SEARS HOLDINGS

Sears Holdings' Fourth Quarter and Full Year 2014 Results
Pre-Recorded Conference Call Transcript
February 26, 2015

Operator:

Good day, ladies and gentlemen, and welcome to the Sears Holdings Corp. Q4 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 to Mr. Rob Schriesheim, Chief Financial Officer. Please go ahead.

Rob Schriesheim:

Thank you, operator. Ladies and gentlemen, welcome to the Sears Holdings earnings call. I am Rob Schriesheim, Chief Financial Officer. Please note that this morning we released our fourth 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 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 would now like to turn to slide 5 and hand the call over to Eddie Lampert.

Eddie Lampert:

Thanks, Rob. Thank you for joining us today.

I would like to begin today by briefly covering the three critical areas we are focusing on in our transformation of Sears Holdings from a traditional store-only based retailer into a more asset-lite, member-centric integrated retailer.

First, we are highly focused on restoring profitability to the company and we believe that the impact of the actions we have taken to transform the company are starting to show up in our financial results. Last quarter, I talked about the improvements we were seeing in our year-over-year EBITDA trend and how we expected this trend to continue into the fourth quarter.

I am pleased to report that the trend did in fact continue as our fourth quarter domestic adjusted EBITDA was $125 million, an increase of $217 million versus last year. We believe this significant year-over-year improvement in our financial results is an indication of the progress we are making in our transformation.

Second, as we continue in our transformation, we are focused on the future and are placing a disproportionate amount of attention and resources on our best members, our best stores and our best categories.

Third, we remain focused on ensuring that we will continue to have the financial flexibility to meet all of our obligations while funding our transformation. To this end, in fiscal 2014 we raised approximately $2.3 billion from a variety of asset reconfiguration and financing activities, including the spinoff of Lands’ End, the sale of a significant portion of our stake in Sears Canada and the issuance of Notes with Warrants in November.

We are continuing our efforts to develop Sears Holdings as a membership company, without the significant asset intensity of its traditional retail business. To this end, we announced in November that we have been exploring the formation of a Real Estate Investment Trust, or REIT, to purchase some of our properties and to manage them like a pure real estate company.

While we can offer no assurances that such a transaction will be consummated, we have made progress and are proceeding towards its formation and separation, which is projected to occur in the first half of this year. We are currently targeting between 200 and 300 Sears and Kmart stores to be sold to the REIT with expected proceeds to Sears Holdings in excess of $2 billion.

We anticipate that the REIT would enable us to continue and to accelerate many of the activities that we have been pursuing over the past several years. Specifically, we have been working to partner with other retailers and mall owners to enable us to reduce the operating footprint of our stores to smaller, but still significant spaces, while leasing part of the store to retailers who will bring increased foot traffic and relevance to our locations.

The completion of a REIT transaction has the potential to make a significant transformation in our capital structure toward a structure that is more flexible, long-term oriented and less dependent on inventory and receivables. We would hope to maintain a long-term presence in each location while allowing Sears Holdings to still have the flexibility to make strategic business decisions should these locations prove unprofitable in the future.

We believe that many locations can be re-purposed with or without Sears Holdings as an anchor, which would give the REIT the potential for value creation, as well as downside protection if Sears Holdings were unable to continue to operate certain stores profitably.

Turning to slide 6, I will now hand the call back to Rob, who will take you through our financial results.

Rob Schriesheim:

Thanks, Eddie.

On slide 7, we show our domestic adjusted EBITDA results for the past eight quarters. In the fourth quarter of this year, we had domestic adjusted EBITDA of $125 million, which represents an improvement of $217 million versus the fourth quarter of last year, driven largely by an increase of $71 million in comparable gross margin dollars and $239 million of expense reductions.

Let me now take 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 reported basis, revenue is down approximately $2.5 billion year-over-year. About $2.1 billion of the decline is due to asset reconfiguration activities such as the deconsolidation of Sears Canada resulting from the rights offering we successfully completed in November, the spin-off of our Lands' End business to shareholders completed in April, and the closure of underperforming stores.

On a comparable basis, our revenue declined by about $370 million, with $313 million of this decline due to comp store sales performance and $57 million due to 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, for the fourth quarter our comparable store sales declined by 4.4%, comprised of a 7.0% decline at Sears Domestic and a 2.0% decline at Kmart.

The 7.0% decline at Sears was driven by declines in consumer electronics, auto and apparel, partially offset by increases in our mattresses and home appliances businesses, which continue to show strong momentum.

Our consumer electronics business continues to negatively impact the Sears format on a comp store sales basis but we are altering the business model as we drive profitability, which Eddie will speak to in more detail later in the call. Adjusting for the negative impact of the consumer electronics business, Sears Domestic comparable store sales would have experienced a decline in comparable store sales of 4.6%.

Kmart experienced a comparable store sales decline of 2.0% for the quarter driven by decreases in consumer electronics and grocery & household, partially offset by increases in apparel, toys, jewelry and seasonal.

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

While comparable sales were down, our focus on profitability was evident in our increase in comparable gross margin dollars, as you will see on the next slide.

Slide 10 is a “waterfall” chart providing components of the year-over-year change in gross margin for the fourth quarter.

On a reported basis our gross margin declined by about $500 million. However, this decline is entirely attributable to non-comp items related to asset reconfiguration activities. On a comparable basis, our gross margin increased by $71 million, or 3.7%, driven by a favorable rate impact of $157 million, including a more focused and efficient use of Shop You Way points, partially offset by the impact of the comp store sales decline.

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

On a reported basis, we reduced selling and administrative expenses by about $610 million year-over-year. Of this reduction, $372 million was related to asset reconfiguration activities with the remaining $239 million in expense reductions on a comparable basis consisting of primarily decreases in payroll, insurance and advertising expenses.

Slide 12 summarizes some of what we believe are our substantial financial resources and liquid assets.

At the end of the fourth quarter, we had $250 million of cash and availability to borrow of about $808 million on our credit facility, resulting in about $1.1 billion of committed availability.
The terms of our credit agreement permit us to raise up to $500 million of short-term debt maturing before April of 2016, of which, $403 million was outstanding at year end, leaving $97 million of uncommitted short-term debt available to us, which when added to our committed availability yields a total liquid availability of about $1.2 billion at year end.

The $1.2 billion of total liquid availability, when taken together with the approximately $3.3 billion of equity in inventory at year end, provides us with $4.5 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 13 we show how our domestic adjusted net debt position, defined as net debt plus unfunded pension obligation, has changed year-over-year.

Looking first at our net debt, you can see that we have reduced net short term debt by $390 million year-over-year by shifting $314 million of the net short term debt balance to long term debt and eliminating an additional $76 million of net short-term debt.

Turning now to the unfunded pension obligation, you can see that it has increased by $768 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 contribution in fiscal 2015 is $275 million, which is a $142 million reduction versus the $417 million contribution in fiscal 2014.

On slide 14, we provide an update on our asset reconfiguration and financing activities for fiscal 2014.

On our Q4 and full year 2013 earnings call last 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 substantially exceeded that objective having generated approximately $2.3 billion of liquidity from financing and asset reconfiguration activities in fiscal 2014 as shown on the slide. These activities have allowed us to fund our transformation and meet all of our obligations.

As indicated on slide 15, we have entered into an agreement to amend and extend the $400 million short term secured loan, effective February 28, 2015. Under the terms of the amendment, we will repay $200 million of the $400 million on March 2 and, in connection with this repayment, the lenders under the short term secured loan have agreed to release one half of the value of the pledged collateral. The remaining $200 million secured short-term loan was extended until the earlier of June 1, 2015, or the receipt by Sears Holdings of the sale proceeds pursuant to the potential REIT transaction.

As part of this amendment and extension, ESL has provided a commitment to re-lend up to $200 million at the Company's election on or prior to June 1, 2015. If we were to re-borrow, the released collateral would be re-pledged. In taking this approach we have paid back funds we do not currently need, our associated collateral was released, our interest expense is reduced, but we have retained the ability to access the full $400 million.

As previously discussed, we are actively exploring the formation of a REIT to purchase some of our properties and to manage them like a pure real estate company. This is consistent with our past statements about evolving our capital structure to be less reliant on inventory and receivables while also providing us with more flexibility in how we manage our ongoing space needs.

While we can offer no assurances that such a transaction will be consummated, we have made progress and are proceeding towards its formation and separation, which is projected to occur in May or June of this year. We are currently targeting between 200 and 300 Sears and Kmart stores to be sold to the REIT with expected proceeds to Sears Holdings in excess of $2.0 billion, substantially enhancing our financial flexibility and recapitalizing our balance sheet.

The REIT itself would be funded by equity and debt with the equity raised through a rights offering. The subscription rights would be distributed pro rata to all stockholders of record of the Company, and every stockholder would have the right to participate proportionate to their ownership interest, except that holders of the Company's restricted stock that is unvested as of the record date would be expected to receive cash awards in lieu of subscription rights.

Moving to slide 16, 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.

As slide 17 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.

Our member-centric Integrated Retail model is built on the foundation provided by two separate and distinct platforms: Shop Your Way, our membership platform, and Integrated Retail, the technology platform that connects our members to our integrated ecosystem of retail channels and member touch points.

Turning to slide 18, 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. We believe that by building these relationships there is significant opportunity for growth through member retention.

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. We are also looking to transform businesses like our Consumer Electronics business, which while an important category for our members, is a category where we have underperformed for too long.

As shown on slide 19, we made significant progress in our ability to personalize our interactions with our members as the percent of total interactions that were personalized more than doubled from 2013 to 2014. Over 25% of our total interactions with members are now personalized which allows us to increase the relevance of these interactions – driving higher retention and engagement which we believe over time will yield increased visit frequency and a higher share of our members' wallet.

Our primary focus is on growth by retaining existing members. We provide products and services across many categories that our members may choose not to purchase from us today, but by nurturing these relationships with personalized and relevant interactions we believe there is substantial opportunity for growth within our existing member base.

Moving to slide 20, 60% of online transactions are now multi-channel, which means that our stores play a crucial role in both the order creation via our in-store kiosks as well as the fulfillment of orders placed online and picked up in store.

Our stores and our supply chain are important Integrated Retail assets and we have taken steps to connect our eco-system of stores and warehouses by leveraging technology and supply chain platforms. This has enabled us to deliver to 99% of U.S. household in two days or less. Connecting our systems has allowed us to make inventory across our entire store network available to our members so they can find and purchase items regardless of physical location. This not only leverages our inventory assets better but it also enables the store closest to the member to fulfill the order so it can be delivered faster to their homes at a lower cost. Just in the months of November and December, we saw slightly over one third of online shipped orders fulfilled by our stores.

Moving to slide 21, with a core focus on improving overall space productivity and better serving the needs of our members, we redeployed or reconfigured about 7 million square feet of real estate within our store network in 2014 from a combination of third party leasing deals, the conversion of Lands' End into a third party tenant and internal changes to reallocate space in support of our best categories.

While we closed 234 largely unprofitable stores, we continue to operate approximately 1,700 stores, which enables us to have significant scale nationally while serving our communities' members. When we close stores in certain communities, we are able to maintain relationships with our members by leveraging our two key platforms: Shop Your Way and Integrated Retail.

The combination of these actions enables us to be more focused on serving our members in our best stores such as we did with our agreement announced earlier this year with Primark. In this manner, Sears will retain a considerable amount of space to serve our members. At the same time, Sears will generate substantial income from leasing space, which we believe will turn unprofitable or unproductive space into profitable space. We believe that this strategy and approach in managing our vast real estate holdings would be further enhanced if we are successful in executing the previously mentioned REIT transaction.

Moving to slide 22, we continue to make technological investments in our best stores to provide more choice and convenience to our members.

Mobile technology now plays a significant role in the way we serve our members in our stores. We continue to develop applications that provide our associates with better tools, improving the quality and speed with which they can assist our members. This mobile technology is currently in over 500 of our Sears stores providing associates instant access to information on millions of products.

Transactions can be completed on the spot using mobile checkout and in 2014 more than 7 million transactions were completed this way. Or, if the member that the associate is assisting is not ready to make her purchase yet, the associate can send the member a digital recap of her store visit, making it easier for her to complete the purchase when she is ready to do so.

This year we replaced paper signs with over 100,000 digital signs across 300 of our best Sears stores. These signs provide our members with dynamic content from product information to instructional videos to consumer reviews, putting the information they need literally right at their fingertips when they need it.

Some 14 years ago, we were one the first retailers to offer Buy Online Pickup in Store, a capability that continues to be one of our members' favorites, accounting for more than 35% of online sales. This year we expanded our pick-up in-store programs to include in-vehicle pick-ups as well as returns and exchanges. Members love having packages delivered right to their cars in five minutes or less.

We also expanded our free store pick up service to be a cross-format service – meaning that members shopping on sears.com can pick-up their merchandise at a Kmart store and vice versa, providing our members with more convenient pick-up locations. These capabilities are driving sales and providing our members with unrivaled convenience.

Moving to slide 23, we are focused on growing our best and most important categories.

In Home Appliances, we are intent on reinforcing our position as the No. 1 appliance seller in the U.S. We are leveraging our Kenmore brand to bring innovation to market by launching products with exclusive features such as accela-wash and accela-chill that significantly outperform the competition in terms of performance. We are expanding our assortments both in our stores and online to make available to our members the products that they are looking for.

We are also expanding our use of digital signs in this category by rolling the functionality out to the appliances department in more of our stores. This functionality improves the in-store shopping experience for our member by providing more dynamic and interactive content about the products they are shopping for while simultaneously providing opportunities for us to increase margin by being more dynamic in how we price.

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 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 and grow the business.

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. As a result of this work, we have reduced our lead times by 10 weeks, giving us the ability to react to member demand in-season which we believe will significantly improve our inventory productivity in this category.

On slide 24, we show how we are transforming our consumer electronics business. Earlier in the call Rob touched on the impact the consumer electronics business is having on our revenue performance. As a company, we are primarily focused on profitability, not revenue, which means that we will be making material changes to the Consumer Electronics business model which has been challenging from a profit standpoint for some time.

I want to be clear that Consumer Electronics is a very important category to our members and we intend to continue to provide our members with the products they are looking for in this category. However, we are thinking about the business very differently. We are transforming to a model that requires less working capital and operating expenses by partnering with other providers. This model will potentially impact our revenue performance since sales may decline in the category in fiscal 2015; however, we believe it will improve profitability, reduce working capital and provide our members more of the products they are looking for.

Moving to slide 25, we made good progress this quarter on our three key areas of focus:

1. We substantially improved our financial performance delivering $125 million in domestic adjusted EBITDA, which was $217 million greater than the same quarter last year. During the quarter, we delivered higher gross margin dollars on a comparable basis and reduced 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. I believe the initiatives I have outlined have us on that path.

2. As we move forward, our focus will be on our best members, our best stores and our best categories. Our business model will continue to be focused on Shop Your Way and Integrated Retail. We believe these platforms have the potential to scale across our member base and we will continue to further enhance our products and services to create a more engaging platform on which to deliver value to our members.

3. During the past quarter and year, we continued to deliver on our commitments to enhance our financial flexibility. With our plans underway to move to a more asset lite member-centric integrated retailer we intend to optimize the value of our real estate and generate substantial liquidity for our company further enabling us to invest in our transformation.

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.