that we also are permitted to raise up to $760 million in second lien debt, subject to borrowing base requirements.

I would also note that we would continue to de-lever our balance sheet and increase our availability to the extent we are successful in monetizing our 51% stake in Sears Canada, which currently has a market value of about $730 million. As indicated on the slide, this affords us the option, should we decide to do so, to apply those proceeds to our domestic revolver. Had such a transaction taken place as of the end of our first fiscal quarter, and had we applied those proceeds to the outstanding domestic revolver balance, we would have had no net short-term debt. Actually, we would have been net cash positive.

I would also note that we currently have $500 million of authorization remaining for share repurchases, as well as $275 million of authorization remaining for repurchases of our debt. As we have commented, we believe that we have ample liquidity to run the business and also have the benefit of access to a rich portfolio of assets.

On slide 20, note that we have continued to manage down our retail store footprint and the associated present value of lease obligations. Over the last three years, we have reduced our lease obligation by about $1 billion, as we have adjusted our store base. As we continue to manage our store footprint, we expect to reduce these obligations in the coming years. Reducing our net minimum lease payments decreases corporate obligations and further de-risks our business model.

While we are reducing our lease obligations by adjusting our square footage and store base, on slide 21, we show that we continue to operate stores in some of the best malls in America. There were two reports that had been done over the past six years -- one by Goldman Sachs and one by Morgan Stanley.

The Goldman Sachs report listed the top 100 malls in America. The Morgan Stanley report listed the top 100 fashion malls in America. In 2007, we had Sears stores in 42 of the top 100 malls in America, and as of 2014, we have 41 stores in these malls.

When looking at the top fashion malls, we were at 41 in 2009 and 39 in 2014. When you view these two lists collectively, because there was overlap between the two lists, there were 149 malls. In 2007, we were in 63 of the malls, and we are now in 61. As you can clearly see from the data, we are retaining stores in some of the best locations as we close stores to optimize our store footprint and reduce lease obligations.

As shown on slide 22, our debt structure is in place for the next few years, as our domestic revolver extends into 2016, and we have negligible term debt maturities over the next several years.

I would now like to shift gears and spend a few minutes to discuss how we are reconfiguring and redeploying our rich portfolio of assets to accelerate and fund our transformation.

On slide 24, we show the framework we use to evaluate potential strategic transactions. We believe that these transactions will enable us to accelerate and fund our transformation when they allow Sears Holdings, the separated entity, or both entities, to, one, become a more focused company that is more efficient to manage and easier to understand; two, pursue their own strategic opportunities and attract talent; three, optimize their capital structures and allocate capital in a more focused manner; four, enhance their financial flexibility; and, five, provide opportunities for our shareholders to continue to participate in the value creation generated by these businesses after separation.

We believe that we are executing on a clear plan to increase financial flexibility, further de-risk our balance sheet, and create shareholder value. We expect to continue with these types of activities during 2014.

On slide 25, we provide an update on our asset configuration activities. On our last earnings call, we disclosed that, at the time, we expected that the combination of, one, the Lands' End transaction, two, our continuing to work with the board and management of Sears Canada to increase the value of our investment, and, three, our evaluation of opportunities with respect to a potential separation of our Sears Auto Centers when taken together would result in cash proceeds to the company in excess of $1 billion in 2014 to help fund our transformation and create value. We believe that we are on track to deliver against this commitment.

On April 4th, we completed the separation of Lands' End through a pro rata distribution to our shareholders and received an exit dividend from Lands' End in the amount of $500 million as anticipated.

On May 14th, we announced that we intended to hire an investment banking firm to explore strategic alternatives for our 51% equity stake in Sears Canada, including a potential sale of our 51% interest or of Sears Canada as a whole. Sears Canada's board of directors has advised us that they intend to cooperate fully with Sears Holdings in this process to achieve value for all shareholders. The market value for our 51% interest was $730 million as of May 20, 2014.

We also continue to evaluate options to separate our Sears Auto Center business. In addition, we are capitalizing on our flexibility in our real estate portfolio to reduce unprofitable stores as leases expire and in some cases accelerate closings when circumstances dictate, as well as continuing to benefit from the value of our real estate in both the U.S. and Canada.

In the first quarter, we received $79 million in proceeds from real estate transactions. In addition, we continue to manage our store base, square footage, and inventory more efficiently.

Slide 26 substantiates our belief that we are an asset-rich enterprise with multiple levers at our disposal to generate what we believe to be ample financial flexibility to both meet all of our financial obligations, as well as fund our transformation. We are focused on investing in those initiatives that we believe will create long-term, sustainable shareholder value. We have demonstrated our ability and willingness to monetize assets as we redeploy capital in support of our transformation to a member-centric model, leveraging Shop Your Way and Integrated Retail.

More specifically, since the beginning of 2012, we have generated about $5 billion from a range of actions, including inventory, fixed expense reductions, asset reconfigurations, real estate, the execution of a term loan through our ABL accordion feature, and a continuing adjustment of our store base. We have executed these transactions in a way that we believe has been value accretive to our shareholders as we fund our investments and honor our financial obligations.

Moving to slide 27, I will now turn the call back over to Eddie, who will cover our plan for restoring our company to profitability.

Eddie Lampert:

Thanks, Rob.

Transitioning to this section on slide 27, I mentioned that I want to use this opportunity to share a framework that outlines the levers to restore profitability to Sears Holdings. Over the course of the next few slides, I will explain this framework.

As I said before, the framework is not intended to provide guidance or predict results. Rather, it is intended to provide some dimensional context for the potential opportunities for increasing profitability, if we are successful in executing on the initiatives outlined.

For some of these initiatives, which we are in the process of implementing, we are developing our plans to implement them for additional product categories. Consistent with the strategic pillars of our transformation, the framework heavily leverages our two key platforms, Shop Your Way and Integrated Retail. These platforms enable us to better engage with and serve our members.

Additionally, it includes potentially transforming select product businesses, such as apparel and consumer electronics, and further expanding product categories like mattresses, where we've seen success.

Finally, the framework illustrates potential significant reductions in both our cost of goods and SG&A structure through strategic sourcing, substituting Shop Your Way points for promotional markdowns, reductions in our square footage, process improvement, and the use of technology.

On slide 28, we show that we are committed to serving our members better, driving sustainable and profitable growth, and maintaining disciplined stewardship of capital, which when taken together will create value for our shareholders. A transformation of this size and scale is difficult, but our entire management team is committed to the transformation.

On slide 29, we show the overview of our framework. I reviewed this slide earlier on the call, but it is a very important slide to understand the model we have been operating for many years and the model we are moving towards. It is a different mindset from selling products and running a store network to being a member-focused company. We are putting our members at the center of our model. Building relationships through personalization is the foundation, and we believe that our Shop Your Way and Integrated Retail capabilities will enable us to better serve our members.

On slide 30, we show the summary of this framework. This framework for profitability is centered on accelerating our new business model, which we believe will better serve our members. We are building on and expanding our Shop Your Way and Integrated Retail capabilities every day, and our members are becoming more and more engaged as our metrics for the first quarter indicate.

We are putting our members at the center of our model. Building relationships through personalization is the foundation, and we believe that our Shop Your Way and Integrated Retail capabilities will enable us to better serve our members.

We also need to address specific product businesses. Consumer electronics, for example, is one of our largest revenue businesses. However, we need to transform this business from one that focuses on selling televisions to a fully integrated Connected Life experience. I will share some specifics on what that means on a subsequent slide.

The framework for profit depicts leveraging our scale, and includes optimizing our store network and square footage; accelerating Shop Your Way and Integrated Retail as the foundation of our business model; transforming select business models; and reducing selling and administrative expenses.

We also believe we can significantly reduce our overall cost structure by, one, shifting our marketing spend from mass to digital campaigns in a more accelerated way; two, leveraging technologies that create labor and other cost efficiencies; and, three, re-engineering core processes throughout our network.

On slide 31, we show how there's an opportunity to optimize our store network. Stores will continue to play a very important role in serving our members, but we believe we can continue to engage and serve our members through our Shop Your Way and Integrated Retail platforms and our remaining vast store network.

Based on experience to date in those stores we have closed over the last year, we believe there is an opportunity to optimize our store network while still maintaining a relationship with the members in those communities through our Shop Your Way and Integrated Retail platforms. The potential benefit of this both could reduce our overall cost structure and working capital needs, while maintaining a substantial portion of the current sales and gross margin derived from members in communities where we may potentially reduce the store footprint.

We believe that the combination of the positive margin impact of continuing to serve our members through Shop Your Way, together with the elimination of fixed expenses and inventory reductions associated with closed stores, could result in a positive $300 million to $400 million of incremental annual EBITDA.

On slide 32, we have made substantial investments in Integrated Retail, and where we have, we are seeing very good results. We will continue to roll these capabilities out to more of our stores.

Three specific capabilities we will continue to expand are, one, our Shop Sears tablets that we currently have in over 571 stores and are currently rolling out to an additional 100 locations; two, digital signs, which we piloted in 60 stores in 2013 and expanded to over 250 locations in the first quarter of this year; three, RFID technology, which we piloted in 12 stores in 2013 and are expanding to over 200 locations this year.

In the case of both RFID and digital signs, we've seen a benefit in sales and margin in the stores where we've enabled these capabilities. In extrapolating from this experience, we believe there is the potential to generate about $500 million in incremental annual revenue and between $150 million and $200 million of incremental annual EBITDA for these two initiatives alone.

The Shop Sears application provides the foundation for integrated retail capabilities. Of course, any investment required to execute on these initiatives would be rigorously evaluated to ensure there is an appropriate return on capital employed.

On slide 33, we show the difference in annual spend between an average engaged Shop Your Way member and a very engaged Shop Your Way member. The spend difference is significant, with our most actively engaged members spending 75% more than our average member. We are focused on targeted actions that will convert more of our average active members to more engaged members. The EBITDA potential is substantial. As an example, moving 1 million members from average to most engaged status represents $50 million in EBITDA.

On slide 34, we show that cost of goods annual spend is $23.6 billion. We are focused on reducing our overall cost of goods through a number of initiatives. We have invested substantially in our pricing capabilities, both in people and technology, which will enable us to be more targeted and real-time, responding to our members' needs and the competitive environment.

We're also focused on shifting our promotional design to be less dependent on promotional markdowns and replacing them with Shop Your Way points, where it makes sense. There will always be a level of promotional markdowns as part of our go-to-market promotional design, but our intent is to replace a portion of our existing promotional markdowns with points.

Also, we are focused on optimizing our supply chain to right-size our network, and leveraging our real estate portfolio, by partnering with other retailers, to lease out valuable, but underproductive space. Through these actions, as outlined on slide 34, you can see that each 1% reduction in our cost of goods, which would include the impact of sub-lease income, would generate an incremental $230 million of annual EBITDA.

On slide 35, selling and administrative expenses is also an area of focus. As we've discussed in the past, we have reduced our fixed expense structure by about $800 million annually over the past three years, though this is a mix of costs included in both cost of goods and selling and administrative expenses.

We believe there's still more opportunity. Our areas of focus are re-engineering processes, leveraging technology, and shifting our marketing mix. I mentioned earlier the benefits we are seeing in revenue and margin related to digital signs. There is also a significant cost benefit as digital signs replace the need for manual labor and paper signs. Each 2% reduction in selling and administrative expenses is $150 million of incremental EBITDA.

On slide 36, we show that we need to provide our members with the products and services they are looking for. We are transforming our apparel business with a focus on refreshed brands and product assortments and are reducing lead times to better meet our members' needs. Our revenue per square foot in our apparel business is about one-third of the industry average. Each $10 improvement in our sales productivity per square foot represents $100 million in incremental annual EBITDA.

On slide 37, we depict our Connected Life business initiative. As an example, in the first quarter, we rolled out the integration of Shop Your Way, with several third-party fitness activity tracking clouds, permitting us to reward members for activities monitored via Fitbit, Jawbone Up, iFit-enabled cardio equipment, and a host of smartphone apps.

We're also going to transform our consumer electronics business from a business that was focused primarily on selling televisions to a business focused on providing Connected Life solutions. We are currently rolling out the concept to select stores and are very excited about its potential to leverage many of Sears Holdings' strengths.

Connected Life is about providing our members with connected products, date and experiences to help them manage their lives. As shown in the picture on slide 37, our capabilities and breadth can provide Shop Your Way members seamless experiences across connected home, car and fitness.

On slide 38, I do want to touch briefly on working capital. It has and will continue to be a big area of focus. As we have discussed before, we have reduced our net domestic inventory levels by over $1 billion over the past three years. We believe there is still substantial opportunity to further improve our inventory productivity. We are focused on a number of initiatives centered on reducing the levels of slow-moving, unproductive inventory; thinking differently about how we buy and flow our merchandise given our Shop Your Way program and integrated retail platform; and buying smaller quantities of merchandise and turning it more frequently.

As you can see on the slide, if we can turn our inventory one more time per year, we can reduce our net working capital requirements by about $400 million, enhancing liquidity, and freeing up capital that could be further used to further invest in our transformation.

On slide 39, we provide a summary of the initiatives laid out in the previous slides. As you can see, these opportunities have the potential to generate incremental annual EBITDA of between $1 billion and $2.5 billion if we successfully execute on these initiatives under the assumptions as indicated.

We believe we have a substantial opportunity to compete successfully in the changing retail landscape by proactively transforming our business to meet the realities of the retail industry. As I have said in the past, transformations of this size and scale are challenging, and we may continue to experience challenges in our financial performance over the next several quarters.

However, we have made progress across a wide spectrum of initiatives, such as leveraging our Shop Your Way and Integrated Retail platforms, reducing our legacy pension obligation, managing our expenses, de-risking our balance sheet, and enhancing our financial flexibility to position ourselves to meet all of our financial obligations.

These initiatives, when coupled with executing on the profitability framework I just described, will position us to play offense, enable us to continue to seek opportunities to grow, and invest in our business through acquisitions and other strategic relationships.

As I indicated earlier, as changes occur in and around retail, we intend to be in the mix focused on investments and acquisitions that accelerate and improve our transformation. Again, we are focused on making a profit, and we expect to continue to focus on our strengths, including increased focused on our best members, best stores, and best categories.

As the CEO and largest individual shareholder of Sears Holdings, I am personally committed to investing in and driving our transformation, improving the profit performance of the company and creating shareholder value. We will do this all while continuing to meet our financial obligations. Our team is committed and is actively engaged in the daily work to make this transformation work.

Operator:

Thank you for participating in today’s call. You may now disconnect.