SEARS HOLDINGS

Sears Holdings’ Third Quarter 2014 Results
Pre-Recorded Conference Call Transcript
December 4, 2014

Operator:

Good day, ladies and gentlemen, and welcome to the Sears Holdings Corp. Q3 2014 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, Rob Schriesheim. Sir, you may begin.

Rob Schriesheim:

Thank you, Operator. Ladies and gentlemen, welcome to the Sears Holdings earnings call. I am Rob Schriesheim, CFO. Please note that this morning we released our third quarter earnings results which are now available on our website.

Joining me today is Eddie Lampert, our Chairman and Chief Executive Officer. 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.

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. You can find factors that could cause the Company's actual results to differ materially listed in today's press release, 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, as defined in the presentation.

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

I would now like to turn to Slide 5 and hand the call over to Eddie Lampert.

Eddie Lampert:

Thanks, Rob. And, thank you for joining us today.

We remain highly focused on restoring our Company to profitability and believe we have a framework and path to do so. We have a number of different levers at our disposal that will enable a company of our size and scope to deliver value to our many stakeholders. My comments today will focus on three key areas:

First, our transformation continues as we leverage Shop Your Way and Integrated Retail.

The holiday season started last week. For all of the focus on crowds in stores, most people - and especially our Shop Your Way Members - are buying gifts on multiple platforms, at all hours.

Adapting for the future has been the major focus of our Sears and Kmart formats and there is a fundamental shift in how Sears and Kmart are interacting with members. We have put an enormous amount of work into understanding how, where and when our members want to shop. We are using this additional data to adapt our platforms and enhance the integrated retail experience for our members.

As we leverage Shop Your Way and Integrated Retail, we will continue to right-size, redeploy and highlight the value of our assets, including our substantial real estate portfolio, as we transition from an asset-intensive, store-focused retailer to an asset-light, integrated retailer.

In addition, we are partnering with other retailers, brands and service providers to leverage our brick and mortar stores and at the same time offer an enhanced shopping experience to our members through one-stop shopping.

Second, we are taking steps to restore profitability to our company.

We have taken and will continue to take actions to address our performance on several levels focusing on three key areas.

The first is improving our pricing and promotional design to yield higher gross margins. Through analytics, we are learning everyday what offers are working, both in terms of member engagement and response. Along these lines, we have made significant progress in transforming our marketing spend from being largely fixed and mass marketing in nature to personalized, digital campaigns. We will share some specifics of those changes in our Framework to Profit section.

Second, rationalizing our physical footprint to focus on our better performing stores. We have more than 1,800 Sears and Kmart stores combined – about 700 of which are owned. Few companies have this scale and reach. Of our leased stores, most are in a five year option period, providing us with significant flexibility as we continue to evaluate our store network in the context of our business model.

The Board and management assess our physical footprint on a regular basis. Among the areas we think about are: store locations, do we have ample floor space to meet or exceed our members' expectations and can we use stock rooms and warehouses more efficiently. The fact of the matter is that a number of our stores are simply in the wrong place and are often too large for our needs. Restoring these locations to profitability is unlikely.

In addition, our analyses show that when we close a store, we retain a significant percentage of our Shop Your Way members who visited the store – because we now meet their needs on other platforms.

With this thinking in mind, year-to-date, we have closed 129 stores and for the full year we currently expect to close a total of about 235 stores. Closing a store is never an easy decision. The associates, members and partners that are the backbone of our Company are the people most affected.

Finally - reducing costs. Our reported expenses were down approximately $250 million year-over-year in our third quarter, and about $550 million year-to-date, as we are driving efficiencies throughout the organization. While a portion of this reduction is related to store closure activity and the spinoff of Lands' End, we have also made material reductions in our ongoing business cost structure with approximately $70 million in year-over-year reductions for Q3 and $155 million year-to-date. Areas of focus include fixed to digital marketing changes, lean/process engineering and leveraging technology to improve existing business processes. We have reduced expenses on a net basis at the same time we continue to invest in our business transformation.

Third, we have taken actions to significantly enhance our financial flexibility and plan to take additional actions with a goal of enhancing long-term flexibility.

Since September, we have generated $1.4 billion in liquidity and $2.2 billion year to date. As a result of these actions, we have increased our liquidity and reduced our debt.

We intend to continue to evaluate and evolve Sears Holdings' capital structure with a goal of utilizing our rich portfolio of assets to achieve more long-term financial flexibility. The actions we have taken over the past few months are tangible steps towards this end.

Consistent with our objective to enhance our financial flexibility, we recently disclosed that we are actively exploring the monetization of a portion of our owned real estate portfolio, potentially in the range of 200 to 300 stores, through a sale-leaseback transaction, with the selected stores to be sold to a newly-formed real estate investment trust, or REIT. Should such a transaction take place, we would continue to operate in the store locations sold to the REIT under one or more master leases.

Similar to some of our other asset separations and financings, we intend to effect the formation and equity funding of the REIT via a rights offering that would provide every shareholder the opportunity to participate according to their pro rata equity interest in Sears Holdings.

There can be no assurance that we will pursue such a transaction, nor can there be any assurance that, even if pursued, such a transaction could be entered into and consummated on satisfactory financial and other terms. However, we believe that if successful, the transaction would result in substantial liquidity to Sears Holdings and would enable us to accelerate our transformation to a more asset-light, member-focused business while retaining the benefits of operating the stores in our ecosystem.

As the CEO and the largest individual shareholder of Sears Holdings, I am personally committed to investing in and driving our transformation, improving the profit performance of the Company, ensuring our financial flexibility and creating shareholder value.

I will now hand the call back to Rob who will take you through our third quarter results and financial position followed by a more detailed update of our asset redeployment and reconfiguration activities.

Rob Schriesheim:

Thanks, Eddie.

Slide 7 is a summary of our third quarter and year-to-date consolidated results. With $7.2 billion of revenue in the third quarter, we have significant scale, which provides us with substantial operating leverage such that small improvements in margin rate and selling and administrative expense can lead to substantial improvements in EBITDA.

On Slide 8, we show our year-over-year domestic Adjusted EBITDA results for the past three quarters. In the third quarter of this year, we had a domestic Adjusted EBITDA loss of $296 million, which was an improvement of $14 million versus the third quarter of last year.

This represents a meaningful improvement in performance, when compared with the year-over-year change in the previous two quarters. We believe that this is an indication of the progress that we are making in our transformation and we currently expect this improvement in year-over-year adjusted EBITDA trend to continue into the fourth quarter.

Let me now take you through some of the year-over-year changes underlying our results.

Slide 9 is a “waterfall” chart providing components of the change in revenues year-over-year.

On a comparable basis, revenue is essentially flat year-over-year. On a reported basis, revenue is was down approximately $1.1 billion year-over-year due to factors other than domestic comparable store sales performance.

Moving to Slide 10, as shown in the top box, our year-over-year comparable store sales trend improved in both the Sears Domestic and Kmart formats, demonstrating a marked improvement in performance in both formats versus trend.

As you can see in the chart on the lower left, our online and multichannel sales are up 18% year-to-date through the end of the third quarter. We continue to make our online capabilities more robust and appealing for our members. We are also expanding our marketplace assortment and increasing the number of locations with in-store tablet capabilities.

Finally, in the third quarter, we derived more than 70% of eligible sales from our members as we continue to invest heavily in our Shop Your Way platform. Within this population of active members, we continue to see significant improvements in member engagement as we have seen increases in the number of active emailable members, the number of active redeemers, redemption sales and redemption sales as a percentage of total member sales.

As indicated on Slide 11, for the third quarter, our domestic comparable store sales declined by 0.1%, as Sears Domestic experienced a 0.7% decline which was partially offset by an increase in the Kmart format of 0.5%.

Sears Domestic experienced a decline of 0.7% driven by declines in consumer electronics, apparel and auto, partially offset by increases in our home appliances and mattresses businesses, which continue to show strong momentum. Our electronics business continues to negatively impact the Sears format. We are addressing this decline by transforming the business from one which has focused primarily on selling TVs into a business focused on providing Connected Solutions for our members. Adjusting for the negative impact of the consumer electronics business, Sears Domestic comparable store sales would have experienced a positive comparable store sales increase of 1.0%.

Kmart experienced a comparable store sales increase of 0.5% for the quarter driven by increases in Apparel, Outdoor Living and Toys, partially offset by decreases in consumer electronics, and grocery and household.

The consumer electronics, and grocery and household businesses continued to negatively impact the Kmart format, which we intend to address moving forward as part of our transformation. After adjusting for the impact of consumer electronics and grocery and household, Kmart would have experienced a comparable store sales increase of 2.8%.

Slide 12 shows that for the quarter our comparable store gross margin was essentially flat. On a reported basis, our gross margin decreased $330 million due to several factors unrelated to the on-going core business. I would also point out that we saw a favorable year-over-year margin impact of $7 million from Shop Your Way points as improvements in member analytics have led to more efficient use of points as a promotional vehicle.

On Slide 13 we show the components of our $251 million year-over-year decline in consolidated selling and administrative expenses as reported. As you can see, we reduced our adjusted domestic selling and administrative expense by $71 million for the quarter as we closed stores and managed marketing and advertising more effectively. On a year-to-date basis, we reduced our adjusted domestic selling and administrative expenses by $155 million for similar reasons.

Slide 14 summarizes some of what we believe are our substantial financial resources.

At the end of the third quarter, we had $326 million dollars of cash, availability to borrow of about $234 million on our credit facility and $4.0 billion of equity in inventory. Taken together, we had about $4.6 billion of liquidity or liquid assets which could be converted into cash in the near term.

After the third quarter ended, we received $836 million of proceeds from the rights offerings for shares in Sears Canada and for Senior Unsecured Notes with Warrants. Adjusting our third quarter as if these proceeds had been received, our Availability on the Facility under our credit agreement would have been $1.1 billion at a time of year when our inventory needs are near their peak.

We believe that we have sufficient financial resources and liquid assets to fund our transformation and meet all of our financial obligations.

Slide 15 presents our domestic inventory, payables and net inventory balances for the past three years. We have had success reducing the capital required to run our business, as we have reduced our domestic net inventory investment by $819 million over the past two years and $534 million year-over-year after adjusting for the impact of the Lands' End separation.

We have been reducing slower selling inventory and focusing on keeping our overall inventory position fresh and relevant to drive better sales, profit and inventory productivity going forward.

On Slide 16, our Domestic Pension Contributions over the past four years, including 2014, have totaled $1.6 billion. We expect this year to mark the peak of our pension funding needs at about $417 million declining to $243 million in 2015.

On Slide 17, we show how we have de-risked our balance sheet by reducing our Adjusted Domestic Net Debt position, defined as net debt plus unfunded pension and retirement obligations, by about $550 million on an as adjusted basis. This reflects proceeds received from the rights offerings after the end of the quarter.

On Slide 18, we show that our Total Short-term Liquid Availability, defined as availability to borrow under our credit facility plus available short-term debt capacity plus cash, was $1.4 billion on an as adjusted basis as compared to $1.3 billion the prior year.

As shown on Slide 19, our debt structure is in place for the next few years. Our domestic revolver extends into 2016, we have negligible term debt maturities over the next few years and we have multiple options available to us for any refinancing we may want to consider.

As indicated earlier we have reduced our inventory by about $1.7 billion over past three years via store closings and productivity improvements which will alter our reliance on inventory as the primary form of collateral in our capital structure. Over the next six to nine months, we intend to work with our lenders and others to evaluate our capital structure with a goal of achieving more long-term flexibility, as we have previously stated, and may take action sooner if appropriate.

Moving to Slide 20, I would now like to shift gears and spend a few minutes discussing how we are redeploying our portfolio of assets, which we believe will accelerate and fund our transformation.

On Slide 21, we show the framework we use to evaluate potential strategic transactions. We believe that these transactions will enable us to accelerate and fund our transformation.

We believe that we are executing on a plan to increase financial flexibility, further de-risk our balance sheet and create shareholder value all while restoring our company to profitability. We currently expect to continue with these types of activities during the remainder of 2014 and 2015.

On Slide 22, we provide an update on our asset reconfiguration and financing activities for fiscal 2014.

On our Q4 and Full Year 2013 Earnings call in February of this year, we disclosed that we intended to generate cash proceeds to the Company in excess of $1 billion in 2014 from asset reconfiguration activities to help fund our transformation and create shareholder value. We have substantially exceeded that objective having generated approximately $2.2 billion of liquidity from financing and asset reconfiguration activities in fiscal 2014 year-to-date as shown on the slide. These activities have allowed us to fund our transformation and meet all of our obligations.

In addition, we have announced that we expect to close about 235 underperforming stores in 2014, which includes a combination of leased and owned locations. To put this into perspective, following these closures, we will still have more than 1,700 Sears and Kmart big box stores in operation, representing about 200 million square feet throughout the United States to serve our members. Few companies have this scale and reach.

I would also point out that based on experience to date we believe that our investments in Shop Your Way and Integrated Retail will enable us to migrate the shopping activity of highly engaged members who previously shopped these closed stores to alternative channels. As a result, we would expect to retain a significant portion of the sales previously associated with these 235 stores.

Finally, as shown on this slide we announced that we are actively exploring means to monetize a portion of our owned real estate portfolio, through a sale-leaseback transaction, with the selected stores to a newly-formed REIT.

As indicated on Slide 23, we would continue to operate in the store locations sold to the REIT under one or more master leases. If we pursued and completed this transaction, we would own between 400 and 500 stores and lease between 1,300 and 1,400 stores.

Further, if we determine to pursue such a transaction, we expect to distribute rights to purchase shares of common stock or other equity interests of the REIT to our shareholders, which would allow all shareholders the opportunity to participate on a basis equal to their proportionate equity ownership interest.

While there is no assurance that we will consummate such a transaction, we believe that if pursued and completed that:

1. Sears would realize substantial liquidity from the sale of the real estate to the REIT while also retaining the benefit of operating the store in our ecosystem.

2. This structure would enable Sears to better manage its real estate needs given our move from a historical store-focused network to a more asset-light, member-centric retailer.

3. Utilizing our real estate in the REIT vehicle is potentially a more effective way to finance and raise capital.

4. Each entity can pursue their respective strategies with a more singular focus, allocating capital consistent with their strategy and with capital structures more appropriate to each entity.

Moving to Slide 24, we provide a timeline of domestic asset monetization and financings since 2012 demonstrating the value in our portfolio of assets and our ability to rapidly monetize these assets with great flexibility. Since 2012, we have raised $4.4 billion of capital from asset monetization and financings, with $2.2 billion raised in fiscal 2014.

I will now turn the call back over to Eddie who will provide an update on the progress that we are making in our transformation.

Eddie Lampert:

Thanks, Rob.

Transitioning to this section on Slide 25, I want to use this opportunity to provide an update on the progress that we are making in our transformation. As I have said before, the framework I am outlining is not intended to provide guidance or assurances as to our future performances. It is intended to frame the opportunities we are actively pursuing to increase profitability.

Slide 26, illustrates the transformation we are undertaking to move from a traditional retail operating model to a member-centric operating model. While retailers continue to be impacted by the same external factors, we are moving aggressively to address what we can control. A key component of transforming our business is to move towards a structure that focuses on providing benefits to our members by using technology and platforms to form individual relationships with them. Our new business model is intended to be less asset-intensive and our new cost structure is intended to be more variable in nature.

Changes in consumer behavior are driving our vision and our actions and the general retail landscape.

As the Wall Street Journal reported in October, Wal-Mart has appealed to investors for patience as it tries to retool its operations for shoppers who are buying more online and in smaller stores closer to home.

In a separate article in The Wall Street Journal, regarding the possibility of Amazon opening its first physical store, a Wells Fargo analyst was quoted saying: “same-day delivery, ordering online and picking up in store are ideas that are really catching on. Amazon needs to be at the center of that.”

If you have been following our Company for any period of time, you have heard me talk about the changes in retail. That is because we have seen this change coming for some time now and we have been investing heavily in our Shop Your Way program and Integrated Retail platform to position ourselves for success in this new retail environment.

On Slide 27, we outline the framework of our new model, which leverages our scale and the investments that we continue to make in the Shop Your Way program and Integrated Retail capabilities. These include:

- Optimizing store network and square footage
- Accelerating Shop Your Way & Integrated Retail as the foundation of our business model
- Transforming select business models, and
- Reducing expenses

Turning to Slide 28, as we've discussed, there is a great opportunity to optimize our store network.

I mentioned earlier, we have announced plans to close about 235 underperforming stores in 2014, having closed about 129 to date. In fiscal 2013, these stores generated almost $1.9 billion in sales; however, they produced an EBITDA loss of about $50 million. By closing these locations, we would expect to generate approximately $50 million of incremental EBITDA on an annualized basis by avoiding the losses they currently produce. Furthermore, closing these locations is expected to reduce our working capital requirements by about $300 million in 2014.

Additionally, as I mentioned earlier, in many cases we are able to retain a portion of the sales associated with the closed locations by maintaining a relationship with the members who shopped those stores. As is shown on the slide, we believe that the annualized EBITDA value of retaining these members could be about $95 million, resulting in a total annualized EBITDA benefit of about $145 million. As our ability to retain members improves, we believe that the potential annualized impact of optimizing our store network could be about $300 million to $400 million.

Moving to Slide 29, as we continue to transform the business to a more asset-light retailer leveraging our Shop Your Way and Integrated Retail platforms, the assets required to support the business will change. Due to our integrated retail capabilities, many of our existing stores are larger than they need to be to effectively serve our members in the most convenient way for them.

As we continue in our transformation leveraging Shop Your Way and Integrated Retail, we will continue to right-size our store footprint and redeploy our real estate assets.

As is shown on the slide, we have partnered with other retailers, such as Forever 21 and Whole Foods, leasing to them a portion of our retail space while continuing to retain an appropriate amount of space to serve our members.

More recently, we announced a deal with Primark, a leading fashion retailer in Europe, in which Primark will lease seven locations from us in conjunction with their entry in the Northeastern United States. Arrangements such as these allow us to continue to serve our members, improve our productivity and profitability while generating substantial leasing income.

Moving to Slide 30, Shop Your Way and Integrated Retail are at the core of our transformation. We continue to see steady growth in online and multichannel sales driven by investments that we have made in Integrated Capabilities over the past few years such as the "Reserve It" functionality rolled out in the third quarter of 2014. We continue to focus on implementing new capabilities that will simplify the shopping experience for our members.

In the third quarter, we derived more than 70% of eligible sales from our members as we continue to invest heavily in our Shop Your Way platform. Within this population of active members, we continue to see significant improvements in member engagement as we have seen increases in the number of active emailable members, the number of active redeemers, redemption sales and redemption sales as a percentage of total member sales.

On Slide 31, our newest Integrated Retailing capability, Reserve It, enables members to shop for clothing and footwear online and reserve the merchandise in store to try on. Reserve It combines the digital world of ecommerce with in-store shopping, another example of how we are leveraging our total asset base to provide more convenience and new capabilities to our members.

This holiday, in addition to Reserve It, our members will have three more ways to shop using Sears Integrated retail capabilities:

- In Vehicle Pickup, Return and Exchange in Five – this service powered by the Shop Your Way app lets members pick up, return, or exchange their purchases for free, guaranteed in five minutes or less, without ever leaving their vehicle.
- Expanded Free Store Pickup – an online/in-store collaboration that allows members to pick up online orders across any of our more than 1,800 locations nationwide.
- Shop Your Way Member Assist – uniquely leverages the online and mobile channels that members already use to give them quick and convenient access to the knowledge and expertise of local store associates.

Moving to Slide 32, we have made substantial progress in our transformation from fixed, mass marketing to variable, personalized marketing. Our progress has been enabled by our Shop Your Way platform which allows us to engage with our members in a personalized way with rich, relevant content.

Through the first three quarters of the year, we have increased our spend in digital and Shop Your Way marketing, but have reduced our total spend in fixed marketing assets by $100 million year-over-year.

In addition to the efficiencies we gain due to digital activities being less expensive than traditional mass marketing, personalized campaigns are more effective due to the ability to tailor the content and the offer to the individual member based on their specific needs. While we have made substantial progress, fixed marketing still represents the majority of our total dollar spend and we will continue to shift even more of our marketing spend from fixed to variable in subsequent quarters.

On Slide 33, we are aggressively transforming our apparel business by placing an increased emphasis on improving product quality to better serve our members. We are focused on refreshing our brands, simplifying our product assortments and are reducing lead times to better meet our members' needs. We have also been working to improve our ability to react faster to member needs and changing trends and to reduce our risk by making smaller and more seasonal buys.

We are excited about how some of the changes are coming to life this holiday season in our Metaphor and Structure brands.

On Slide 34, we provide a summary of the initiatives laid out in the framework for profit I presented on our last earnings call. As you can see, if we successfully execute on these opportunities, we believe they have the potential to generate incremental annual EBITDA of between $1 and $2.4 billion under the assumptions as indicated. We believe that we are making good progress on many of these initiatives.

Moving to Slide 35, we believe we have a substantial opportunity to compete successfully in the changing retail landscape by proactively transforming our business to meet the new realities of the industry. As I have said in the past, transformations of this size and scale are not easy. While we may continue to experience challenges in our financial performance, our third quarter represented a meaningful improvement when compared with the year-over-year change in the previous two quarters.

We believe that this is an indication of the progress that we are making in our transformation and we currently expect this improvement in year-over-year EBITDA trend to continue into the fourth quarter.

We have made progress across a wide spectrum of initiatives, such as leveraging our Shop Your Way and Integrated Retail platforms, reducing our legacy pension obligation, managing our expenses, de-risking our balance sheet, and enhancing our financial flexibility to position ourselves to meet all of our financial obligations.

We believe these initiatives, when coupled with executing on the profitability framework I just described, will position us to play offense and enable us to continue to seek opportunities to grow and invest in our business through acquisitions and other strategic relationships. As I have said before, as changes occur in and around retail, we intend to be in the mix focused on investments and acquisitions that accelerate and improve our transformation.

It's important for all of you to know that we are seeing an improving EBITDA trend which we expect to continue in the fourth quarter, we are continuing to show our financial flexibility and we are focused on the future of our company leveraging our strengths, including our best members, best stores and best categories.