SEARS HOLDINGS

Sears Holdings' Third Quarter 2015 Results
Pre-Recorded Conference Call Transcript
December 3, 2015

Operator:

Good day, ladies and gentlemen, and welcome to the Sears Holdings Corp. Q3 2015 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 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 third quarter earnings results, which are now available on our website. 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.

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.

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, Domestic Adjusted EBITDA or Domestic Adjusted EBITDA excluding Seritage and JV rent, as defined in the presentation.

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

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

I will now hand off the call to Rob.

Rob Schriesheim:

Thank you, 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 to the Company. As our results demonstrate, we successfully improved EBITDA performance during the third quarter as we continued to become more efficient with our promotional programs and to invest in targeted and personalized digital interactions with our members. Simultaneously, we continue to manage expenses as part of our transformation strategy noting that since 2012 we have reduced our annual expenses by about $1.3 billion.

During the third quarter, we delivered an EBITDA improvement of $16 million versus last year, when excluding rent associated with the recent Seritage and JV transactions. This marks our fifth consecutive quarter of improved EBITDA performance with our trailing 12 months EBITDA improved by $368 million on a year-over-year basis.

Second, we are confident that we have the financial flexibility to continue to fund our transformation while meeting all of our financial obligations. In the third quarter, we substantially reduced our Total Domestic Net Debt, excluding pension costs, by $2billion or 44% to about $2.5 billion as compared to the third quarter of 2014.

As part of our plan to reduce leverage, reduce interest expense and free up collateral, we successfully completed a tender offer in August of this year in which we repurchased $936 million of our outstanding 6 5/8% Senior Secured Notes Due 2018 ("Notes"). As a result of the tender offer, we have reduced our annualized cash interest expense by $62 million and freed up $936 million of 2nd lien debt capacity under our credit agreement.

The tender offer followed the successful amendment and extension of our $3.275 billion domestic credit facility with approximately $2.0 billion maturing in 2020 and the remaining approximately $1.3 billion maturing in April of 2016. Our new facility reflects our reduced needs, consistent with lower inventory levels associated with our transformed business model; however, the new facility provides increased financial flexibility through additional features in the agreement.

Finally, the sale-leaseback transaction with Seritage Growth Properties generated $2.7 billion of gross cash proceeds to Sears Holdings in the second quarter of 2015. This has enabled us to continue to operate Sears and Kmart stores in our current locations; with lease terms that provide a structure that we believe, will accelerate the transformation of our physical stores by providing us with flexibility in how we manage our store network.

As a result of the actions we have taken, we ended the quarter with $294 million in cash and approximately $963 million in availability under our domestic credit facility, as well as substantial other rapidly available financial resources and unencumbered assets, providing us with a solid financial foundation to accelerate the investment in our transformation.

Third, we continue to make progress in our transformation from a traditional, store-network based retail business model to a more asset-light, member-centric integrated retailer leveraging our Shop Your Way platform.

Turning to slide 6, let's review our third quarter financial results.

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

The third quarter of this year marked our fifth consecutive quarter of improved EBITDA performance as we delivered a $16 million improvement versus the third quarter of last year, when excluding approximately $52 million of additional rent and assigned/forgone sub-tenant income related to the recent Seritage and joint venture transactions.

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. So, while the rent paid to Seritage and the Joint Venture partners is a real cash expense, we have chosen to exclude it here to provide a more consistent and comparable view of our operating performance.

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 change in revenues.

Like many of our competitors, the Apparel business experienced lower than expected revenue for the quarter, in part due to a warmer October, which impacted cold weather categories. As a result, because the Apparel business represents a significant portion of our total revenue, this was a drag on both our total revenue and margin rate.

On a comparable basis, adjusting for the deconsolidation of Sears Canada and the closing of underperforming stores, our revenue declined by $488 million, with $417 million of this decline due to comparable store sales performance and $71 million due to declines associated with ongoing business operations that are not directly attributable to a store, such as declines in Home Services revenue, as well as revenue from our ongoing relationships with Sears Hometown & Outlet Stores and Lands' End.

As indicated on slide 9, third quarter domestic comparable store sales declined 8.6%, comprised of decreases of 7.5% at Kmart and 9.6% at Sears Domestic. There are three main factors underlying our comparable store sales performance:

1. First, our focus is on restoring profitability to the Company. We have taken deliberate actions with respect to our promotional design and marketing spend in pursuit of this objective. As expected, the result of these actions was that, in many categories, we saw an increase in profitability despite experiencing comparable store sales declines.

2. Second, the Apparel and Consumer Electronics businesses represented half of our comparable store sales decline. As we have discussed, we are altering our Consumer Electronics business model to one that requires less working capital and operating expenses by leveraging partners to continue to meet the needs of our members. The change in business model has negatively impacted our comparable store sales in this category; however, it has

resulted in improved profitability, which is our primary focus. Additionally, recent business actions positively changing the operations of the Sears Auto Center business has resulted in improved EBITDA. While we are making progress in changing our apparel business model to better meet the needs of our members, it has not yet translated into improved financial performance.

3. Third, in categories where both comp store sales and EBITDA were lower than last year, we have more work to do to translate the operational progress we are making into improved financial performance as we continue our transformation. One particular business we are very focused on is our Home Services business. We are making changes to our business model to better meet the needs of our members. We need to be more responsive to our members repair needs, reducing the time from when they contact us to the time it takes to fix their repair needs. We are investing in people and technology to address this. In October, we announced a new leader for our Home Services business, with a focus on service efficiencies and new members.

On slide 10, we provide a “waterfall” chart displaying the components of the year-over-year change in gross margin for the third quarter.

On a comparable basis, after adjusting for non-comp items primarily related to asset reconfiguration activities and closed stores, our gross margin decreased $153 million, driven by an unfavorable volume impact of $111 million and an unfavorable rate impact of $42 million. The decline in margin rate is primarily attributed to a decrease in occupancy leverage, partially offset by an improvement in overall product margin.

As it relates to our real estate costs, our overall occupancy expense increased as a percentage of sales. As we transform our business, however, 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 such, we expect that our cash rent obligations will decrease as space in the stores is recaptured as part of our on-going reconfiguration of our physical footprint.

On slide 11 is a “waterfall” chart that shows components of the year-over-year change in expenses for the third quarter.

On a reported basis, we reduced selling and administrative expenses by $381 million year-over-year. Of this reduction, $174 million was related to non-comp items primarily from asset reconfiguration activities. The remaining $207 million of expense reductions is on a comparable basis consisting primarily of decreases in payroll and advertising expenses. I would note that since 2012, we have reduced our annual expenses on a comparable basis by about $1.3 billion.

Slide 12 shows we have reduced inventory by about $1.3 billion versus the third quarter of 2013 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 benefits both us and our vendor-partners.

Slide 13 summarizes some of what we believe are our substantial financial resources and liquid assets.

At the end of the third quarter, we had $294 million of cash and about $963 million of availability to borrow on our credit facility, resulting in $1.3 billion of Total Liquid Immediate Availability. Further, we had $3.9 billion of equity in inventory at the end of the third quarter, which when added to the $1.3 billion of Total Liquid Availability yields $5.2 billion of liquidity and liquid assets, which could be converted into cash in the near term.

In addition, you can note the substantial financing resources available to us under our credit facility, our 2nd Lien Debt capacity and our 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.

On slide 14, we show how we have reduced our Total Domestic Adjusted Net Debt position, defined as Net Debt plus Unfunded Pension Obligation, by about $1.3 billion year-over-year. Looking at the Unfunded Pension Obligation, you can see that it has increased by $767 million year-over-year. This increase was driven by the combination of a 90 basis point decrease in the GAAP interest rate used to measure funding status as well as decreases in the mortality rates used to compute the liability. Note, however, that the current forecast for pension contributions in fiscal 2015 is $298 million, which is $119 million lower than the contributions in fiscal 2014.

Moving now to slide 15, I would 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.

As shown on slide 16, we have completed numerous transactions over the past two years, which have enhanced our liquidity and financial flexibility while providing a solid financial foundation to continue funding our transformation.

We completed the rights offering and sale lease-back transaction with Seritage Growth Properties, receiving aggregate gross cash proceeds of $2.7 billion from the sale of 235 owned properties as well as our 50% interests in three real estate joint ventures with three of the country's leading mall owners.

As part of the 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.

A portion of the proceeds from the Seritage transaction was used to reduce our leverage, reduce our interest expense and free up collateral. At the end of August, we used the balance of the proceeds to complete a tender offer for $936 million principal amount of our 6 5/8% Senior Secured Notes of which we had approximately $1.25 billion outstanding. As a result, we have reduced our annualized cash interest expense by $62 million and have freed-up $936 million of additional second lien debt capacity under our credit facility, subject to borrowing base requirements.

Consistent with our prior comments on enhancing our flexibility through adjustments made to our capital structure, 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 in place until 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. The amendment also provides additional flexibility with a $1.0 billion accordion feature, a $500 million First-In Last-Out facility, a $250 million increase in the short-term debt basket from $500 million to $750 million, and a more flexible fixed charge coverage ratio holdback.

With the completion of these recent transactions we have successfully executed capital structure adjustments made to our capital structure and reduced the Total Domestic Net Debt, excluding pension, by $2 billion versus the prior year.

As you can see on slide 18, Sears Holding has materially increased its financial flexibility and capacity. First, in extending the ABL for five years, we added to or created three financing options that expand the total capacity by $196 million, subject to borrowing base requirements. Second, the short term debt basket, for debt issued with a maturity date inside that of the ABL, was increased from $500 million to $750 million. 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 for additional capacity.

In addition, the ABL permits up to $2 billion of additional inventory-based financing, which has served to support our 2nd Lien Notes. With the successful tender offer for $936 million of second lien notes behind us, the second lien capacity is now increased by that same amount from $760 million up to $1.696 billion, subject to borrowing base requirements contained in the existing 2nd Lien Notes indenture.

Finally, following the successful execution of the Seritage REIT transaction, Sears Holding still possesses a substantial, valuable real estate portfolio. Specifically, we own 421 stores, of which 125 are part of the REMIC securitization. The credit agreement places no restrictions on our ability to monetize or finance against real estate. That owned real estate and our leased real estate, has substantial value, which provides great flexibility for Sears Holdings.

Moving to slide 18, I would like to spend a few minutes on the progress that we are making in our transformation.

As slide 19 depicts, we are in the process of transforming our Company from a Traditional Store Network Model into one which we describe as 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 network to building integrated retail capabilities that leverage the store network to create solutions that allow us to better serve our members.

Turning to slide 20, 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. We are applying 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 with all of our members.

As part of our shift to a Member-Centric Integrated Retail Model, we will focus on Our Best Stores 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 real estate portfolio.

Finally, we are the market leader in several of the key categories in which we do business, such as Home Appliances, Home Services and Fitness Equipment, and we continue to invest in Our Best Categories to further reinforce those leadership positions. We have hired new leaders to manage the Home Services business, the Hardlines business, and the Kenmore, Craftsman and Diehard brands – leaders with deep experience to drive better results and profitability in these categories.

Moving to slide 21, we made good progress this quarter on our three key areas of focus: restoring profitability to our company, funding our transformation and transforming into a member-focused company.

1. We have delivered five consecutive quarters of improved Domestic Adjusted EBITDA performance year-over-year. While our financial results have improved, we still have much work to do to deliver performance that generates an acceptable level of return for our shareholders.

2. We have taken actions to generate substantial amounts of liquidity and provide our Company with longer-term financial flexibility in a way that not only allows us to continue to operate our stores but also is structured to accelerate the right-sizing of our store space. We have recapitalized our balance sheet, enhanced our financial flexibility and put in place a solid financial foundation, which will allow us to accelerate investments in our transformation while meeting all of our obligations.

3. As we move forward, our business model will continue to leverage Shop Your Way and Integrated Retail as we focus on Our Best Members, Our Best Stores and Our Best Categories.

We recognize that we have much work to do, but it is also important that you know that we are making progress in our transformation, as evidenced by our improvement in profitability and in our member engagement. As we mentioned earlier, we have brought in a number of experienced, data-driven leaders from leading online retail and Fortune 500 companies to drive our business forward with a plan to win as a member-centric retailer.

We saw a modest uptick in our member penetration during the quarter and continued to spend capital in member-driven solutions such as Meet with an Expert for appliance purchases. Our new leaders will enhance and build solutions in logistics, the Home Services business, and the Kenmore, Craftsman and DieHard brands while working with all of our businesses to drive our best categories, stores and members.

We also continue to optimize the space in our stores to drive a mix of product and services which we believe will improve our profitability. We are committed to being a member-centric, integrated retailer and to delivering financial results that generate acceptable returns to our shareholders on a sustained basis.