SEARS HOLDINGS

Sears Holdings' Second Quarter Results
Pre-Recorded Conference Call Transcript
August 25, 2016

Operator:

Good day, ladies and gentlemen, and welcome to the Sears Holdings Corp. second quarter 2016 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 Schriesheim, our Executive Vice President and Chief Financial Officer. Please note that this morning we released our second 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, as defined in the presentation.

On Slide 4, we show the agenda for today's call. Rob will provide some information on our second 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 have been focusing on during our transformation.

First, we remain focused on restoring profitability. We continue to face a challenging and competitive retail environment. In our second quarter, we reported an EBITDA loss of $191 million, an improvement of $35 million versus last year.

During the second quarter we executed on the following objectives:

1. Continuing to evaluate and optimize our cost structure. During the second quarter of 2016, we reduced expenses by $193 million on a comparable basis and since 2012, we have reduced expenses by $1.8 billion;
2. Focusing around store-level marketing expenditures and staffing levels; and
3. Improving inventory management, noting a reduction in net inventory of $1.1 billion since the second quarter of 2012.

As we move into the second half of 2016, our focus continues on generating positive EBITDA. We are continuing to explore alternatives for our Kenmore, Craftsman and Diehard Brands, and Sears Home Services businesses by evaluating potential partnerships or other transactions. Additionally, we will continue to take actions to adjust our capital structure and manage our business to enable us to execute on our transformation.

Two, as it relates to funding our transformation, we continue to focus on the funding of our transformation while meeting all of our financial obligations, using the levers available to us through our portfolio of assets and businesses, including un-encumbered owned real estate as well as a large and valuable below market lease portfolio.

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. In the second quarter of 2016, we generated $176 million in proceeds from real estate transactions and other asset sales. In August 2016, we received an offer from ESL Investments, Inc. to provide $300 million of additional debt financing secured by a junior lien against our inventory, receivables and other working capital, and this offer has been accepted. Under the ESL proposal, the Company may, in its discretion, offer to third party investors the right to participate up to an incremental $200 million of debt financing on the same terms and conditions. The financing is subject to customary conditions and is expected to close in the next seven to 10 business days.

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 75% 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 second quarter financial results.

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

In our second quarter of this year, we improved year-over-year Adjusted EBITDA performance by $35 million versus the second quarter of last year. The reported Adjusted EBITDA includes approximately $48 million of additional rent related to the Seritage and joint venture transactions in the second quarter of 2016 as compared to $26 million in the second quarter of 2015. The increase in rent reflects a full quarter of rent in 2016 versus a partial quarter of rent in 2015 due to the timing of closing in the Seritage transaction in the prior year. Let me take a moment to explain again 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 have with Seritage, we expect that our cash rent obligations to Seritage and the Joint Venture partners will decline 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 likely to decline in the next few years, either through recapture or exit.

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. On a comparable basis, adjusting for the closing of underperforming stores, our revenue declined $349 million, with $240 million of this decline due to comparable store sales performance and $109 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 second quarter.

The Company incurred $48 million of REIT related expenses in the second 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. 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 which began in July of this year for Seritage leases, subject to certain limitations, we expect that our cash rent obligations will decrease.

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 $100 million, driven by an unfavorable volume decline of $79 million and an unfavorable rate impact of $21 million. The decline in margin rate is primarily attributed to an increase in promotional markdowns; including an increase in Shop Your Way points expense, which is partially offset by reductions in traditional advertising spend recorded in selling and administrative expenses.

Slide 10 is a "waterfall" chart that shows components of the year-over-year change in expenses for the second quarter. On a reported basis, we reduced selling and administrative expenses by $210 million year-over-year and $193 million on a comparable basis, or an 11% reduction in SG&A year-over-year, primarily driven by decreases in payroll and advertising expenses. Since 2012, we have reduced our total annual expenses on a comparable basis by about $1.8 billion.

Slide 11 shows we have reduced gross inventory by $2.4 billion and net inventory by about $1.1 billion versus the second 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, which de-risks our business model in a way that both benefits us and our vendor-partners.

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

At the end of the second quarter, we had $276 million of cash, $191 million of availability to borrow on our credit facility and $149 million of availability on our short-term borrowing basket, resulting in $616 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. As previously discussed, in August we received an offer from ESL Investments, Inc. to provide $300 million of additional debt financing secured by a junior lien against our inventory, receivables and other working capital and this offer has been accepted. Under the ESL proposal, the Company may, in its discretion, may offer to third party investors the right to participate in up to an incremental $200 million of debt financing on the same terms and conditions. The financing is subject to customary conditions and is expected to close in the next seven to 10 business days. Had this $300 million financing closed as of the end of the second quarter we would have had $916 million of total liquid availability.

We had approximately $3.3 billion of equity in inventory at the end of the second quarter, which when added to the $616 million of Total Liquid Availability yields nearly $4.0 billion of liquid and liquid assets, before the $300 million noted ESL loan which will close in the next seven to 10 days, all of which could be converted into cash in the near term.

In addition, under the terms of our debt agreements, we have financing resources available to us under our credit facility, our 2nd Lien Debt capacity and our unencumbered real estate assets. We believe that we have the 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 balance grows throughout the year, so does the borrowing base. Second, our ABL availability will benefit in the third quarter from the change in the Fixed Charge Coverage Ratio or “FCCR” “holdback” amount, which was $375 million in the second quarter of 2016 and has decreased to $200 million in August, resulting in a net “holdback” improvement of $175 million.

Finally, we would like to 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 is intended to ensure 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, during the second quarter by about $260 million as compared to the first quarter of 2016.

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.

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 financial flexibility while providing the foundation on which to continue funding our transformation. Since 2012, we have generated $9.1 billion of liquidity from a combination of asset monetization and financing activities within the framework of sustainable shareholder value creation.

As previously discussed, we recently accepted an offer from ESL to provide $300 million of additional debt financing. In the second quarter of 2016, we generated $176 million in proceeds from real estate transactions and other asset sales. During the first quarter of 2016, we closed on a $750 term loan which matures in July 2020. 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. As we have often noted this has provided us with substantial additional flexibility and how we manage our real estate assets to enhance our space productivety and our real estate related lease expenses. In addition, we executed on several other transactions demonstrating our flexibility. Importantly, we amended and extended our ABL credit facility.

As you can see on Slide 17, we have substantial financial resources which are augmented by our portfolio of assets as we turn to slide 18.

As you can see on Slide 18, we continue to have a diverse real estate portfolio following the sale of 266 properties to Seritage and the joint venture partners. As shown, we own 414 stores and we lease 1,178 stores, of which 926 are non-Seritage or JV leased stores. In total, we operated 1,592 stores across the two formats as of the end of the second quarter.

As shown 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, as shown on Slide 20, our lease expirations in the 1,178 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 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.

We have a substantial member base with 75% of sales derived from Shop Your Way members, which are up from 58% since 2011. 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.

We will continue to 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. Additionally, we recently launched a stand-alone free standing appliance store which integrates our digital assets with the real estate space to better serve our members.

Finally, 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. The Home Appliance business and Kenmore, Craftsman, and Diehard brands are focused on providing innovative products, to better serve our members. The Home Services business continues to deliver positive growth by executing their revenue growth strategy while focusing on expense reductions.

Moving to Slide 24, as we have stated, our primary focus for 2016 is to generate positive EBITDA. We have made progress towards our goal of being a member-centric integrated retailer. We continue to face a challenging environment, and while we experienced a loss for the quarter, we delivered year-over-year EBITDA improvement of $35 million during the second quarter. We believe we have the financial flexibility to fund our transformation including more than $4.0 billion of liquidity and liquid assets as of the end of the second quarter, our previously discussed $300 million of additional debt financing, our ABL credit facility and other flexible financing features, and a significant and un-encumbered real estate portfolio.

We continue to de-risk our financial profile having reduced our gross inventory by $2.4 billion and our net inventory by over $1.1 billion since 2012 and have also reduced our annual expenses by $1.8 billion since 2012. 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 members, our best stores and our best categories.