SEARS HOLDINGS

Sears Holdings' Second Quarter 2014 Results
Pre-Recorded Conference Call Transcript
August 21, 2014

Operator:

Good day, ladies and gentlemen, and welcome to the Sears Holdings Corp. Q2 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 call, Rob Schriesheim, Executive Vice President and Chief Financial Officer for Sears Holdings. Sir, you may begin.

Rob Schriesheim:

Thank you, Operator.

Ladies and gentlemen, welcome to the Sears Holdings earnings call. I am Rob Schriesheim, Executive Vice President and Chief Financial Officer. Please note that this morning we released our second 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 2, I would like to remind you that today's discussion will contain forward-looking statements related to future events and expectations. These statements are based on current expectations and the current economic environment or are based on potential opportunities 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 3, 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 4 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 4, I will provide an update on the progress we are making in our transformation, review key highlights from the second quarter and briefly review some of the actions we are taking 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 provide an update on the framework for profit that I introduced on our last earnings call outlining our efforts to restore Sears Holdings to profitability. This framework is not meant to give guidance as to our future results or to predict that we will be successful in executing every aspect of this framework, but rather to highlight some of the different levers we have at our disposal that could restore profitability.

As the CEO and the largest individual shareholder of Sears Holdings, I am personally committed to investing in and driving our transformation, improving the profit performance of the company, ensuring our financial flexibility all while creating shareholder value.

Slide 6 illustrates the transformation to move from a traditional retail operating model to a member-centric operating model. While retailers continue to be impacted by the same external factors, we are moving aggressively to address what we can control. We have a number of different levers at our disposal that will enable us to return a company of our size and scope to profitability and deliver value to our many stakeholders.

A key component of transforming our business is to move towards a structure that focuses on providing benefits to our members by using technology and platforms to form individual relationships with them. Our new business model is intended to be less asset-intensive and our new cost structure is intended to be more variable in nature.

Moving now to Slide 7.

I will direct my opening summary comments on 5 key areas of focus:

First, while we have continued to show progress in our transformation, as demonstrated by growth in our Shop Your Way penetration rates and our on-Line sales growth, our second quarter earnings are unacceptable. We are taking steps to address our performance on several levels including reducing costs, investing in the acceleration of our transformation, rationalizing our physical footprint to focus on our better performing stores and markets, and improving our pricing and promotional design to yield higher gross margins.

Given our scale, small changes can have a big impact on our results. For example, a 100 basis point increase in margin rate in the second quarter would increase EBITDA by approximately $80 million for the quarter and over $300 million on an annualized basis.

Second, our transformation continues through Shop Your Way and Integrated Retail. We continue to see increasing engagement from our Shop Your Way members who drove 73% of eligible sales in the quarter. In addition, our integrated retail initiatives drove our online and multi-channel sales up 18% in the quarter and 22% in the first half. The success of these two platforms is allowing us to maintain relationships with our members as we rationalize our store footprint and place an increased focus on supporting our better performing stores. Despite the fact that adjusting our footprint has resulted in store closures, we continue to have a substantial nationwide footprint with a presence in many of the top malls in the country similar to what we had in 2007.

Third, we plan to take short and long term actions to enhance our financial flexibility. We have reduced our inventory by $1.7B over the past 3 years as we closed stores and improved productivity. As a result, in the future we will be less reliant on inventory as the primary form of collateral in our financing arrangements.

In the next 6-12 months, we intend to work with our lenders and others to evaluate our capital structure with a goal of achieving more long term flexibility.

Fourth, we have a proven record of funding our transformation and our business model. We have a large, valuable, diverse and unencumbered set of assets and businesses. In the first half of 2014, we generated $665 million in proceeds towards our initial stated goal of $1 billion for the year.

We also continue to reduce our liabilities by:

1. Decreasing lease obligations by over $1 billion over the past 3 years;

2. Reducing our underfunded pension status by over $600 million in the past year, and

3. Reducing our overall pension liability, including making $1.5 billion in lump sum payments in 2012 to our pension plan participants, which reduced our exposure to the market risk associated with managing pension plan assets.

Fifth, we continue to add to the talent pool of the company. We have brought in new leaders, and elevated others within the company, as we change our culture to be more accountable and focused on driving performance. We currently expect the combination of these actions to improve operating results.

We will continue to take actions that we believe will create value and provide us with the financial flexibility to invest in the strategic priorities of the company. As changes occur in and around retail, we intend to be actively involved, focused on investments and acquisitions that we believe will accelerate and enhance our transformation.

I will now hand the call over to Rob who will take you through our second quarter results and financial position followed by a more detailed update of our asset redeployment and reconfiguration activities.

Rob Schriesheim:

Thanks, Eddie.

Slide 9 is a summary of our second quarter and year-to-date consolidated results. As we continue to invest in Shop Your Way and Integrated Retail, as part of our business model transformation, we seek to improve member engagement and enhance margins as we transition to a more variable-based promotional cost model. In the near term, we are incurring the cost of two promotional programs while also reducing our inventory levels, both of which impact our gross margins. Longer term, we expect our fixed promotional costs and selling and administrative expenses to decline and our variable promotional costs to result in higher margins. While our area of greatest leverage is margins and promotional costs, we have continued to reduce fixed expenses. Since 2012 our annual fixed expenses have declined by about $800 million. Our significant revenue scale provides us with substantial operating leverage such that small improvements in margin rate and selling and administrative expense can lead to substantial improvements in EBITDA.

Let me now take you through some of the year-over-year changes underlying our results.

Slide 10 is a “waterfall” chart providing components of the decline in revenues year over year. As you see in the box on the upper, about 95% of the $858 million year-over-year decline was due to factors other than domestic comparable store sales performance.
The primary drivers of the decline include:

- Domestic closed stores, which account for about 30% of the decline or $256 million. As we have invested heavily in Shop Your Way and Integrated Retail capabilities, we believe we have the ability to retain a portion of members who shopped the closed stores.

- The separation of Lands' End accounting for 39% of the decline or $330 million,
- $47 million for domestic comparable store sales, about 6% of the decline, and
- Sears Canada accounted for 16%, or $140 million of the decline.
- Finally, we also experienced a revenue decline in our Home Services business during the quarter, as well as a decline in delivery revenues which combined, accounted for the majority of the other revenue decline of $85 million.

Moving to Slide 11, as shown in the top box, the increase in our comparable store sales trends demonstrates a marked improvement in the performance of both Sears and Kmart store sales.

The steady growth we are seeing in Shop Your Way Members sales penetration and Online and Multichannel Sales is indicative of the success of the transformation. While we are moving in the right direction, there is more work to be done to get results where we expect them to be and to put other parts of the business on the right path forward.

As you can see in the chart on the lower left, our online and Multichannel Sales grew 18% in the quarter and I note our first half was up 22%. 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 locations with in-store tablet capabilities.

Finally, we continue to invest heavily in our Shop Your Way platform. As a result, we continue to see higher levels of member engagement, demonstrating that our members are becoming even more engaged.

As indicated on Slide 11, for the quarter, our domestic comparable store sales declined by 0.8%, as Kmart experienced a 1.7% decline which was partially offset by an increase in the Sears Domestic format of 0.1%.

Sears Domestic experienced continued momentum in our appliances and mattresses categories in Q2 leading to a positive comparable store sales growth of 0.1% as compared to a 0.8% decline last year, despite the continuing impact of negative consumer electronics industry trends. Our electronics business has been a drag on the Sears format for some time. We are addressing this decline by shifting the focus of our electronics business away from simply selling TVs. By transforming the business into one that focuses on empowering Connected Living, we expect that the new electronics business will bring together our capabilities in fitness, electronics, appliances, home services and auto. Adjusting for the negative impact of the consumer electronics business, Sears Domestic comparable store sales would have been about 150 basis points higher. Our auto business, despite its efforts to focus on services, experienced a comparable store sales decline in the low double digits in the second quarter.

Kmart's comparable store sales were down 1.7% as compared to a 2.1% decline last year. Our grocery and household business continued its poor performance which has persisted for more than a year and which we intend to address going forward with assortment updates, private label growth, and pricing promotional effectiveness initiatives. If we exclude the impact of the grocery and household and electronics categories, the comparable store sales performance at Kmart would have declined 1.0%.

Note further, that had it not been for the consumer electronics and grocery and household categories, Total SHC Domestic would have had a comparable store sales increase of 0.4%.

Slide 13 shows that for the quarter, our gross margin decreased about $444 million to $1.7 billion in 2014. About 37% of the year-over-year decline was due to margin rate deterioration, with the remaining change of 63% due to other factors. More specifically,

- The year-over-year impact of domestic closed stores accounted for approximately $54 million, or about 12% of the change.

- The impact of the Lands' End separation represents about $126 million, or about 28% of the change.

- The set of bars labeled "Domestic Operating Performance," is a net amount of $167 million or about 38% of the total margin decline. With the margin rate impact accounting for nearly all of decline. As compared to the prior year, Kmart's gross margin rate declined 250 basis points, with decreases experienced in a majority of categories, particularly apparel, home and grocery & household. Sears Domestic's gross margin rate declined 330 basis points for the quarter with decreases experienced in a majority of categories, most notably apparel, home appliances (partially due to free delivery), tools and footwear.

- Next, as indicated, we increased our year-over-year investment in Shop Your Way points by $43 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 and into 2015 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 plan to move through the transformation in a thoughtful and deliberate manner.

- Finally, Sears Canada's gross margin declined by $54 million in the second quarter, accounting for approximately 12% of the total year-over-year margin decline.

Slide 14 summarizes some of what we believe are our substantial financial resources. We had $839 million dollars of cash at quarter-end on a consolidated basis.

In addition, we had immediate availability to borrow about $486 million 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 $3.9 billion of equity in inventory. Note that 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 $5.2 billion of liquidity or liquid assets on a consolidated basis which could be converted into cash in the near term. While I will provide more detail on our resources later, year to date, we have generated approximately $664 million of proceeds from non-core asset dispositions including $500 million from a dividend associated with the distribution of Lands' End and approximately $164 million derived from the sale of real estate.

We continue to have multiple options to generate additional liquidity given our ability to access diverse funding sources as well as the asset rich nature of our portfolio. More specifically:

- We have a $500 million uncommitted commercial paper line of which we had $493 million available as of the end of the second quarter.

- We have a 51% equity stake in Sears Canada with a current market value of about $765 million as of August 19th.

- We have continued to demonstrate our ability to monetize our substantial unencumbered real estate assets and there are numerous other forms of transactions that we could pursue to provide additional liquidity expeditiously using our real estate.

- We are permitted to raise up to a maximum of $760 million of second lien debt, subject to borrowing base requirements.

- I would also point out that we have no term debt maturities until June of 2018 and our revolver is in place until April of 2016.

- We also, as previously disclosed, continue to explore strategic alternatives for Sears Auto Centers

Slide 15 presents our inventory, payables 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 investment by about $1.7 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, improving our business model in a way that benefits both us and our vendor-partners.

Inventory productivity has been a key priority this quarter and our efforts have resulted in a decrease of our domestic net inventory of $510 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 our efforts now to build a fresher and more productive inventory assortment are important and necessary steps to drive better sales, profit and inventory productivity going forward.

On Slide 16 you can see that our Domestic Pension Contributions over the past 9 years, including 2014, have totaled $2.9 billion. We expect this year to mark the peak of our pension funding needs going forward with our pension funding declining through 2019, at which point we expect our pension to be fully funded. As you can see, prior to taking into account new legislation, our aggregate pension funding requirements over the 5 year period ending 2019 are expected to be about $1.1 billion based on current interest rates and regulations – and possibly sooner should interest rates increase. This should provide relief from the funding pressure we have felt as we have honored our legacy pension obligations.

On August 8th, new legislation was enacted that amends existing pension funding requirements. We expect the new legislation to increase the discount rate we use to determine our pension liability, resulting in lower liabilities and lower funding obligations as shown in the yellow highlighted box.

Slide 17 itemizes our debt balance as of the end of the second quarter, and after making some adjustments, provides our "Adjusted" Domestic Net Debt Position. Let me offer a few comments.

First, as the box on the upper right notes, our revolver borrowings and our commercial paper outstanding are down with our short term borrowings down by $352 million. Our domestic cash is up by $213 million, meaning that our "Net" short term borrowings are down by $565 million on a year-over-year basis.

Second, while our Total Domestic Debt has increased by about $592 million, our "Adjusted" Domestic Net Debt Position, when including cash and our unfunded pension obligation, is down about $220 million year-over-year. Note that the company's legacy pension obligation is essentially a form of debt and has influenced revolver usage. The $1.1 billion of contributions made in the last 10 quarters have been funded by revolver borrowings. On a pro forma basis, the revolver balance would be $339 million absent these contributions. We have used one form of debt, being the revolver, to fund another form of debt, the pension. Since 2012, about $1.1 billion of the second quarter revolver balance of $1.4 billion was driven by pension contributions which should be distinguished from funding operating expenses.

If we are successful in monetizing our 51% stake in Sears Canada at current market values, this would result in cash proceeds of about $765 million. This would afford us the option to apply those proceeds to our domestic revolver, which would have the impact of reducing the domestic revolver and Adjusted Domestic Net Debt balances, should we decide to do so.

On Slide 18 we show our domestic Net Short Term Debt position was down vs. last year by $565 million to $808 million primarily due to lower borrowings under our revolver, lower levels of commercial paper and higher levels of cash.

Next, we show availability on our committed domestic credit facility. I want to make two points about the year-over-year change in the availability on our committed domestic credit facility, both of which are primarily driven by our more efficient management of inventory.

1. First, our capacity at the end of the second quarter was about $2.3 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 based on 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.

2. Second, as we have managed our inventory more efficiently, we have less need to borrow, and our resulting borrowing capacity is about $665 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 second quarter was $240 million versus $759 million at the end of the second quarter last year. However, as with net short term debt, that doesn’t tell the whole story. Cash was greater than last year and incremental capacity under our uncommitted commercial paper program was also greater than last year. After including the impact of cash and incremental commercial paper capacity, we had $1.3 billion of potential liquidity compared with $1.4 billion last year. Note that we also are permitted to raise up to $760 million in additional 2nd 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. I would also note that we currently have $500 million of authorization remaining for share re-purchases as well as $275 million of authorization remaining for re-purchases of our debt.

As we have commented, we believe that we have sufficient liquidity to run the business and also have the benefit of access to a rich portfolio of assets.

Moving to Slide 19, you will see that we have continued to manage down our retail store footprint and the associated present value of lease obligations. As we continue to manage our store footprint, we expect to further reduce these obligations in the coming years. Reducing our Net Minimum Lease Payments decreases corporate obligations and further de-risks our business model.

As shown on Slide 20, our debt structure is in place for the next few years, as our domestic revolver extends into 2016, we have negligible term debt maturities over the next several years and we have multiple options available to us for any refinancing we may want to consider.

As indicated earlier we have reduced our inventory by $1.7 billion over past 3 years via store closings and productivity – and as Eddie commented this will alter our reliance on inventory as the primary form of collateral in our capital structure. Over the next 6 to 12 months, we intend to work with our lenders and others to evaluate our capital structure with a goal of achieving more long term flexibility, and may take action sooner.

I would now like to shift gears and spend a few minutes discussing how we are redeploying our portfolio of assets which we believe will accelerate and fund our transformation.

SEARS HOLDINGS

On Slide 22, 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:

1. Become a more focused company that is more efficient to manage and easier to understand,

2. Pursue its own strategic opportunities, and attract talent,

3. Optimize its capital structures, and allocate capital in a more focused manner,

4. Enhance its financial flexibility, and

5. 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 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 the remainder of 2014.

On Slide 23, we provide an update on our asset reconfiguration activities.

On our Q4 and Full Year 2013 Earnings call in February of this year, we disclosed that at the time, we expected that the combination of (1) the Lands' End transaction, (2) our continuing to work with the board and management of Sears Canada to increase the value of our investment, and (3) our evaluation of strategic alternatives with respect to 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 cash proceeds of $1 billion, having raised $664 million through the first half of the year.

- 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. We subsequently engaged BofA Merrilll Lynch to assist us in connection with these efforts. Sears Canada's board of directors has advised us that they intend to support Sears Holdings in this process to achieve value for all shareholders. The market value of our 51% interest was about $765 million as of August 19, 2014.

- As we have previously disclosed, we are continuing to evaluate strategic alternatives for our Sears Auto Centers business. We have had discussions with third parties regarding a variety of opportunities, including partnerships. We can't give you any assurance that we will be successful in this effort or with Sears Canada.

In addition we are:

- Capitalizing on the flexibility in our real estate portfolio to reduce unprofitable stores as leases expire and in some cases accelerate closings when economically prudent – as well as continuing to benefit from the value of our real estate in both the US and Canada. Through the first half of the year, we have received $164 million in proceeds from Real Estate transactions.

- We have announced that we expect to close about 130 stores in 2014, which includes a combination of leased and owned locations. We have closed about 95 to date. To put this into perspective, following these closures, we will still have about 1,900 Sears and Kmart big box stores in operation, representing about 200 million square feet throughout the United States to serve our members. Few companies have this scale and reach.

- I would also point out that we believe that our investments in Shop Your Way and Integrated Retail will enable us to migrate the shopping activity of highly engaged members who previously shopped these closed stores to alternative channels. As a result, we would expect to retain a portion of the sales previously associated with these 130 stores by nurturing and maintaining our relationships with the members that shopped these locations.

- We expect that 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 improve our profitability going forward.

- I would also point out, that while we are adjusting our store base, we continue to operate stores in some of the best malls in America. Two reports have been done over the past six years, one by Goldman Sachs listing the top 100 malls in America, and the other by Morgan Stanley listing the top 100 fashion malls in America. Combining the two lists, in 2007, we were in 63 of the malls and we are now in 61. We are retaining stores in some of the best locations even as we close stores to optimize our store footprint and reduce lease obligations.

Moving to Slide 24, I will now turn the call back over to Eddie who will provide an update on the framework for profit that he outlined on our previous earnings call.

Eddie Lampert:

Thanks, Rob.

Transitioning to this section on Slide 24, I mentioned that I want to use this opportunity to provide an update on the levers we are using to restore profitability to Sears Holdings. As I have said before, the framework I am outlining is not intended to provide guidance as to our future results or predict that we will be successful in executing any aspect of this framework. It is intended to describe the opportunities we are focused on to increase profitability.

On Slide 25, we show that we believe that fostering deep and lasting relationships with our members will drive sustainable and profitable growth. As we pursue this fundamental objective, we will remain disciplined stewards of capital, with an overriding focus on creating value for our shareholders. A transformation of this size and scale is difficult, but our entire management team is committed to its execution.

On Slide 26 we outline the framework of our new model, which leverages our scale and the investments that we continue to make in the Shop Your Way program and Integrated Retail capabilities. These include:

- Optimizing store network and square footage
- Accelerating Shop Your Way & Integrated Retail as the foundation of our business model
- Transforming select business models
- Reducing selling and administrative expenses

Turning to Slide 27, as we've discussed, there is a great opportunity to optimize our store network.

I mentioned earlier, we have announced plans to close about 130 stores in 2014, having closed about 95 to date. In fiscal 2013, these stores generated almost $1B in sales; however, they generated an EBITDA loss of about $26 million. Due to the flexibility in our real estate portfolio we believe we will be able to close these underperforming locations efficiently. So, by closing these locations, we would expect to generate approximately $26 million of incremental EBITDA on an annualized basis by avoiding the losses they currently produce. Furthermore, closing these locations is expected to reduce our working capital requirements by about $160 million in 2014.

Additionally, we believe that there is opportunity to retain a portion of the sales associated with the closed locations by maintaining a relationship with the members who shopped those stores. This belief is based on experience we have had to date in stores that we have closed over the last year. As is shown on the slide, we believe that the annualized EBITDA value of retaining these members could be about $50 million, resulting in a total annualized EBITDA benefit of about $73M. As our ability to retain members improves, we believe that the potential annualized impact of optimizing our store network could be about $300 million to $400 million.

On Slide 28, we show that we have made substantial investments in Integrated Retail capabilities in our stores. We are seeing these investments drive very good results, and we will continue to roll out these capabilities to additional stores throughout the remainder of the year. For example, these capabilities include more flexible technology, like the ShopSears app utilized by associates in stores, digital signs, which enable dynamic pricing and marketing, and RFID technology, which enables our associates to do inventory counts in a fraction of the time giving them more time to focus on serving our members. This has resulted in improved sales and margins in the stores where we have enabled this technology. Based upon this experience, which we have introduced at hundreds of locations, we believe there is the potential to generate about $500 million in incremental annual revenues and between $150 million to $200 million of incremental annual EBITDA for these initiatives alone.

On Slide 29 we wanted to highlight that our In Vehicle Pickup has received very positive feedback from our members. We launched this member benefit in the first half of the year at our Sears Full-Line Stores to make pickup of online orders easier. This is one of the many ways we demonstrate our industry leadership in leveraging online channel and physical stores to enhance the integrated shopping experience. Based on that positive feedback we are looking to expand this capability to Kmart and are piloting it in 115 Kmart stores.

On the bottom half of this slide, we show that during the second quarter we announced new functionality that allows our members and customers to order from sears.com and kmart.com and pick up in each other's stores – all over the U.S. This will allow Members and customers to shop their favorite brands and pickup at the location most convenient to them, with no charge for shipping.

On Slide 30, we show that the difference in annual spend between an average engaged Shop Your Way member and a very engaged Shop Your Way member continues to be significant, with our most actively engaged members spending 75% more than our average active member. We are focused on targeted actions that will convert more of our average active members to more engaged members and we continue to see positive signs that these actions are working. Both the number of members that have redeemed points in the last 12 months and the number of emailable members have increased meaningfully. To put this in perspective, moving 1 million members from average to most engaged status represents $50M in EBITDA.

We are focused on enhancing margins and reducing our overall cost of goods through a number of initiatives. On Slide 31 we show that cost of goods annual spend is $23.6B. We have invested 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 are 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 Shop Your Way 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 unproductive space.

Strategic sourcing is one specific area I would like to call out where we have made some progress since our last call. In the first half of the year, we have executed a number of strategic sourcing initiatives that we expect will improve profitability for the company in the future by $80 million on an annualized basis. We will continue to utilize the strategic sourcing framework to continue to identify and go after additional savings across both merchandise and non-merchandise sourcing.

Through these actions, you can see that with revenue held constant, 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 32, selling and administrative expense is also an area of focus. As we have 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 Sold and Selling and Administrative expense. Through the first half of the year, we have reduced our fixed expenses by $30M, and we believe there is still significantly more opportunity. Our areas of focus are re-engineering processes, leveraging technology and shifting our marketing mix. In the first half of the year, we shifted more of our marketing dollar spend from fixed marketing assets to more variable-based, targeted digital assets, reducing our marketing expenses by $42 million while maintaining similar levels of marketing productivity. Again, I would point out that the impact of these initiatives can be substantial. With revenue held constant, each 2% reduction in selling and administrative expenses translates into $150 million of incremental EBITDA.

On Slide 33 we aim to clearly show both the challenge and the opportunity represented by Apparel. 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. To that end, we are aggressively transforming our apparel business with a focus on refreshed brands and product assortments and are reducing lead times to better meet our members' needs.

We are excited about our brand introductions, including the launch of Impact by Jillian Michaels, a performance activewear collection for women, which further strengthens our fitness offerings.

We recognize the need to continue to innovate in our fabrics and unique styles and designs. We plan to launch new technology in fabrics and design in our Everlast women and men's lines.

We have also been working to improve our ability to react faster to member needs and changing trends. We will reduce risk by making smaller and more seasonal buys, and reducing lead times to better meet our members' needs. We successfully reduced lead times by over 30% in more than 25 brands, and reduced SKUs by about 30%. These shorter lead times and focused assortments will permit greater flexibility, speed and accuracy going forward.

Turning to Slide 34, we depict our connected solutions business initiative. Connected Solutions are focused on providing our members with products that can be monitored and managed from their smart device anywhere in the world, helping our members better manage their lives.

We've brought together one of the most authoritative assortments of smart, connected home and personal automation products from both well-known national brands as well as innovative start-ups – across diverse categories such as:

- Home automation products such as thermostats, smart locks, lighting, switches and sensors
- Mobile phones and tablets as well as service plans from AT&T and Verizon
- Smart Watches
- Fitness products such as treadmills, fitness bands and heart rate monitors
- Connected garage door openers, including Craftsman Assurelink
- Connected baby monitors

Slide 35 shows our phased approach to growing the Connected Solutions platform. In phase 1, we piloted three 2,000 square foot shops in the Chicagoland area. In phase 2, we plan on opening an additional 7 locations with a focus on optimizing the experience and testing a smaller 500 square foot format. In phase 3, we plan to leverage the learnings from phases 1 and 2 as we scale the concept and roll-it out to additional stores.

On Slide 36, I do want to touch briefly on working capital, which 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 3 years. We believe there is still substantial opportunity to further improve our inventory productivity. We are focused on a number of initiatives centered on:

1. Reducing the levels of slow moving and unproductive inventory

2. Buying and flowing our merchandise differently given our Shop Your Way program and Integrated Retail platform, and

3. Buying smaller quantities of merchandise and turning it more frequently

As you can see on the slide, if we can turn our inventory 1 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 used to further invest in our transformation.

On Slide 37, we provide a summary of the initiatives laid out on the previous slides. As you can see, if we successfully execute on these opportunities, they have the potential to generate incremental annual EBITDA of between $1 and $2.4 billion 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 new realities of the industry. As I have said in the past, transformations of this size and scale are not easy, 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. We believe these initiatives, when coupled with executing on the profitability framework I just described, will position us to play offense and 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. We are committed to driving profitability, and we expect to focus on our strengths, including our best members, best stores and best categories.

As the CEO and the largest individual shareholder of Sears Holdings, I am personally committed to driving our transformation, improving the profit performance of the company and creating shareholder value. Our team is committed and is actively engaged in the daily work to make this transformation work.

Operator:

Ladies and gentlemen, thank you for participating in today's conference. This concludes today's program. You may now disconnect. Everyone, have a great day.