Hudson's Bay's sales must rise before investors jump in

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February 1, 2013

Nathan Denette/The Canadian Press/APHBC's portfolio includes 90 stores under the Bay banner, 69 Home Outfitters box stores and 48 Lord & Taylor stores, the New York department store chain that accounts for 35% of its revenue. It aims to boost the Bay's sales per square foot to $170 to $180 in three to five years from $133 in 2011, and at Lord & Taylor to $240 to $250 per square foot from $210 in 2011.

Hudson's Bay Co.'s shares have quietly languished below their IPO price since the country's oldest company took its second run on the public markets with a $17 share offering in late November.

The analysts who have initiated coverage on the retailer uniformly praise president Bonnie Brooks for adding sizzle to the once lacklustre department store chain, but there is clearly some investor trepidation about whether or not the executive team's efforts will be enough to raise sales to the level they are hoping for. That fear is only somewhat mitigated by the potential for a spinoff real estate investment trust that might unlock some shareholder value.

Of course, it should be noted that even though most of the analysts who initiated coverage are bullish about the stock, many are also in the syndicate of institutional investors that bought into HBC's IPO. But even they concede HBC faces some significant risks, not the least of which is the entry of new competitors such as Target and Nordstrom into the Canadian market.

But the risks go beyond the retailer's core businesses to things it can't control. For instance, the Nov. 20 IPO raised a tidy $365-million, but the shares were repriced to $17 from an initial range of $18.50 to $21.50 roughly a month earlier. Bookrunners on the deal, including RBC, put the shift down to a tepid IPO market, particularly after the U.S. election, and the general market uncertainty at the time.

It could be, however, that HBC's shares are treading water simply because investors are sitting on the sidelines to see how the retailer performs for a few quarters before buying in.

"Since the fourth quarter tends to account for about 33% of sales and roughly 55% of profits, investors may not receive confirmation of the unfolding of the potential growth story until the end of fiscal 2013," said analyst David Hartley of Credit Suisse in a report to clients, rating the shares outperform with a target price of $20.50.

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That will be challenging, despite the radical overhaul and increased sales that have come since Connecticut-based real estate investor and current CEO Richard Baker bought the ailing business in 2008. Canadian consumer appetite for traditional department stores has waned over the years since big-box specialty stores began flooding the market in the 1990s, and many industry experts wonder if HBC has too much square footage to ever be truly productive.

"The company has a high fixed cost base and low productivity of assets," said a report from analysts Tal Woolley and Irene Nattel of RBC Capital Markets, who rate the shares as outperform but with an above-average risk. Their target price is $21.

Analyst Perry Caicco of CIBC World Markets, who also has an outperform rating with a target of $22, put the central issue more bluntly in his initial report on the stock: "Mature major department stores do not meaningfully grow square footage – in fact, they generally have too much square footage."

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While there may be some growth in retailers' online sales, without square footage growth the bottom line of mature department stores is highly sensitive to tiny changes in sales productivity, gross margin rates and selling, general and administrative (SG&A) spending.

"The most remarkable economic feature of department stores is the very violent sensitivity of earnings to small changes in sales or margins," Mr. Caicco said. And a lot can go wrong, he noted: "bad weather, desperate competitors, a sluggish economy, off-trend fashions, or weak promotional planning can all hammer the earnings quickly and are largely unrecoverable."

But there is a big potential upside since there are a number of key assets that work in HBC's favour, analysts note. For one, HBC has a seasoned and bold management team of retail executives who were

unafraid to axe 90 of 100 former legacy executives and replace scores of irrelevant brands with fashionable ones.

The latter move gave HBC some ammunition to better fill the void in Canada "between mass merchants and value retailers such as Walmart, and high-end luxury retailers," Mr. Woolley and Ms. Nattel said.

They say the retailer has targeted smart categories with high growth potential for increased sales: women's apparel and footwear, menswear, cosmetics, handbags and accessories and jewelry. For the three years ending fiscal 2011, sales of these categories have increased 13.5% at HBC and 25% at Lord & Taylor.

Aaron Lynett/National PostThe analysts who have initiated coverage on the retailer uniformly praise president Bonnie Brooks for adding sizzle to the once lacklustre department store chain.

While HBC has a 5% share of those categories, the analysts estimate it will have to capture an additional 1% to 2% market share over the next five years to meet its sales growth targets. "The caveat, however, is that the less natural growth in the market, the more share Hudson's Bay needs to take."

Mr. Hartley believes leveraging expenses and strong gains in sales per square foot will drive average per-share-earnings growth of 15% at HBC through fiscal 2016. But getting the hottest brands is not possible without a sustained investment inside the stores to make them look great, Mr. Hartley added — something prior management failed to do.

"In 2000 to 2005, HBC was capital starved and, unfortunately, there appears to be a correlation to the sales generated," he said.

Capital expenditures represented 2.4% of sales during that time period, compared with about 5% by the chain's competitors. He expects HBC will spend 5% of sales on capital expenditures between 2013 and 2016.

HBC's decision to self-fund its capital expenditures reduces the financial risk of these improvements for investors, but it also implies a longer turnaround time, meaning weaker stores in non-urban markets could be more vulnerable in the interim, Mr. Woolley and Ms. Nattel said.

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They also cite a concern about Target beyond its obvious competitive allure to shoppers as the new game in town. Target's off-the-beaten-path locations, a legacy of the Zellers' leases it bought in 2011 from HBC for $1.8-billion, could disrupt mall traffic patterns, "making it difficult to determine whether today's best and busiest malls remain so in the future."

The chief asset analysts seem to like at HBC is its solid real estate portfolio. HBC owns or controls 11 million square feet of retail space in Canada and has 11.7 million of leased retail space with long-term leases at below market rent. Mr. Baker in December said the retailer may launch a REIT in the future like grocery chain Loblaw Cos. plans to do mid-2013.

Mr. Hartley believes HBC could create an additional $3.78 in per-share value by selling its owned real estate into an 80%-owned REIT, and sees Home Outfitters as a divestiture candidate, but not a big one — perhaps worth $75-million or 62¢ per share.

Mr. Woolley and Ms. Nattel estimated that if HBC spins out its real estate into a REIT, the REIT could be worth approximately $3.00 per share and the retail business would be worth approximately $18 per share. Mr. Caicco makes the same estimates.

HBC's leases also work in its favour as an operator, with terms longer than 45 years on 88% of its leased space and renewal options, Woolley and Nattel noted. None of the leases exceed $10 per square foot and the analysts estimate the retailer's average occupancy cost is under $6 per square foot.

The lone dissenting analyst when it comes to HBC stock is ***Kathleen Wong*** of V***eritas Investment Research***, who believes the retailer is already overvalued. She has a sell rating on the stock, with a target price of $12.

She asserts HBC will need a very strong fourth quarter with 8.5% sales growth and a 22% improvement in EBITDA to make its 2012 guidance. Making those goals more difficult is that retailers, including the Bay, have been in full promotion mode since Black Friday in November, she said, which could hurt the chain's gross profit margin.

And investors shouldn't depend on HBC spinning out a REIT in the near term, ***Ms. Wong*** added, leaving them to rely on the company's core business for share-price growth.

"Properties typically selected for a REIT would include mature assets with stable cash flows," she said. "We believe the priority for management is to focus on bringing HBC's business up to par."