SEARS HOLDINGS

Sears Holdings' Fourth Quarter and Full Year 2015 Results
Pre-Recorded Conference Call Transcript
February 25, 2016

Operator:

Good day, ladies and gentlemen, and welcome to the Sears Holdings Corp. fourth quarter 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 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 fourth 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, Domestic Adjusted EBITDA or Domestic 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 fourth 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 fourth quarter, we delivered an improvement in comparable store sales versus the prior three quarters and January was the most improved month of the year. While we had delivered year-over-year EBITDA improvement in each of the previous consecutive four quarters, we experienced an EBITDA decrease of $207 million versus last year in our fourth quarter, when excluding rent associated with the recent Seritage and joint venture transactions. As we will discuss, when excluding Apparel and our softlines businesses, our Adjusted EBITDA would have been relatively unchanged from the fourth quarter of last year.

For fiscal 2016, our focus will be on generating positive EBITDA. We intend to take more aggressive actions as we transition to an asset-light member-centric integrated retailer leveraging our Shop Your Way program and to eliminate operating losses while continuing to meet all of our financial obligations. More specifically, we intend to:

1. Aggressively evaluate our store space and productivity to best meet our members' needs. As part of this initiative, we intend to accelerate the closing of unprofitable stores, including the roughly 50 stores we announced last month.

2. Continue to evaluate and optimize our cost structure, focusing on:

    - Store-level marketing expenditures and staffing levels; and
    - Taking actions to reduce fixed costs and improve inventory management.

3. Continue aggressive expense reductions in 2016 by taking actions to further reduce costs by between $550 million and $650 million, depending on sales volume, on top of reducing expenses by $783 million in 2015 and $1.4 billion since 2012.

4. Target at least $300 million of asset sales during the first half of the 2016 fiscal year.

5. Continue to consider our overall capital structure and take actions as appropriate and as market conditions permit with the goals of creating long-term value, enhancing our financial flexibility and funding our transformation.

Finally, 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. As part of this transformation, we intend to optimize the value of our assets and to take actions that will generate positive EBITDA in the near future.

Second, we continue to have financial flexibility to fund our transformation while meeting all of our financial obligations. We continue to 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 fourth quarter, we reduced our Total Domestic Net Debt, including the impact of our unfunded pension obligations and post-retirement benefits obligations, by about $1.0 billion as compared to the fourth quarter of 2014.

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 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 including a $1.0 billion accordion facility, a $500 million FILO or "First In Last Out" feature, both subject to borrowing base conditions, and an increase in our short-term borrowing basket from $500 million to $750 million.

Additionally, 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. It is important to note the optionality and flexibility in the lease terms with Seritage. More specifically, under the lease, Seritage has the right to recapture space from Sears while Sears has the right to terminate space with our respective rights subject to certain annual limitations. We expect that our annual lease expense will decline over time.

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 74% over the last four years. 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 fourth quarter financial results.

On Slide 7, we show our Domestic Adjusted EBITDA results for the past eight quarters.
The operating performance of our apparel business has a substantial impact on our overall profitability. In 2016 and future periods; we intend to improve the performance of our apparel business through changes to our sourcing, product assortment, space allocation, pricing, expense management and inventory management practices. Excluding the EBITDA decline in our Apparel and softlines business, our Adjusted EBITDA would have been relatively unchanged from the fourth quarter of last year.

Our EBITDA declined $207 million versus the fourth quarter of last year, when excluding approximately $55 million of additional rent and assigned sub-tenant income related to the recent Seritage and joint venture transactions. Due to the lease structure, 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 and or exited to the extent that both Seritage and Sears exercise their respective options. 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 holiday selling season proved to be challenging, with historically warm weather, increased promotional activities and intense competition pressuring margins and driving comparable store sales declines. This negatively impacted both our total revenue and margin rate. As indicated, when excluding the EBITDA decline in our Apparel and softlines business, our Adjusted EBITDA would have been relatively unchanged from the fourth quarter of last year. On a comparable basis, adjusting for the closing of underperforming stores, our revenue declined $505 million, with $458 million of this decline due to comparable store sales performance and $47 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.

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

On a comparable basis, after adjusting for non-comparable items primarily related to closed stores, our gross margin decreased $340 million, driven by an unfavorable volume impact of $125 million and an unfavorable rate impact of $215 million. As discussed, our apparel business had a substantial impact on our gross margin performance, accounting for more than half of the gross margin decline, primarily due to increased promotional activities.

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 $150 million year-over-year and $146 million on a comparable basis, primarily driven by decreases in payroll expense. Since 2012, we have reduced our annual expenses on a comparable basis by about $1.4 billion.

Slide 11 shows we have reduced net inventory by about $870 million versus the fourth quarter of 2011 due to inventory productivity improvements and the closure of unproductive stores.

By reducing our inventory investment and our payables since 2011, 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. Concurrently, we have made adjustments to our capital structure to provide additional flexibility in light of our reduced level of inventory associated with our new business model.

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

At the end of the fourth quarter, we had $238 million of cash and about $316 million of availability to borrow on our credit facility, resulting in $554 million of Total Liquid Immediate Availability.

Further, we had approximately $3.6 billion of equity in inventory at the end of the fourth quarter, which when added to the $554 million of Total Liquid Availability yields $4.1 billion of liquidity and liquid assets, which could be converted into cash in the near term.

In addition, we have a wide range of significant financing resources available to us under our credit facility, our 2nd Lien Debt capacity and our substantial and 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.

On Slide 13, we show how we have reduced our Total Domestic Adjusted Net Debt position, defined as Net Debt plus unfunded pension benefits and post-retirement obligations, by about $1.0 billion year-over-year.

Moving to Slide 14, 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.

As shown on Slide 15, we have completed numerous transactions since 2012 which have enhanced our liquidity and financial flexibility while providing the foundation on which to continue funding our transformation. Since 2012, we have generated $7.5 billion of liquidity from a combination of asset monetization and financing activities.

In 2015, 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. 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 16.

With the completion of these transactions, we have reduced the Total Domestic Net Debt (including pension obligations) by $1.0 billion versus the prior year.

As you can see on Slide 16, we have materially increased our financial flexibility.

Consistent with our intentions to enhance 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.

In extending the ABL for 5 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. 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 $2.0 billion of additional inventory-based financing, which has served to support our second lien notes. With the successful tender offer for $936 million of second lien notes in 2015, the second lien capacity is now approximately $1.7 billion, subject to borrowing base requirements contained in the existing second lien notes indenture.

Following the successful execution of the Seritage REIT transaction, Sears Holding still possesses a substantial and unencumbered real estate portfolio. The credit agreement places no restriction on our ability to monetize or finance against real estate. We believe that our portfolio of owned real estate and our leased real estate has substantial value and provides flexibility for Sears Holdings.

To this last point, turning to Slide 17, 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 419 stores, of which 125 are part of the REMIC securitization, and we lease 1,253 stores of which 998 are non-Seritage leased stores. In total, we operated 1,672 stores across the two formats as of year-end 2015.

As you can see on Slide 18, 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 19, our lease expirations in the 1,253 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 21 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 22, 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 23 depicts, we have a substantial member base with almost 75% of sales derived from Shop Your Way members, which is up from 58% over the last four years. Going forward, our focus will be on increasing our level of engagement with our members to enhance member sales and penetration.

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 with all of our members.

As you can see on Slide 24, 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.

On Slide 25, 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 Sears and Seritage 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.

Finally, as you can see on Slide 26, 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. Apparel remains a substantial part of our business and one of our focuses is on increasing our levels of productivity through managing our space utilization and taking advantage of our real estate flexibility.

We continue to focus on changes to our apparel business model to better serve our members' needs and improve profitability. We are refining our product strategy to be more focused on basic categories like denim and active wear. Supply chain continues to be an area of focus to improve both flexibility and profitability. We are increasing our sourcing capabilities that will enable us to grow our direct import penetration and lead to higher gross margin.

Moving to Slide 27, as we have stated, our primary focus for 2016 will be to generate positive EBITDA. We have made substantial progress towards our goal of being a member-centric integrated retailer. With Shop Your Way penetration now at 74% of our sales, combined with the robust set of integrated retail capabilities that we have developed, we are now in a position to much more aggressively evaluate our physical store footprint and accelerate 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 net inventory by nearly $900 million since 2011, having reduced our annual expenses by $1.4 billion since 2012 and having reduced our Domestic Adjusted Net Debt by about $1.0 billion year over year. We intend 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.