Does he know something we don't?

As promises of better results continue to go unfulfilled, the Street is losing patience with HBC and its management team under George Heller.

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If you were a publicly traded company, you'd know you were really on the outs with the analyst community when your year-end results inspired commentary as scathing as that which Hudson's Bay Co. has recently endured. "What can you say about numbers like these except SELL?" Cynthia Rose-Martel, an analyst with Jennings Capital Inc., wrote after the retailer (TSX:HBC) reported in March that, on sales of more than $7 billion, it earned only $54 million, or 77¢ a share, in 2004--down 21% from 2003. "Even more disgraceful," Rose-Martel wrote, is that HBC's credit card operations generated virtually all its earnings; the retail operations, comprising the Bay and Zellers chains, actually lost money. But Rose-Martel saved her particular scorn for HBC management's adherence to its business plan: "Cynthia to fourth ring of Saturn--it's not working!"

Or how about the bon mots from **Veritas Investment Research Corp.** analyst **Peter Holden**? His latest report on HBC starts with a quote from Benjamin Franklin, who defined insanity as "doing the same thing over and over and expecting different results." It's a reference, perhaps, to the fact that HBC, under George Heller, chief executive officer since 1999, has largely stuck to the same game plan for years: trying to cut costs, improve stores and increase foot traffic with better selection, more convenience items and an emphasis on private or exclusive brands. **Holden** isn't impressed. Management "isn't even close to meeting its performance targets," he writes, then asks, rhetorically, "Where are the repercussions?"

Another analyst, Merrill Lynch's Patricia Baker, uses a more measured tone. Yet her disappointment with HBC is clear. "The declining traffic at both chains, coupled with an inability over the past five years to gain traction in the marketplace despite many strategic efforts, is worrisome," she says in a research note, "and suggests that the competitive changes in Canada and changed consumer behaviour have left the company behind."

Those are just a few illustrations of how deep the investment community's disappointment with HBC runs. Analysts are indeed finding "it's hard not to think of the Bay," as the tag line of its ad campaign goes, but not for reasons the company would like. Investors keep looking to the horizon for a white knight who has never shown up. Meanwhile, every year, management says the business is looking up; every year, earnings seem to fall further behind. "I think we have all lost patience and we're fed up," says Research Capital Corp. analyst David Brodie. "What is it they see that we don't see? Because it strikes me that [HBC's] strategies have done nothing for them over the past few years, and what's going to be so much better over the next few years?"

How did HBC get to this point? Some analysts are more gentle in their criticism than others--"the past three years have been difficult for HBC," says a mildly chiding George Hartman, of Dundee Securities Corp.—but most still following the company have either Sell or Underperform recommendations on the stock, and they suggest its shares, at about $13, are overvalued, despite trading at less than half book value. Most say the stock, on the basis of fundamentals, should be trading in the $7 to $11 range, and note that the only reason the shares are priced higher is the lingering hope of a takeover bid--the most-discussed candidate being trendy U.S.-based discounter Target Corp.

The latest spate of rumours on that front started back in 2003, when Jerry Zucker, a South Carolina-based takeout artist and financier, began accumulating HBC stock through Maple Leaf Heritage Investments ULC, an affiliate of his InterTech Group Inc. Zucker said at the time that he was simply making a good investment in a company whose shares had become cheap, but analysts and investors jumped on the news, no doubt out of an ardent desire for someone to do something to realize shareholder value on a company whose stock had been in a free fall for years. (In 1998, the stock traded at about $38 and had got as low as the $6 level before Zucker started to take an interest.) After Zucker's interest became known, HBC stock topped $15 a share, and has remained remarkably stable despite the company's poor results. "We thought Zucker would put a burr under HBC's saddle," says Brodie.

Heller--whom one would expect to be the point man for the burning questions about the fate of HBC—is being selective about whom he talks to lately. "I am not going to serve him up for another wide-ranging interview about his vision and the future of the company," said HBC spokesman Rob Moore, in declining repeated requests for a meeting with the CEO. Some analysts, like **Holden** at **Veritas**, haven't fared much better than the press. In his most recent report, **Holden** writes that, when he phoned HBC chief financial officer Mike Rousseau to voice his difficulty in trying to understand adjustments and restatements for 2003 results, he was told: "We don't care if you're confused--we're not taking your calls." **Holden** believes the curt response probably was reaction to previous, negative **Veritas** commentaries on HBC.

Just before this story went to press, Heller did respond to several e-mail questions. "The plan to reinvent Hudson's Bay Co. and grow sales is working," he wrote. "We have improved the asset and competency base on which the company can grow. From better stores, to an improved balance sheet, to better assortments, to better technology and supply chain systems, our shareholders own a better company today than at any point in recent history." Heller adds: "We are on the right path, not necessarily the easy path. The pieces are in place; what separates us from success is not rebuilding a Company--we have done this—it is a 2% to 3% sales increase per year." Heller says he is confident in delivering that growth by "leveraging the full potential of a 500-plus-store retail powerhouse," with more product, more valuable credit card and loyalty programs "and a single view of the market with the greatest breadth and depth of assortment in the industry."

That neatly sums up Heller's mantra for fixing HBC. But retail watchers greet his interpretation with a large degree of skepticism. At the heart of the displeasure with HBC, says **Holden**, is that over the past five years, HBC retail revenues have totalled $35 billion, but total earnings before interest and tax have come in at $174 million--for an average pre-tax profit margin of 0.5%. During the same period, **Holden** points out, HBC has either written off as one-time items, or deferred, expenses totalling $172.9 million. "The critical question is: Of the $35 billion HBC Retail has taken in over the last five years, how much did it manage to hang on to?" says **Holden**. "The answer appears to be: virtually none."

Of course, Hudson's Bay Co., founded in 1670, is a survivor. From its roots as a fur trader and governor of a vast portion of what is now Canada, it has settled down to become "the dowager duchess of the Canadian retailing sector," to use **Holden**'s words. Perhaps, as Heller and his management team promise, it will rise like a phoenix. HBC operates almost 550 stores under the Bay and Zellers banners, as well as smaller chains such as Home Outfitters and Fields. Its most profitable division is financial services, offering credit cards that can be used in HBC stores as well as Esso gasoline outlets. It had operating earnings before interest and taxes of $162 million last year--while the company as a whole had EBIT of $129 million. The retail operations have been losing money, and, says **Holden**, "things could start to snowball" if sales drop further, customer traffic falls, credit card receivables decline and losses increase.

In late 2003, Heller outlined a strategy to boost sales and profits, targeting earnings of $2 a share by 2006 and $2.85 by 2008, on sales, respectively, of $8.5 billion and $9 billion. To get there, the company added new product categories, such as pharmacy and convenience items, to boost traffic at Bay stores; it beefed up efforts to sell appliances, jewelry and electronics, relying less on the volatile apparel market; it pushed to improve its house brands, and signed exclusive agreements for clothing lines to make stores more of a fashion destination. It has also been busy trying to integrate its various divisions' management, back-office, marketing and distribution operations; it has made a concerted effort, through its credit cards and its loyalty programs, to get customers to spend more dollars within the HBC family. To do all that, Heller is relying on two executives he has worked with since the 1980s: Thomas Haig, formerly responsible for Zellers, is now president of HBC stores and specialty; Marc Chouinard, who was head of the Bay, is president of HBC merchandising group.

Now, the company has been forced to pull back on the growth targets Heller announced back in 2003. In fact, the company says it will no longer release earnings guidance at all. To achieve its 2008 goal, notes analyst Baker, HBC would have to achieve an average annual rate of sales growth of 6.2% and average earnings-per-share growth of 38.7%.

It's one thing to abandon unrealistic goals; it's another to contend, as HBC management has, that the plan in place to meet those now-abandoned goals is still working. "The current strategies with respect to Zellers and The Bay stores will remain in place and in fact be expanded upon," says a March report from analyst Jamie Spreng of Fraser Mackenzie Ltd. (Spreng has since moved to Sprott Asset Management.) "Having watched traffic counts at Zellers struggle over the years, and now seeing The Bay stores also losing foot traffic," he adds, "this is discouraging." Spreng points out that Zellers' performance has been steadily declining despite its traffic-generating initiatives. Now, the Bay is suffering through the same problems--and the same initiatives to fix them. At the same time, both Zellers and the Bay have to deal with new players in the Canadian apparel business, such as Abercrombie & Fitch, and with the continuing encroachment of recent entrants like Old Navy, H&M and Zara.

Baker says another inherent problem in forecasting HBC's fortunes is that, like most department stores, how it fares "really plays out" in the fourth quarter--and, within that, the month of December. "The ability to mitigate the potential negative impact of weather, changing consumer behaviour, competitor actions, has been, to date, limited," Baker says. Though HBC "is pursuing new business opportunities or product categories," she says, "in each case they are pursuing incremental growth in categories which for the most part Canadian consumers are ably served by other players."

To a large extent, HBC's problems are those of the department store sector as a whole. "Consumers don't favour the traditional multi-storey department store anymore," says John Chamberlain, an analyst with bondrating agency DBRS. Department stores, he adds, can "increase sales by dropping prices radically, or they're able to get margins up a bit by cutting costs, but they can't seem to do both." As for a discount player such as Zellers, it must contend with the phenomenon that is Wal-Mart. Since the Bentonville, Ark.-based retailer arrived in Canada in 1993, it has steadily gained market share--it now has more than half of the department store sector--and out-produces its competitors on a sales-per-square-foot basis. That only makes it stronger--making it harder for Zellers to catch up.

Not that it has never been done elsewhere. Hani Zayadi--former boss and mentor to Heller, Haig and Chouinard at HBC and at the now-defunct Woodward's chain back in the late 1980s and early 1990s-- moved to Australia in 2001 to take on the job of turning around the Kmart division of Coles Myer Ltd., the country's biggest retailer. "The challenges weren't too dissimilar," says Zayadi, who was president of Zellers in its pre-Wal-Mart glory days. When he arrived, the most significant threat to Australia's Kmart (no relation to Kmart in the United States) was the Big W division of Australia's Woolworths Ltd. Big W had an "everyday low price" strategy like Wal-Mart, with which it has a strategic relationship.

Zayadi put in place a plan to lower prices, change the merchandise mix and build a team committed to improving Kmart's productivity. The strategy "didn't look too good" in its first year, says Zayadi, who is now head of Coles Myer's food, fuel and liquor division. But the improvements eventually clicked, and in three years Kmart was able to boost annual sales to more than A$4 billion, from about A$3 billion. Zayadi, who worked for Wal-Mart International in Canada before going to Coles Myer, admits that had his adversary actually been Wal-Mart, and not a clone, the recovery might have been more difficult. Wal-Mart "would have fought back" harder, he says. And he defends his former proteges still fighting it out in Canada. Heller and crew have strong leadership capabilities and have "earned their stripes," he says, noting the three have "managed reasonably well, under the circumstances," to keep HBC alive.

Zayadi's experience with Kmart in Australia suggests, however, that just about nothing is impossible when it comes to retail. Maybe that's what Jerry Zucker, HBC's biggest single shareholder, is banking on. If so, the highly secretive financier isn't saying. But Robert Johnston, vice-president of strategic planning for InterTech and Zucker's main spokesman, admits to being frustrated with HBC's progress, especially after the fourthquarter and year-end results released in March. "We can't really get comfortable that the company has a finger on the pulse as to why the quarter went so wrong," says Johnston, a Canadian who keeps a house in Montreal. "That has left a bit of discomfort."

However, Johnston reiterates that Zucker is willing to give HBC time. He points out that it has managed to pay down $1 billion in debt in recent years, generated cash flow of $300 million last year, and remodeled and upgraded many of its stores. "We're very patient investors," he says. But he adds that HBC's strategy "needs to start showing results."

Of course, analysts note that Zucker is in a delicate position with his HBC investment. He is still in the money, having bought his shares at an average price of around $10. But if he gave up on HBC, says Brodie, he would have a hard time unloading his stake--just under 20% of outstanding shares--without the stock taking a huge hit. If he wanted to cross the 20% threshold without triggering a poison-pill provision, he would need the board's approval of an offer to all shareholders to take over the company. Most retail watchers don't think Zucker, who has no experience as a retailer, plans to take over HBC with the aim of running it himself. However, Johnston says that as an investor, Zucker is open to a number of options, including buying, tendering or selling the shares. Johnston also acknowledges that anyone who would break up the company for its parts must "tread very lightly," both from a financial perspective and with a view to respecting an entity of such iconic importance to Canadians.

Still, analysts have been busy crunching numbers, trying to figure out the best way to unlock the value of HBC, which has a book value of about $30 a share. Among the scenarios are monetizing real estate assets (management has indicated to analysts that they're worth $500 million), selling off the credit card business, or finding a buyer interested in taking over the company's leases. Spreng says in his research note, however, that a strategic buyer such as Target would likely want no more than 160 stores--perhaps even fewer--and wouldn't want to pay more than $5 to $10 a share for them. That's because of HBC's off-balancesheet items, including $2.5 billion in lease obligations.

Holden has put together a scenario outlining what a different kind of buyer might get for HBC after liquidating merchandise at cost within a month, selling the credit card portfolio at a premium (no bad debt surprises), selling real estate at appraised values, discharging its 70,000 employees, unloading equipment at 50% of estimated value, and terminating leases for 20% of face value. In a best-case scenario, **Holden**'s calculations suggest that there would be $539 million, or $7.78 per share, for shareholders.

Numbers like that speak to the gravity of HBC's situation. Probably, 2005 will be a make-or-break year for the company and its current management team. "These guys have had a serious shot at it, and there doesn't seem to be any light on the horizon," says **Holden**. HBC's board of directors has been content to see Heller's plan play out. So far. But **Holden** says "it's inevitable" the retailer will be taken over--an opinion shared by many who have stood and watched it struggle. The only question in their minds is price--that, and whether those now in charge of trying to save a piece of Canadian history will be there to witness its end.