SEARS HOLDINGS

Sears Holdings' First Quarter Results
Pre-Recorded Conference Call Transcript
June 8, 2015

Operator:

Good day, ladies and gentlemen, and welcome to the Sears Holdings Corp. Q1 2015 earnings conference call. At this time, all participants are in a listen-only mode. [Operator instructions]

I would now like to introduce your host for today's conference call, Mr. Chris Brathwaite, Vice President of Corporate Communications. Please go ahead.

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 by Rob Schriesheim our executive vice president and chief financial officer.

Please note that this morning we released our first 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.

On Slide 2, we show the agenda for today's call.

Rob will provide some information on our first quarter financial results and a brief update on our transformation from both a financial and operating perspective.

Moving to Slide 3, 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 4, 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 or Domestic Adjusted EBITDA, as defined in the presentation.

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

I will now hand off the call to Rob.

Rob Schriesheim:

Thank you Chris.

Turning to Slide 5, I'd like to begin today by briefly covering the three critical areas we are focusing on in our transformation.

First, we are highly focused on restoring profitability to the Company. During the first quarter we delivered EBITDA improvement versus last year of $37 million and have now delivered improved quarterly EBITDA performance on a year-over-year basis for three consecutive quarters. We are successfully enhancing our margin rates and EBITDA performance as we become more efficient with the use of Shop Your Way in our promotional programs while replacing more traditional forms of marketing with targeted and personalized digital interactions.

Second, as our recent actions show, we remain focused on maintaining the financial flexibility to continue investing in our transformation while meeting all of our obligations.

- Last year we raised more than $2.3 billion through a series of asset reconfiguration and financing activities.

- In the first quarter of 2015, we continued to unlock the value of our assets, enhance shareholder value, and further our strategy. We continue to make progress towards the formation of a public REIT, Seritage Growth Properties. We expect that we will be declared effective by the SEC later this week and are targeting to launch the rights offering on Friday June 12th. If the transaction is successful, we expect it will result in $2.6 billion in cash proceeds to Sears Holdings in early July. When combined with the cash already received from the three previously announced joint ventures, this would total $3.0 billion in cash realized.

- Also, consistent with our objective to evolve and enhance the flexibility of our capital structure, we have reached agreement with three of our leading ABL lenders, representing $1.175 billion of commitments, on terms pursuant to which they would be willing to amend and extend, to 2020, our $3.275 billion revolving credit facility, currently expiring in April of 2016. We have already initiated discussions with our broader lender group and expect to close the refinancing during our second quarter with an extended facility of approximately $2.0 billion maturing in 2020 and the remaining $1.275 billion of the existing ABL in place until April of 2016.

- Assuming a successful completion of both the REIT transaction and the amendment and extension of our credit facility we will have enhanced our financial flexibility, recapitalized our balance sheet and secured a solid financial foundation to accelerate the investment in our transformation.

Third, during the first quarter, we continued 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. The completion of the joint venture transactions with three leading shopping mall owners and operators and the formation of the REIT are expected to do more than simply raise capital for Sears Holdings. They are structured in a way that we believe will help Sears Holdings become more productive with our physical store space, which will help position us for long-term success.

Let me now take you through our first quarter financial results.

On Slide 7, we show our domestic Adjusted EBITDA results for the past eight quarters. In the first quarter of this year, we delivered an improvement in domestic Adjusted EBITDA of $37 million versus the first quarter of last year. The improvement was driven by $190 million in adjusted expense reductions, partially offset by a $153 million reduction in adjusted gross margin dollars. Let me walk you through some of the year-over-year changes underlying our results.

Slide 8 is a “waterfall” chart providing components of the year-over-year change in revenues. On a comparable basis, having adjusted for various activities related to asset re-configurations and the closing of underperforming stores, our revenue declined by $577 million, with $558 million of this decline due to comparable store sales performance and $19 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, first quarter domestic comparable store sales declined 10.9%, comprised of decreases of 7.0% at Kmart and 14.5% at Sears Domestic.

There are three main factors underlying our comparable store sales performance:

1. First, we are focused on restoring profitability to our Company and we have taken deliberate actions with respect to our promotional design and marketing spend in pursuit of this objective. 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 Consumer Electronics business represented approximately 2 percentage points of our comparable store sales decline. As we have discussed, we are altering our business model in this category 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.

3. Third, we were impacted by port delays on the West Coast, which particularly impacted our apparel business.

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

On a comparable basis, after adjusting for non-comp items primarily related to asset reconfiguration activities and closed stores, our gross margin decreased $47 million, driven by an unfavorable volume impact of $140 million, partially offset by a favorable rate impact of $93 million. Similar to the fourth quarter of 2014 where, on a comparable basis, we experienced a gross margin rate increase of 190 basis points, we had success in our first quarter as our gross margin rate increased by 160 basis points on a comparable basis. This improvement was driven primarily by increases in product margin rate as we reduced our overall promotional depth while also reducing our Shop Your Way points expense by $40 million through the more efficient use of points as a promotional vehicle.

Slide 11 is a “waterfall” chart providing components of the year-over-year change in expenses for the first quarter.

On a reported basis, we reduced selling and administrative expenses by $408 million year-over-year. Of this reduction, $218 million was related to non-comp items primarily from asset reconfiguration activities with the remaining $190 million in expense reductions 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 $830 million.

Slide 12 shows how, since the first quarter of 2013, we have reduced inventory by about $1.7 billion 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 first quarter, we had $286 million of cash, $726 million of availability to borrow on our credit facility and an additional $196 million of commitments available to us under our secured short-term loan, resulting in about $1.2 billion of Total Liquid Availability.
Further, we had approximately $3.4 billion of equity in inventory at the end of the first quarter, which when added to the $1.2 billion of Total Liquid Availability yields $4.6 billion of liquidity and liquid assets which could be converted into cash in the near term.

I would also point out that had the Seritage REIT transaction closed prior to the end of the first quarter, we would have had a cash balance of about $2.3 billion, availability on the credit facility of about $1.1 billion and a total of about $7.2 billion in liquidity and liquid assets which could be converted to cash in the near term.

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 our Domestic Adjusted Net Debt position, defined as Net Debt plus Unfunded Pension Obligation, has changed year-over-year.

As of the end of the first quarter, our Total Net Debt position was $114 million higher than last year. This change was comprised of an increase in long-term debt of $320 million partially offset by a reduction in Net Short-term Debt of $206 million.

In 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 increases in the mortality rates used to compute the liability. Note however, that the current forecast for pension contributions in fiscal

2015 is $291 million, which is a $126 million reduction versus the $417 million contributions in fiscal 2014.

When adjusting net debt as if the Seritage REIT transaction had occurred prior to the end of the first quarter, you can see in the bar on the far right that our Adjusted Net Debt would have been about $3.3 billion reflecting the substantial recapitalization and deleveraging effect to our balance sheet.

I would like to spend a few minutes now to talk about funding our transformation.

Moving to Slide 16, as we outlined in our Second Quarter 2014 earnings call, we have been working with our lenders and advisors to evaluate our capital structure with a goal of achieving more long-term flexibility while moving to a structure that is less reliant on inventory as a form of collateral. Consistent with these remarks, we have taken a series of actions over the past two years that demonstrate our financial flexibility and should provide confidence to all of our stakeholders.

These actions include:

- a series of asset reconfiguration and financing activities completed in fiscal 2014 which raised more than $2.3 billion in cash proceeds,
- the completion of joint venture transactions with three leading shopping mall owners and operators in the first quarter of fiscal 2015 which generated $429 million of gross cash proceeds,
- the formation of Seritage Growth Properties and the subsequent sale-leaseback transaction with Sears Holdings, which we expect will close in early July and if consummated will generate $2.6 billion of cash proceeds to Sears Holdings,
- And finally, the progress we have made in working with our lenders to amend and extend our credit agreement through 2020, providing us with longer term financial flexibility.

Moving to Slide 17, in the first quarter of 2015, we continued to demonstrate our ability to unlock the value of our assets and our commitment to creating shareholder value through the formation of real estate joint ventures with three of the country's leading mall owners.

- On April 1st, we entered into a joint venture with General Growth Properties in which we contributed 12 properties located at General Growth Properties malls to the joint venture in exchange for $165 million in cash and a 50% interest in the joint venture.
- On April 13th, we entered into a joint venture with Simon Property Group in which we contributed 10 properties located at Simon malls to the joint venture in exchange for $114 million of cash and a 50% interest in the joint venture.
- On April 30th, we entered into a joint venture with The Macerich Company in which we contributed 9 properties located at Macerich malls to the joint venture in exchange for $150 million of cash and a 50% interest in the joint venture.

In all of these cases, we entered into lease agreements with the joint ventures to allow Sears and Kmart to continue to operate retail stores in the locations contributed to the joint ventures.

Turning now to Slide 18, we expect that on June 12th we will launch the rights offering for the formation of a public REIT, Seritage Growth Properties. Pursuant to this transaction, Seritage will purchase 235 properties from Sears Holdings and our remaining 50% interests in the three previously announced joint ventures under a sale leaseback transaction which we expect will result in $2.6 billion in cash proceeds to Sears Holdings in early July.

When combined with the initial proceeds already received from the joint ventures, this will total $3.0 billion in cash realized. We expect to utilize a portion of the proceeds from the REIT transaction to pay down our existing revolver borrowings. Had the REIT transaction closed in the first quarter, we would have had cash balances of $2.3 billion and availability under our credit facility of $1.1 billion.

I would also note that the terms of the lease with Seritage will afford substantial flexibility to Sears Holdings in its management of its real estate configuration to enhance its productivity by aligning the interests of Seritage with Sears Holdings. As a result of these features, the rent obligation by Sears Holdings under the lease is not fixed and can decline significantly should Seritage exercise its recapture rights or should Sears exercise its right to terminate the lease as to individual properties.

Moving to Slide 19, consistent with our prior comments on enhancing our flexibility with our capital structure, we have reached agreement with three of our leading ABL lenders, representing $1.175 billion of commitments, on terms pursuant to which they would be willing to amend and extend, to 2020, our $3.275 billion revolving credit facility, currently maturing in April of 2016.

We have already initiated discussions with our broader lender group and expect to close the refinancing during our second quarter. We are seeking a smaller credit facility, reflecting lower inventory levels associated with our transformed business, with fewer stores, a greater online presence, and a capital structure less reliant on inventory. Any non-extending lenders will be in place until April of 2016.

The amended credit facility would provide additional flexibility with features, such as a $500 million First-In Last-Out facility, a more flexible fixed charge coverage ratio holdback and a $250 million increase in the short-term debt basket, such that taken together we would have over $2.85 billion of availability. In addition, the facility would also include a $1.0 billion accordion feature.

In an effort to provide some context around the significant impact that the pending REIT transaction will have on our financial position and liquid assets, Slide 20 shows the pro forma view as if the transactions had occurred as of the end of the first quarter.

Moving to Slide 21, we provide a pro forma view of the balance sheet as if the REIT transaction had occurred in the first quarter. This demonstrates that assuming the completion of the REIT transaction and the amendment and extension of our ABL facility, we will have enhanced our financial flexibility, de-levered our balance sheet and placed our Company on a solid financial foundation to invest in our transformation.

Moving to Slide 22, I will now provide an update on the progress that we are making in our transformation.

As Slide 23 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 24, as we continue in 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 very substantial member base with more than 70% of sales being 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 learnings towards increasing engagement and strengthening our relationships with all of our existing members.

As we shift from a Traditional Store Network Model to our Member-Centric Integrated Retail Model, we will focus on **Our Best Stores** and 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 that leadership position.

As shown on Slide 25, we are focused on **Our Best Members** and we continue to make significant progress in our ability to personalize our interactions with them. In the first quarter, approximately 50% of our total interactions were personalized. Personalizing our interactions allows us to increase relevance, driving higher retention and engagement which we believe over time, will yield increased visit frequency and a higher share of our members' wallets.

Moving to Slide 26, we are focused on achieving **Our Best Stores.** In structuring the REIT transaction, we set out to accomplish three main objectives:

1. We wanted to make a significant transformation to our capital structure, toward a structure that is more flexible, long-term oriented and less dependent on inventory and receivables.

2. We wanted to have a structure that would enable Sears and Kmart to continue to maintain a retail presence while providing the flexibility to make strategic business decisions should these locations prove unprofitable in the future.

3. We wanted a structure that would accelerate the work that we've been conducting to right-size our store footprints where appropriate and redeploy the excess retail space to more productive use with third-party tenants.

On Slide 27, we show that our retail presence in the top malls in the country will remain unchanged even after the REIT transaction is completed as Sears Holdings will continue to own or directly lease stores in 60 of the top 149 malls in the country. As part of the REIT transaction, Seritage will lease stores back to Sears Holdings allowing Sears and Kmart to continue to maintain a retail presence in the locations sold to the REIT. Furthermore, the lease provides Sears Holdings with termination rights that give Sears the flexibility to make strategic decisions about whether or not to continue operating any of these locations should they turn unprofitable in the future.

I'd also point out that assuming the closing of the REIT transaction, Sears Holdings will continue to own about 425 properties.

Moving to Slide 28, many of the stores we operate today are much larger than they need to be in order to effectively serve our members and this has hurt our productivity over the years. On previous earnings calls, we have spoken about some of the actions we have taken to right-size our store space and improve our productivity by subletting excess space to third party tenants such as Forever21 and Whole Foods. In structuring the joint venture and REIT transactions, we wanted to create a mechanism that would continue these efforts in an accelerated fashion. As such, one of the principles that we put into place is that the REIT will have the ability to recapture up to half of the space in each of our stores that are a part of the REIT.

The REIT's recapture right creates an opportunity for the REIT to put new tenants in the excess Sears and Kmart space that they recapture at higher rental rates than will be paid by Sears or Kmart. Over time, this will enable Sears and Kmart to move from, for example, a 150,000 square foot store to a 75,000 square foot store, without Sears Holdings having to put up the capital to reconfigure the store. In addition to the benefits we expect from the reduction in store space, we also believe that the recapture and redeployment of excess space will be good for Sears and Kmart as it will bring more traffic to our part of the mall, which in turn will bring more traffic to our stores.

Moving to Slide 29, we are focused on Our Best Categories.

In Home Appliances, we are intent on reinforcing our position as the #1 appliance retailer in the U.S. In the first quarter, we launched a program to expand our assortment within the Kmart format and broadened our assortment online. We introduced new products in our Kenmore laundry line with industry leading capacity and we invested further in digital sign technology to enhance our members' in-store shopping experience.

With more than 12 million service and installation calls completed in 2014, Home Services is another example of where we continue to be a market leader. Despite this leadership position, we believe that there is an opportunity for us to improve our service levels and response times to better serve our members. We are devoting significant resources to ensure that we have the right people, processes and technology in place to deliver these improvements.

With apparel, we are focused on elevating both the style and quality of our proprietary branded products. By having an in-house design function, we are able to better control the product development process resulting in both higher quality at a lower cost and a more consistent stylistic fit with our proprietary brands.

Additionally, our apparel team has been working hard to streamline the sourcing process to reduce our lead times giving us the ability to react to member demand in-season which we believe will significantly improve our inventory productivity in this category.

Moving to Slide 30, we have made good progress this quarter on our three key areas of focus:

1. We have delivered 3 consecutive quarters of improved domestic Adjusted EBITDA performance year-over-year by enhancing our gross margin rate and reducing our expenses in a focused manner. 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. Assuming both the REIT and the ABL amendment and extension transactions are successfully consummated, we will have recapitalized our balance sheet, enhanced our financial flexibility and put in place a solid financial foundation which will allow us to continue to accelerate investment in our transformation while meeting all of our obligations and providing confidence to all of our stakeholders.

   As we have often said, this is an owner driven transformation and by raising capital via a rights offering, we provide all of our shareholders, both large and small, an equal opportunity to participate when we separate assets from the Company. In our past rights offerings, a large proportion of our ownership has participated and we would expect the same to be true in the REIT rights offering. ESL and Mr. Lampert have stated their intention to participate to the full extent of their pro rata interest in Sears in the REIT rights offering. Our other large shareholder, Fairholme Capital, has stated that it anticipates that certain of its clients are likely to exchange a portion of their subscription rights for non-voting shares and that certain other clients of Fairholme Capital currently intend to exercise their subscription rights to purchase common shares in the Seritage rights offering.

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**.

Make no mistake, 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. We are committed to being a member-centric, integrated retailer and to delivering financial results that generate acceptable returns to our shareholders on a sustainable basis.