SEARS HOLDINGS

Sears Holdings' First Quarter 2017
Pre-Recorded Conference Call Transcript
May 25, 2017

Operator:

Good day, ladies and gentlemen, and welcome to the Q1 2017 Sears Holdings Corp. earnings conference call. [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 Riecker, our Chief Financial Officer. This morning, we released our first quarter results for 2017, which are available on the investors section of our website under Events and Presentations. You can access the accompanying slide presentation for our call today through the same section of the website.

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 Annual Report on Form 10-K and other 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, as defined in the presentation.

I will now hand off the call to Rob.

Rob Riecker:

Thanks, Chris.

Good morning and thank you for joining our call. Let's turn to slide 4.

In the first quarter, we continued to take decisive actions to improve our operational performance and liquidity position. I will highlight some of the key initiatives we have executed to drive our transformation.

In April, we increased our annualized cost savings target from our ongoing restructuring program to $1.25 billion from $1.0 billion based on the significant progress we delivered during the first quarter, including $700 million in annualized cost savings actioned to date. As part of the program:

- we completed the previously-announced closure of 150 non-profitable stores and initiated the closure of 92 underperforming pharmacy operations in certain Kmart stores and 50 Sears Auto Center locations;
- we took various actions to simplify our organizational structure and drive operational efficiencies, including consolidation of the leadership of retail operations for Sears and Kmart, and elimination of certain senior management roles; and
- we conducted a comprehensive review of the Company's value chain to identify broader opportunities for competitively priced products that drive cost savings.

These actions contributed to the significant reduction in our operating expenses during the first quarter, and we continue to take necessary steps to rationalize our cost base to offset continued revenue pressures in a difficult retail environment. We believe this restructuring program is critical to becoming a more competitive, efficient and agile retailer moving forward.

Moving to our financial flexibility…

Since the beginning of the fiscal year, we have successfully executed numerous transactions to increase our financial flexibility to fund our operations and continued transformation.

As previously announced, in February 2017, we entered into an amendment to our existing asset-based credit facility, which reduced our aggregate revolver commitments from $1.97 billion to $1.5 billion and provided additional flexibility in the form of a $250 million increase in the general debt basket from $750 million to $1.0 billion. In addition, the amendment implemented other modifications to covenants and reserves against our credit facility borrowing base that improved net liquidity.

We also completed the sale of the Craftsman brand to Stanley Black & Decker for a net present value of over $900 million in cash and received an initial upfront cash payment of $525 million, which was subject to closing costs and an adjustment for working capital.

These actions provided us with the confidence to target a $1.5 billion reduction in our debt and pension obligations as we are able to use the proceeds from asset sales, including those from the Craftsman sale and the sale of real estate properties to reduce these obligations.

During the first quarter of 2017, we were able to pay down approximately $418 million of our term loan debt outstanding. And as previously announced, we reached an agreement to extend the maturity of $400 million of our $500 million 2016 Secured Loan Facility, from July 2017 to January 2018, which I will discuss in detail shortly.

Beyond the completed transactions I have outlined, we continue to evaluate our options to generate additional liquidity and improve our capital position.

As previously announced, the Special Committee established by our Board of Directors to market certain real estate properties continues to evaluate offers with the target of raising at least $1.0 billion in proceeds. As of the date of this call, the Special Committee has executed $28 million of real estate sales out of over $700 million in non-overlapping bids received to date on over 60 separate real estate properties. The Committee is evaluating the remaining offers and is expecting additional bids in the near future. We are planning on using the proceeds from the sale of these properties to further reduce our outstanding debt and strengthen the Company's balance sheet.

We continue to have a valuable real estate portfolio, which at the end of the quarter comprised over 900 leases with significant optionality, as well as over 350 owned stores, many in prominent locations. We continue to have a high degree of flexibility across our store leases as a result of the minimal base lease commitment and renewal options. We will continue to assess opportunities to right-size our store footprint and inventory levels to ensure they align to our ongoing transformation to an asset-light integrated retail model.

Going forward, we will also continue to evaluate strategic options to unlock value from our Kenmore and DieHard brands, as well as our Sears Home Services and Sears Auto Centers businesses through partnerships, joint ventures or other means.

While these actions are aimed at unlocking value and creating financial flexibility, we also continue to work toward providing a more rewarding member experience through our Shop Your Way ecosystem.

A key development in the last quarter was the official launch of our new Sears Mastercard with Shop Your Way which we developed in partnership with Citi. Our new Mastercard offers an industry-leading rewards program including:

- 5% back in points on eligible purchases made at gas stations,
- 3% back in points on eligible purchases at grocery stores and restaurants;
- 2% back in points on eligible purchases made at Sears and Kmart; and
- 1% back in points on all other eligible purchases.

We believe this new credit card product will significantly strengthen the competitiveness of our Shop Your Way platform and has the opportunity to become a key performance driver for our Company.

Turning to slide 5 for key operational and financial performance highlights in Q1…

From a member engagement perspective, we are increasingly focused on expanding frequency of usage of Shop Your Way. We are doing this through targeted marketing and member engagement initiatives that leverage our data analytics and personalization capabilities – and we are seeing the results:

- we have tens of millions of active members and that number continues to grow;
- we expanded our VIP program to reward our members based on spend and frequency in addition to traditional spend-based points architecture, which has resulted in a nearly a 50% increase in the number of VIP members year to date compared to the same period last year;
- we saw an increase in the number of trips, order volumes and cross-category purchases by our members as they became more aware of our Shop Your Way program benefits; and
- we also continue to actively pursue new partnerships and other membership offerings to deliver more value and better services for our members.

On the product and innovation front, we were named 2017 Partner of the Year by ENERGY STAR and received their Sustained Excellence Award for our long-term commitment to protecting the environment through the achievements of our energy efficiency initiatives. Our proprietary Kenmore brand partnered with the ENERGY STAR program to introduce new certified products across multiple categories in 2016, earning the brand numerous "best buy" designations from a leading consumer publication. We were honored to be recognized for our product innovations and have built on this achievement. Earlier this month, Edison Awards, which recognizes the best in innovation and excellence in the development of new products, honored the Craftsman brand at Sears with one Gold and two Bronze Awards for Innovation.

In addition, we opened the first DieHard Auto Center in San Antonio, Texas in February of 2017, with a new and innovative store format that offers state-of-the-art technology and services in a contemporary, comfortable setting that, combined with our experienced associates, can help today's drivers make the right choices for their vehicles' needs.

We also continued to take decisive actions to improve our business performance and drive our transformation.

As we previously indicated, the retail headwinds persisted in the first quarter, with continued softness in store traffic and elevated promotional markdowns due to competition.

We reported total revenues of $4.3 billion in the first quarter of 2017, compared to $5.4 billion in the same quarter last year, representing a decrease of $1.1 billion. This was largely driven by having fewer stores in operation, which accounted for $557 million of the sales decline, and declines in our comparable store sales due to the industry headwinds I just mentioned, which accounted for $417 million of the decline.

Our first quarter comparable store sales at Sears and Kmart declined 11.9% on a combined basis, compared to the prior-year period. Kmart comparable store sales declined 11.2% during the first quarter of 2017 led by declines in the grocery & household, pharmacy, apparel and home categories, while Sears Domestic comparable store sales decreased 12.4% during the quarter, primarily driven by decreases in the home appliances, apparel and lawn & garden categories.

Selling and administrative expenses decreased by $236 million in the first quarter of 2017, as compared to the prior year quarter. This significant expense reduction was largely attributable to the steps we've taken to improve our operational efficiency, including our reductions in payroll. In addition, advertising expense declined as we shifted away from traditional advertising to the use of Shop Your Way® points awarded to members, the expense for which is included in gross margin.

As a result of the Craftsman sale, we recorded first quarter net income of $244 million, as compared to a net loss of $471 million in the same quarter last year.

We reported an Adjusted EBITDA loss of $222 million in the first quarter of 2017, compared to an Adjusted EBITDA loss of $181 million in the prior year first quarter. As a reminder, reconciliations of Adjusted EBITDA to the most directly comparable GAAP financial measures can be found in the appendix of this presentation and in today's earnings release.

So, while we have made significant progress in reducing our cost base and enhancing our member value proposition, we need to take further action.

Moving to the next slide, I would like to review our financial position.

At the end of the first quarter, we had a total cash balance of $264 million, compared to $286 million at the end of the last quarter, ending January 28, 2017. We ended the quarter with $551 million in short-term borrowings, consisting of $536 million of revolver borrowings and $15 million of commercial paper outstanding.

Merchandise inventories decreased to $3.9 billion at the end of the first quarter, compared to $5.0 billion at the end of the same period last year. Merchandise payables at the end of the first quarter were $961 million, down from $1.3 billion in the first quarter of 2016. The significant reduction in our merchandise inventory and payables is primarily driven by our efforts to tightly manage our inventory, as well as the closure of non-profitable stores.

At April 29, 2017, our total long-term debt, including current portion of long-term debt and capital lease obligations, was $3.7 billion compared to $4.2 billion at January 28, 2017.

We continually review our options to further de-risk our balance sheet and increase our financial flexibility.

Earlier this week, we reached an agreement with our lenders to extend a portion of our $500 million 2016 Secured Loan Facility originally maturing in July of 2017. Through this agreement, we extended the maturity of $400 million at the same interest rate to January 2018, with the option to extend the loan until July 2018.

Finally, we have been evaluating our options for de-risking the Sears Pensions Plans, to which we have contributed over $3.7 billion since 2005. On May 15, we were pleased to enter into an agreement to purchase a group annuity contract from MetLife. Under this agreement, we transferred approximately $515 million of the current Sears Pension Plans' benefit obligations to MetLife and reduced the size of Sears Pension Plans by approximately 51,000 participants. Starting August 1, 2017, MetLife will begin making benefit payments and providing administrative services to the affected retirees. All retirees will receive the same monthly benefit they were receiving from the Sears plan.

This action is expected to have an immaterial impact on the funded status of our total pension liability and obligations, but will serve to reduce the size of the Company's combined pension plan, reduce future cost volatility and reduce future plan administrative expenses.

With that, let's turn to today's final slide.

In summary, we remain committed to improving our operating performance and financial flexibility in a very challenging retail environment.

We have certainly made significant progress on our strategic initiatives in the first quarter of 2017, including $700 million in cost savings actions. Through these actions, we significantly reduced our SG&A expenses during the first quarter and are committed to taking further decisive steps to improve our short-term performance and strengthen our financial position.

Consistent with our ongoing strategy of focusing on our Best Stores, Best Categories and Best Members, we are sharpening our focus on profitable areas of our business. Our comprehensive restructuring program is now targeting $1.25 billion of annualized cost savings by the end of this fiscal year, a $250 million increase from our previous target.

As we previously mentioned, we entered into an agreement with MetLife to annuitize $515 million of pension liability.

In addition, we increased our financial flexibility through an agreement to extend the maturity of $400 million of our $500 million 2016 Secured Loan Facility.

And, we continue to evaluate ways to improve our financial position by unlocking value from our asset base, including our Kenmore and DieHard Brands, as well as our Home Services and Auto Centers businesses.

We will continue to closely evaluate the stores where a clear path to return to profitability is not in sight. We are determined to take necessary actions to improve the performance of Sears Holdings and will leverage our lease optionality to reconfigure our stores and reduce capital obligations.

As we reduce the Company's overall cash funding requirements, we will be better equipped to support our continued focus on the evolution of the Shop Your Way ecosystem. We remain focused on its integrated retail strategy and are actively pursuing new partnerships and other membership offerings to deliver more value and better services for our members.

We are firmly focused on delivering on our targets and look forward to reporting progress.