Sears Holdings' First Quarter Results
Pre-Recorded Conference Call Transcript
May 26, 2016

Operator:

Good day, ladies and gentlemen, and welcome to the Sears Holdings Corp. first quarter 2016 earnings conference call. At this time, all participants are in a listen-only mode. [Operator instructions]

Chris Brathwaite:

Thank you, Operator. Ladies and gentlemen, welcome to the Sears Holdings earnings call. I am Chris Brathwaite, Vice President of Corporate Communications for Sears Holdings and I am joined today by Rob Schriesheim, our Executive Vice President and Chief Financial Officer. Please note that this morning we released our first quarter earnings results which are available on the investors section of our website under events and presentations. For our call today, you may access the accompanying slide presentations.

Moving to 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. Factors that could cause the Company's actual results to differ materially from those listed in today's press release can be found 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. Finally, we assume no obligation to update the information presented on this call, except as required by law.

In addition, as noted 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 or Adjusted EBITDA excluding Seritage and JV rent, as defined in the presentation.

On Slide 4, we show the agenda for today's call. Rob will provide some information on our first quarter financial results and a brief update on our transformation.

I will now hand off the call to Rob.

Rob Schriesheim:

Thanks Chris.

Turning to Slide 5, let's begin by briefly covering the three critical areas we are focusing on in our transformation.

First, we remain focused on restoring profitability. In our first quarter, we successfully improved EBITDA performance marking six out of the last seven quarters with improved profitability. We delivered an EBITDA improvement of $14 million versus last year, when excluding rent associated with the recent Seritage and JV transactions.

Our focus continues on generating positive EBITDA. We have undertaken aggressive actions in the first quarter as we transition to an asset-light member-centric integrated retailer and eliminate operating losses while continuing to meet all of our financial obligations. More specifically, during the first quarter we executed on the following objectives:

1. Aggressively evaluated our store space and productivity to best meet our members' needs and accelerated the closing of 50 unprofitable stores as previously announced in the fourth quarter of 2015. In addition, we announced, to date, an additional 117 stores to be closed this year.
2. We continue to evaluate and optimize our cost structure:
   - In the first quarter of 2016, we reduced expenses by $176 million on a comparable basis and since 2012, we have reduced expenses by $1.6 billion;
   - Focus around store-level marketing expenditures and staffing levels; and
   - Improve inventory management.

Finally, as we said, we do not intend to borrow money to fund continued operating losses, but rather to provide us with flexibility as we transition to an asset-light member-centric integrated retailer leveraging our Shop Your Way program. Given that our first quarter performance fell short of this goal, the additional store closings and expense reductions are examples of the types of actions we will take in response to such performance; whereas in the past, we were more patient while we pursued other actions to generate profit.

Second, we continue to have financial flexibility to fund our transformation while meeting all of our financial obligations. We have a rich portfolio of businesses and assets, including a substantial amount of un-encumbered owned real estate as well as a large and valuable below market lease portfolio. We continue to de-risk our financial profile and, as of the end of the first quarter, we reduced our Total Net Debt, including the impact of our unfunded pension obligations and post-retirement benefits obligations, by about $300 million as compared to the first quarter of 2015.

In the first quarter of 2016, we closed a $750 million term loan and obtained a $500 million real estate loan facility secured by 21 properties. The proceeds from these transactions were utilized to pay down the revolver balance and positioned us for increased financial flexibility when we need more seasonal inventory, which we will discuss in detail on slide 13.

In 2015, we successfully amended and extended our $3.275 billion domestic credit facility with approximately $2.0 billion maturing in 2020 and the remaining approximately $1.3 billion which matured in April of 2016. The new facility provides increased financial flexibility through additional features in the agreement including a $1.0 billion accordion facility of which $750 million was used for the recently completed term loan, leaving $250 million outstanding; a $500 million FILO or "First In Last Out" facility, both subject to borrowing base availability; and an increase in our short-term borrowing basket from $500 million to $750 million of which $114 million is available after taking into consideration the $500 million real estate loan facility and $136 million of Commercial Paper outstanding as of the end of the first quarter 2016.

Third, we continue to make progress in our transformation to a more asset-light, member-centric integrated retailer leveraging our Shop Your Way platform. Our member sales penetration has grown from 58% to 73% since 2011. Going forward, we intend to increase our level of member engagement while focusing on our best members, our best stores and our best categories.

Turning to Slide 6, let's review our first quarter financial results.

On Slide 7, we show our Adjusted EBITDA results for the past seven quarters.

The first quarter of this year marked our sixth out of seven consecutive quarters of improved EBITDA performance as we delivered $14 million of improvement versus the first quarter of last year, when excluding approximately $54 million of additional rent and assigned sub-tenant income related to the recent Seritage and Joint Venture transactions. Let me take a moment to explain how we think about this and we leave it to investors to make their own determinations as to how they evaluate our Company's operating performance.

Due to the structure of the leases, we expect that our cash rent obligations to Seritage and the Joint Venture partners will decline materially over time as space in these stores is recaptured. When space is recaptured, the rent is reduced proportionately without any payment by Sears Holdings. If a store is unprofitable as defined, Sears Holdings has the option to exit the lease by making a payment equal to one year of rent. So, while the Seritage and Joint Venture rent is a real, cash expense, it is an expense that is highly likely to decline materially in the next few years, either through recapture or exit. When modeling the earnings power of Sears Holdings, this breakout allows an investor to better understand the characteristic of this particular expense.

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

Slide 8 is a "waterfall" chart showing the components of the year-over-year changes in revenues. Like many of our competitors, the apparel business continues to prove challenging with pressure on margins and comparable store sales. On a comparable basis, adjusting for the closing of underperforming stores, our revenue declined $339 million, with $268 million of this decline due to comparable store sales performance and $71 million due to declines that are not directly attributable to a store, including revenue from our ongoing relationship with Sears Hometown & Outlet Stores.

On Slide 9, we provide a "waterfall" chart displaying the components of the year-over-year change in gross margin for the first quarter.

The Company incurred $54 million of REIT related expenses in the first quarter contributing to a reduction in gross margin and an increase in our overall occupancy expense as a percentage of sales. As previously noted, the terms of our leases with Seritage and the Joint Venture partners provide us with the ability to accelerate the transformation of our physical stores. We expect that our cash rent obligations will decrease as space in the stores is recaptured as part of our ongoing reconfiguration of our physical footprint or as a result of our ability to exit leases beginning in July of this year, subject to certain limitations.

On a comparable basis, after adjusting for items primarily related to closed stores, the previously mentioned REIT related expenses and a one-time occurrence of vendor credits, our gross margin decreased $148 million, driven by an unfavorable volume impact of $78 million and an unfavorable rate impact of $70 million. The decline in margin rate is primarily attributed to a decrease in product margin resulting from fall/winter inventory clearance markdowns, which partially was funded by reductions in traditional advertising spend recorded in SG&A.

Slide 10 is a "waterfall" chart that shows components of the year-over-year change in expenses for the fourth quarter. On a reported basis, we reduced selling and administrative expenses by $178 million year-over-year and $176 million on a comparable basis, primarily driven by decreases in payroll and advertising expenses. Since 2012, we have reduced our annual expenses on a comparable basis by about $1.6 billion.

Slide 11 shows we have reduced gross inventory by $2 billion and net inventory by about $740 million versus the first quarter of 2012 due to inventory productivity improvements and the closure of unproductive stores.

By reducing our 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 both benefit us and our vendor-partners.

In the first quarter of 2016 as compared to the prior year, net inventory was largely impacted by higher overall net inventory within the Apparel business. This increase is attributed to both lower payables and higher inventory for Apparel due to the prior year's port delay issues. We intend to manage inventory closely with a goal to increase our overall inventory productivity and to reduce our net inventory position from the first quarter level.

Slide 12 summarizes some of our substantial financial resources and liquid assets.

At the end of the first quarter, we had $286 million of cash, $265 million of availability to borrow on our credit facility, and $114 million of availability on our short-term borrowing basket, resulting in $665 million of Total Liquid Immediate Availability. We had total utilization under our credit facility of less than $1.0 billion out of a total of $1.971 billion, primarily for letters of credit. Finally, note that the Company's ABL usage is down about 16% this year versus last year and we are only using about 45% of the $1.971 billion facility as of the end of the first quarter of 2016.

We had approximately $3.7 billion of equity in inventory at the end of the first quarter, which when added to the $665 million of Total Liquid Availability yields $4.4 billion of liquidity and liquid assets, which could be converted into cash in the near term.

In addition, under the terms of our debt agreements, we have a wide range of financing resources available to us under our credit facility, our 2nd Lien Debt capacity and our substantial unencumbered real estate assets.

We believe that we have sufficient financial resources and liquid assets to fund our transformation and meet all of our financial obligations.

Slide 13 illustrates how the Company's credit facility addresses our working capital needs. Two factors provide additional availability during the peak holiday season. First, as our inventory balances grow throughout the year, so does the borrowing base.

Second, our ABL availability will benefit in September from the change in the Fixed Charge Coverage Ratio or "FCCR" "holdback" amount which was $413 million in 2016 first quarter and is expected to drop to $200 million in September; resulting in a net "holdback" improvement of $213 million.

Finally, note that this potential increase was factored into the Company's decision to raise the $750 million term loan in April 2016. As our inventory balance and borrowing base grows during the year, we benefit from the incremental capacity provided by the $750 million term loan. The new term loan contemplated the expected growth in the Company's borrowing base into the holiday season and ensures that we have the borrowing availability if we need it to support our business.

On Slide 14, we show how we have reduced our Total Adjusted Net Debt position, defined as Net Debt plus unfunded pension benefits and post-retirement obligations, by about $300 million year-over-year.

Moving to Slide 15, I'd like to provide an update on the actions that we have taken to ensure we continue to have the financial flexibility to fund our transformation while we also create long term value for our shareholders.

As shown on Slide 16, we have completed numerous transactions since 2012 which have been consistent with our objective to right-size, redeploy and highlight the value of our assets as we transition from a traditional network-based retailer to a more asset-light member-centric integrated retailer leveraging our Shop Your Way program. As we have executed on these transactions we have enhanced our liquidity and financial flexibility while providing the foundation on which to continue funding our transformation with a focus on long term shareholder value creation. Since 2012, we have generated $8.9 billion of liquidity from a combination of asset monetization and financing activities within the framework of sustainable shareholder value creation.

As we continue to evaluate opportunities to accelerate our transformation and drive growth, we recognize there is significant potential to further develop our Kenmore, Craftsman and DieHard (KCD) and Sears Home Services (SHS) businesses.

As we announced today, and consistent with our focus to create long term shareholder value, our board of directors has decided to explore alternatives including evaluating potential partnerships that could expand the distribution of our KCD brands beyond Sears Holdings formats. These iconic brands are beloved by the American consumer and we believe the recent performance of Sears and Kmart have impeded their ability to grow. These brands have substantial potential and we believe that exploring alternatives is the right approach to create long term value.

In addition, the control of Sears Home Services by SHC has discouraged other retailers from utilizing the capabilities of this business. As a result, we intend to explore alternatives for SHS which includes our Protection Agreements, Parts Direct, and Delivery/Installation/Repair businesses. We believe there is significant opportunity to expand these offerings more broadly,

including to one or more competing retailers. As the "internet of things" develops and as more of our lives become connected, we believe SHS stands to benefit significantly.

We have retained Citigroup Global Markets and LionTree Advisors to assist us in these efforts. There can be no assurance that we will complete one or more transactions, but we intend to aggressively pursue these alternatives during the balance of 2016.

In 2016, we closed on a $750 term loan which matures in July 2020. Proceeds from the loan were used to pay down the revolver balance and provide additional availability during our peak period as discussed on Slide 13. Additionally, we obtained a $500 million real estate loan maturing in July 2017 which is secured by 21 properties.

In 2015, we completed the rights offering and sale lease-back transaction with Seritage Growth Properties as well as our 50% interests in three real estate joint ventures with three of the country's leading mall owners. In addition, we executed on several other transactions demonstrating our flexibility. Importantly, we amended and extended our ABL credit facility, which we will discuss further on slide 17.

As you can see on Slide 17, we have materially increased our financial flexibility. Consistent with our intentions to enhance our flexibility through adjustments made to our capital structure, in 2015 we completed an amendment and extension of our $3.275 billion domestic credit facility with an extending tranche of approximately $2.0 billion maturing in 2020 and a non-extending tranche of the remaining approximately $1.3 billion that matured in April of 2016. The extending tranche is a smaller facility, reflecting our reduced needs consistent with lower inventory levels associated with our transformed business model which has fewer physical stores, and a greater online presence. In extending the ABL for five years, we first expanded the total capacity by $196 million, subject to borrowing base requirements.

Second, the short-term debt basket, which is for debt issued with a maturity date inside that of the ABL, increased from $500 million to $750 million of which $114 million is currently available after taking into consideration the recently completed $500 million real estate secured facility and $136 million of outstanding commercial paper. Third, we added a "FILO" tranche or "First in Last Out", which represents up to a $500 million incremental advance against the same inventory collateral that supports the ABL. Finally, we refreshed the $1.0 billion accordion capacity that was consumed in October 2013 in order to have additional capacity. Of the $1 billion, we have $250 million remaining after taking into consideration the recent $750 million Term Loan.

In addition, the ABL permits up to $2.0 billion of additional inventory-based financing, which has served to support our second lien notes. With the tender offer for $936 million of second lien notes in 2015, the second lien capacity is now approximately $2.0 billion of which $304 million is outstanding at the end of the first quarter, subject to borrowing base requirements contained in the existing second lien notes indenture.

To this last point, turning to Slide 18, we continue to have a substantial and diverse real estate portfolio following the sale of 266 properties to Seritage. As you can see, we own 418 stores and we lease 1,204 stores of which 952 are non-Seritage leased stores. In total, we operated 1,622 stores across the two formats as of the end of the first quarter.

As you can see on Slide 19, in addition to the size of our real estate portfolio, we maintain a substantial presence in the top malls and top fashion malls in America, which we believe provides an indication of the quality of our real estate.

Additionally, on Slide 20, our lease expirations in the 1,204 stores provide us with significant option value with minimal commitments since more than half of the leases expire in less than five years while we have the option to renew the leases for more than 25 years. This lease portfolio provides us with substantial value as well as flexibility as we continue to transition to a more asset-light member-centric integrated retailer leveraging our Shop Your Way platform.

Moving to the next section, let me offer some comments on the progress we are making in our transformation.

As Slide 22 depicts, we are in the process of transforming our Company from a traditional store network model into a member-centric integrated retail model. At the core of this transformation is a change in perspective. We are shifting from being product-centric to member-centric, from transacting with customers to building relationships with our members, from focused on driving our customers to our store networks to building integrated retail capabilities that leverage the store network to create solutions to meet our members' needs.

Turning to Slide 23, as we continue our transformation, we are focused on the future and are placing a disproportionate amount of our attention and resources on our best members, our best stores and our best categories.

As Slide 24 depicts, we have a substantial member base with almost 73% of sales derived from Shop Your Way members, which is up from 58% over the last four years. Going forward, our focus is on increasing our level of engagement with our members. We will continue to apply our resources towards better understanding the wants and needs of our best members so that we can apply these insights towards increasing engagement and strengthening our relationships.

If you shop with us 10 times a year and spend $300, we'd like you to shop 20 times a year and spend $1,000. The Shop Your Way platform, which adds a variety of social and sharing features, on top of loyalty-related coupons and e-commerce, depends on member activity to generate social benefits and insights. Our reputation and brand will change when our members are more engaged with the Shop Your Way network. Shop Your Way already has a large member base which is evidence of the potential of the platform and shows how important Shop Your Way is to the future and growth of the Company.

As you can see on Slide 25, we will focus on our best stores as part of our shift to a member-centric integrated retail model and we will continue to optimize the productivity of our space as we right-size, redeploy and highlight the value of our assets, including our substantial and unencumbered real estate portfolio. We have the ability to rationalize our retail store footprint and generate additional lease income through partnerships with other retailers. Many of our stores have generated significant profitability for years, despite the fact that there have also been a meaningful number of stores that have suffered from losses or low profitability, which we are addressing through a variety of means, including store closures.

On Slide 26, we show that as part of the Seritage REIT transaction, we entered into a master lease with Seritage which allows for Sears and Kmart to continue to operate in these locations. We structured the master lease to include features that align the interests of Seritage and Sears Holdings in a way that we believe will both accelerate the transformation of our physical stores and will provide us with substantial flexibility in how we manage our store network moving forward. Note, during the first quarter of 2016, we closed three stores pursuant to recapture notices from Seritage. We expect that many of our other stores will adjust to a smaller footprint, pursuant to these recapture provisions. Contractually, you can also see that Seritage has the option to acquire approximately half of the space that we lease from Seritage. Similarly, after the first year, Sears Holdings has the legal right to exit unprofitable leases up to 20% of the total rent obligations, subject to certain annual limitations.

Finally, as you can see on Slide 27, we are the market leader in several of the key categories in which we do business, such as Home Appliances and Home Services, and we continue to invest in our best categories to further reinforce these leadership positions. In the first quarter of 2016, the Home Services business successfully delivered positive growth by executing their revenue growth strategy while focusing on expense reductions.

Moving to Slide 28, as we have stated, our primary focus for 2016 is to generate positive EBITDA. We have made substantial progress towards our goal of being a member-centric integrated retailer. We delivered positive year-over-year EBITDA improvement of $14 million, marking 6 out of the last 7 consecutive quarters with improved profitability. We are more aggressively evaluating our physical store footprint and accelerating the closing of unprofitable stores while retaining our best members. We have the financial flexibility to fund our transformation and meet our financial obligations including more than $4.0 billion of liquidity and liquid assets, a newly amended credit facility and a significant and un-encumbered real estate portfolio.

We continue to de-risk our financial profile having reduced our gross inventory by $2 billion and our net inventory by over $700 million since 2012, having reduced our annual expenses by $1.6 billion since 2012 and having reduced our Domestic Adjusted Net Debt by about $300 million year over year.

As we have taken these actions we have re-allocated capital from our traditional retail model and directed it to accelerate our transformation to a more asset-light member-centric integrated retailer leveraging Shop Your Way with a focus on our best categories, our best stores and our best members.