SEARS HOLDINGS

Sears Holdings' Third Quarter Results
Pre-Recorded Conference Call Transcript
December 8, 2016

Operator:

Good day, ladies and gentlemen, and welcome to the Sears Holdings Corp. third 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 Jason Hollar, our Chief Financial Officer. Please note that this morning we released our third quarter 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. Jason will provide an update on our transformation and information on our third quarter financial results.

I will now hand off the call to Jason.

Jason Hollar:

Thanks, Chris.

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

First, while many observers have acknowledged the rich asset base of Sears Holdings, we understand the concerns related to our operating performance. We have fallen short on our own time-table for achieving the profitability that we believe the Company is capable of generating. With that said, the team remains fully committed to restoring profitability to our Company and creating meaningful value.

Actions towards our commitment for restoring profitability include the following:

- Reducing unprofitable stores;
- Reducing space in stores we continue to operate;
- Reducing or eliminating specific categories we operate in where the performance and return on investment is poor; and
- Improving our gross profit performance and SG&A relative to sales.

We believe all of these actions have the potential to return the Company to profitability in the near term. We have already employed some of the actions above, and although comp revenue continued to decline in the month of November, we are encouraged to see an improvement in adjusted EBITDA for the month relative to the prior year driven by expense reductions that exceeded the reduction in margin. In some cases, we will be more aggressive around actions that have worked and in other instances, we will take additional actions to drive better results.

Second, as it relates to funding our transformation, we continue to focus on funding our transformation while meeting all of our financial obligations. We believe that our liquidity needs will be satisfied through the foreseeable future using the levers available to us through:

- Our portfolio of assets, including un-encumbered owned real estate, brands and businesses, as well as a large and valuable below market lease portfolio;
- Debt financing activities; and
- Expense reductions.

Third, our focus on generating positive EBITDA continues. 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.

Let me be clear what we mean by not intending to borrow money to fund continued operating losses. We have a variety of initiatives designed to restore profitability to the Company. As we progress quarter by quarter, to the extent those initiatives are not able to improve our performance in the timeframe we expected, we will consider additional actions to mitigate the operating losses we are incurring. We cannot guarantee when we will return to profitability, but it is our intention to do so as soon as possible.

One of the primary actions we have taken over the past several years to reduce our operating losses is closing unprofitable stores. As we have explained before, this is a necessary but painful action as the way consumers shop has changed. Many of the stores that we have closed had lease options that we declined to exercise, which highlights the flexibility we have in our long term leases. At the same time, we raise cash from the sale of inventory in our stores, net of severance and other costs, as we wind down their operations. We have incurred significant restructuring costs from closing stores, but we believe closing these unprofitable stores was the right thing to do to improve performance.

Focusing on our product categories, over the past several years, we have significantly reduced the size of our consumer electronics business, which has experienced operating losses. This shows up in reduced same store sales and reduced overall sales; but, it also has reduced our losses. We have implemented a variety of initiatives, primarily focused online, to maintain and restructure how we serve our members in the consumer electronics category.

In the past quarter, we have reduced the size of our pharmacy business which operates in many, but not all, of our Kmart stores. This business is composed of a number of profitable pharmacies and a number of unprofitable pharmacies. As we optimize our pharmacy footprint to generate better operating results, we are also mindful that the pharmacy category is instrumental in the lives of many of our members. We will seek a broader pharmacy solution for our members through our Shop Your Way platform. This is an example of how Shop Your Way serves as a platform that enables us to transform the Company from a traditional retailer to an asset light-member centric one that focuses on making our members' lives easier every day.

As it relates to our members, our Shop Your Way membership program engages tens of millions of members every year. These members shop more frequently, they earn more points and we provide them with other opportunities to help them manage their lives.

Since inception, we have invested over $2 billion in our Shop Your Way membership program in terms of points redeemed by members, which has created substantial value and opportunities for our active members.

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

On Slide 7, we show a summary of our third quarter results.

Over the past several years, our third quarter has been our poorest performing quarter of the year. Since 2014, we have had negative EBITDA of roughly $300 million in each of the past third quarters and this year was no different. We continue to believe that the opportunity to perform better is right in front of us, but we have to convert that belief to reality. The retail environment has continued to be challenging for many traditional retail companies but we will not use that as an excuse. We need to perform better and we are taking actions, large and small, to achieve better 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 changes in revenues. On a comparable basis, adjusting for the closing of underperforming stores, our revenue declined $398 million, with $304 million of this decline attributed to lower comparable store sales in a variety of categories including the apparel, grocery and household, consumer electronics, home appliances and pharmacy categories and $94 million due to declines that are not directly attributable to a store, including revenue reduction from our ongoing relationship with Sears Hometown & Outlet Stores, Inc.

While we will not be able to completely overcome the revenue reduction in our consumer electronics business and our pharmacy business in some of our stores, we do believe that we have the opportunity to grow our sales in several categories by focusing on our best members and serving them better. It does not take a large improvement in revenues, if we can improve our overall gross margin rate and dollars through a better mix of inventory investment and pricing discipline. For example, a 100 basis point increase in gross margin rate equates to over $200 million in increased gross margin dollars on an annual basis.

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

Our gross margin decreased $195 million on a comparable basis, driven by an unfavorable volume impact of $85 million and an unfavorable rate impact of $110 million. The decline in margin rate of 220 basis points is primarily attributable to declining performance in the apparel and home appliance businesses, as well as an increase in 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.

We have a variety of initiatives underway designed to improve our gross margin dollars and rate, including reduced investment in lower margin categories, improved sourcing and pricing initiatives designed to drive more profit, even if it comes at the expense of sales.

Slide 10 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 $87 million year-over-year and $224 million on a comparable basis, or a 13% reduction, primarily driven by decreases in payroll and advertising expenses. Since 2012, we have reduced expenses in aggregate on a comparable basis by about $2 billion as of Q3 2016.

While there are some expenses that are more difficult to cut than others, we believe that we have the opportunity to continue to reduce costs by reengineering how we run the business and to invest some of those dollars into activities designed to improve the member experience and drive a better overall profit result.

Slide 11 shows we have reduced our inventory levels by approximately $3.1 billion since 2012. At the end of the prior year third quarter, we had total inventory of just over $6.2 billion. This year that number has reduced by approximately $1.2 billion to just over $5 billion.

In addition, our reliance on vendor funding and their exposure to Sears Holdings has also been reduced significantly. At the end of the prior year third quarter, our payables were $2.3 billion, as compared to $1.6 billion at the end of this year's third quarter, a reduction of over $700 million.

We greatly appreciate the partnership we have with so many of our vendors, both long-term vendors and newer vendors. We have ongoing discussions concerning our liquidity and financial position with the vendor community, and third parties that offer various credit protection to our vendors. The topics discussed have included such areas as pricing, payment terms and ongoing business arrangements. While we will continue to work with our vendors constructively, we will also be firm in protecting the long-term interests of Sears Holdings and ensuring that we have the right type of partnership with our vendors.

Moving to Slide 12, 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 while we also create long term value.

Slide 13 summarizes some of our financial resources and liquid assets. At the end of the third quarter, we had $258 million of cash and $174 million of availability to borrow on our credit facility. We had total utilization under our credit facility of approximately $1 billion out of a total of $1.971 billion, consisting of $660 million letters of credit outstanding and $370 million of borrowings.

In the fourth quarter, our borrowing base increased by approximately $175 million due to growth in our inventory levels for the Holiday season. The availability under the Company's ABL revolver largely depends on the amount of inventory we carry at a given point during the year and typically expands during the holiday season.

Another source of liquidity is the approximately $3.5 billion of equity in net inventory at the end of the third quarter, which could also be a source of cash if converted 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.

We believe that we have the resources to fund our transformation and meet all of our financial obligations. As of today, December 8th, we have passed the peak of our inventory needs for the holiday season and we continue to meet our commitments to our various constituents.

As shown on Slide 14, we have completed numerous transactions since 2012, which highlights our ability to unlock value from our resources. These transactions 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 $9.4 billion of liquidity from a combination of asset monetization and financing activities within the framework of sustainable shareholder value creation.

Slide 15 describes the resources available to us to continue to fund our transformation. We believe we can generate additional liquidity through operational initiatives, financing transactions and asset monetization, as required.

First, we are working on optimizing our store footprint and inventory to provide our members what they need. As part of this initiative, we plan to improve our store performance and working capital.

Second, we have substantial financial resources consisting primarily of longer-term inventory-based financing capacity as well as other short-term financings.

Finally, we have a significant asset base which we believe could be monetized to generate liquidity. As previously announced, we have had strategic parties express interest in our Kenmore, Craftsman and DieHard brands, and our Home Services business, and we continue to evaluate opportunities for these businesses. Additionally, we have over 400 owned store properties in addition to our large portfolio of leases at below market rents that can be monetized to support our transformation.

As shown on Slide 16, as of the end of the third quarter, we continued to operate in over 1,500 stores. This number will drop as our previously announced store closures occur during the fourth quarter. We own over 400 of these stores and we have many valuable leases as part of the other 1,100 stores which is highlighted further on Slide 17. Even where we have unprofitable stores in many cases, we have either the flexibility to allow the leases to expire, limiting our longer term exposure or the ability to gain value from sub-leasing or working with landlords for mutual benefit.

Additionally, as shown on Slide 17, the lease expirations in the 1,100 leased 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 in many of our stores 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 19 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 that meet our members' needs.

As described on Slide 20, our focus is on our members and 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 would 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 as our members become 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 entered into a strategic partnership with Citi Retail Services where we have made the Sears MasterCard the core credit card of the Shop Your Way Platform. The complimentary 5-3-2-1 benefit (5% back on gas, 3% on grocery and dining, 2% at Sears and Kmart, and 1% on all others) went into effect in November and will evolve into a branded Shop Your Way credit card in early 2017. Additionally, Shop Your Way, along with Sears Auto Centers, entered into a partnership with Uber where riders and drivers can earn points. Finally, we entered into a relationship with Activehours whereby we integrated the Shop Your Way platform into Activehours' mobile application, enabling our members to get paid upon completion of their work as opposed to waiting for a check.

Turning to Slide 21, we will continue to focus on our best stores as part of our shift to a member-centric integrated retail model. As we reduce our overall store base, we believe we will inevitably end up with stores that are profitable, operate at a small loss or have a clear path to profitability. We continuously evaluate our store base and expect that we will continue to close unprofitable stores as their leases come due and as other opportunities present themselves to eliminate the losses. We expect to end up with a smaller but meaningfully-sized store base that will leverage our Shop Your Way membership program and Integrated Retail capabilities to serve our members.

Turning to Slide 22, we will continue to emphasize our better performing categories and to eliminate or reduce the investment in categories that do not earn an acceptable return on investment or where we can better serve members by partnering with third parties.

The big ticket category performance in the Sears format significantly outperforms the apparel and home fashions businesses. We will continue to emphasize the big ticket categories while working to right-size the apparel and home fashions categories through the initiatives related to the formation of Seritage and other activities to reduce the overall apparel category footprint while improving its performance.

Health care represents an important member need and one where we believe we can serve our members adequately, but the performance of our pharmacy business over the past several years has not been acceptable. To the extent that we can monetize our pharmacy business and eliminate our losses, we will continue to do so. What that means is that the store performance where we close a pharmacy may suffer on a same store sales basis, but should benefit from the elimination of the pharmacy losses.

Moving to Slide 23, as we have stated, we have a lot going on and we know we have a lot to prove. We expect that you will see more aspects of Shop Your Way and the potential it has to meaningfully drive member behavior in the quarters to come. We will continue to pursue partnerships that will enhance the lives of our Shop Your Way members and we will continue to manage the assets of the company in a way that creates both the liquidity to fund our transformation and does so in a way that creates long term value.

Over the next few months, we will continue to evaluate opportunities for our Kenmore, Craftsman and DieHard brands and our Home Services business. Our goal remains to externalize these brands and capabilities beyond Sears Holdings and to create value for our shareholders in the process.

Additionally, as discussed, we will continue to accelerate the closing of underperforming stores and reduce the investment we have in underperforming categories.

Despite the challenges that we face, both real and perceived, we have a plan to deliver for our members and turn the Company profitable. We are completely focused on execution and look forward to reporting progress.

Finally, we want to thank the large number of men and women working hard every day to serve our members and improve the performance of the Company. Their persistence in the face of difficult circumstances deserves our admiration.