SEARS HOLDINGS

Sears Holdings' Second Quarter 2015 Results
Pre-Recorded Conference Call Transcript
August 20, 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]

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 second 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 second 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, I would 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. As our results demonstrate, we are successfully enhancing our margin rates and improving EBITDA performance as we become more efficient with our promotional programs and the use of our Shop Your Way program to replace traditional forms of marketing with more targeted and personalized digital interactions with our members. During the second quarter, we delivered an EBITDA improvement of $98 million versus last year, when excluding rent associated with the recent Seritage and JV transactions. This marks our fourth consecutive quarter of improved EBITDA performance.

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 second quarter, we substantially completed the capital structure adjustments we laid out in August 2014. This included the formation of an independent, publicly traded Real Estate Investment Trust or REIT, named Seritage Growth Properties, which was accomplished via a rights offering, which allowed all Sears shareholders to participate according to their pro rata ownership.

Concurrent with its formation, we entered into a sale-leaseback transaction with Seritage which generated $2.7 billion of gross cash proceeds to Sears Holdings while enabling us to continue to operate Sears and Kmart stores in these locations. Furthermore, the terms of the lease provide a structure that we believe will accelerate the transformation of our physical stores and provide us with substantial flexibility in how we manage our store network moving forward.

In addition, we successfully amended and extended our $3.275 billion domestic credit facility with approximately $2.0 billion maturing in 2020 and the remaining $1.3 billion maturing on its existing maturity date in April of 2016.

As a result of the actions we have taken, we ended the quarter with $1.8 billion in cash and approximately $1.2 billion in availability under our domestic credit facility, 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, I will now take you through our second quarter financial results.

On Slide 7, we show our Domestic Adjusted EBITDA results for the past eight quarters.
The second quarter of this year marked our fourth consecutive quarter of improved EBITDA performance as we delivered a $98 million improvement versus the second quarter of last year, when excluding approximately $26 million of additional rent 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.

On a comparable basis, adjusting for the deconsolidation of Sears Canada and the closing of underperforming stores, our revenue declined by $636 million, with $584 million of this decline due to comparable store sales performance and $52 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, second quarter domestic comparable store sales declined 10.8%, comprised of decreases of 7.3% at Kmart and 14.0% 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 Consumer Electronics business represented approximately 170 basis 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, 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.

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

On a comparable basis, after adjusting for non-comp items primarily related to asset reconfiguration activities and closed stores, our gross margin decreased $99 million, driven by an unfavorable volume impact of $143 million, partially offset by a favorable rate impact of $44 million as we improved our gross margin rate by 70 basis points on a comparable basis. This improvement was driven primarily by increases in product margin rate as we reduced clearance markdowns and overall promotional activity while also reducing our Shop Your Way points expense by $20 million through the more efficient use of points as a promotional vehicle.

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

On a reported basis, we reduced selling and administrative expenses by $424 million year-over-year. Of this reduction, $184 million was related to non-comp items primarily from asset reconfiguration activities. The remaining $240 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 $1.1 billion.

Slide 12 shows how, since the second quarter of 2013, we have reduced inventory by about $1.5 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 second quarter, we had $1.8 billion of cash and about $1.2 billion of availability to borrow on our credit facility, resulting in $3.0 billion of Total Liquid Availability.

Further, we had $3.3 billion of equity in inventory at the end of the second quarter, which when added to the $3.0 billion of Total Liquid Availability yields $6.3 billion of liquidity and liquid assets, which could be converted into 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 we have reduced our Domestic Adjusted Net Debt position, defined as Net Debt plus Unfunded Pension Obligation, by about $1.6 billion year-over-year.

At the end of the second quarter, our Total Net Debt position was $2.3 billion lower than last year. This change was driven by a reduction in Net Short-term Debt of $2.6 billion, which was partially offset by an increase in long-term debt of $281 million.

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 $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.

Turning now to Slide 16, in the second quarter, 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 the three real estate joint ventures we entered into in the first quarter 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 we believe will 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.

Moving to Slide 17, consistent with our prior comments on enhancing our flexibility through 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, consistent with lower inventory levels associated with our transformed business with fewer stores, a greater online presence and a more flexible capital structure. 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.

Slide 18 provides an update on our plan to use a portion of the proceeds from the Seritage transaction to reduce our leverage, reduce our interest expense and free up collateral. At the beginning of August, we launched a tender offer for up to $1.0 billion of our 6 5/8% Senior Secured Notes of which we had approximately $1.24 billion outstanding.

On August 17, we announced that prior to the early tender deadline, $936 million principal amount of notes had been tendered. 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.

The offer remains open until August 28, 2015, for additional notes to be tendered. If the full $1.0 billion amount is tendered, we would realize an additional $4 million of annualized cash interest expense savings for a total of $66 million and we will have increased our second lien debt capacity under our credit agreement by a total of $1.0 billion, subject to borrowing base requirements.

If the full $1.0 billion is not tendered, any amount remaining would be available to the Company to opportunistically purchase additional debt securities, further reducing our leverage levels and further mitigating our interest expense.

Moving to Slide 19, as we outlined in our Second Quarter 2014 earnings call, we have been working to evolve our capital structure with the goal of achieving more long-term financial flexibility while moving to a structure that is less reliant on inventory as a form of collateral. As you can see from the slide, we have completed numerous transactions over the past two years in pursuit of this objective.

With the completion of the Seritage transaction and the amendment and extension to our credit agreement, we have substantially completed these capital structure adjustments, placing the Company on a solid financial foundation to continue funding our transformation.

Moving on to Slide 20, I would like to spend a few minutes on the progress that we’ve made in our transformation.

As Slide 21 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 focusing 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 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.

We have a very substantial member base with more than 70% of sales derived from Shop Your Way members. We are applying our resources toward 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 into 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.

Moving to Slide 23, 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 four 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. 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 important that you know that we are making progress in our transformation as evidenced by our improvement in profitability as well as having put in place a solid financial foundation allowing us to continue the acceleration in the transformation and in our improvement of 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.