SEARS HOLDINGS

Sears Holdings’ Fourth Quarter 2016 and Full Year Results
Pre-Recorded Conference Call Transcript
March 9, 2017

Operator:

Good day, ladies and gentlemen, and welcome to the Sears Holdings Corp. fourth quarter 2016 earnings conference call. [Operator instructions]

Chris Brathwaite:

Thank you, Operator. Ladies and gentlemen, welcome to the Sears Holdings earnings call. I am Chris Brathwaite, Vice President of Corporate Communications for Sears Holdings and I am joined today by Jason Hollar, our Chief Financial Officer. Please note, that we have now released our fourth quarter and fiscal year 2016 results, which are now available on the investors section of our website under events and presentations. You can access the accompanying slide presentation for our call today through the same section of the website.

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

In addition, as noted 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, as defined in the presentation.
I will now hand off the call to Jason.

Jason Hollar:

Thanks, Chris.

Good morning and thank you for joining our call.

As you have seen in our press release, our fourth quarter performance demonstrated notable improvement in our Adjusted EBITDA driven by our relentless focus on achieving profitability.

Before we move further into details of our financial performance, I will provide an update on our transformation. So, let's turn to slide 4.

As you know, Sears Holdings is undergoing a strategic transformation from a traditional store network model into a member-centric integrated retail model with our Shop Your Way platform at its center. While we continue to implement this fundamental shift across our organization, we are also focused on improving our short-term operational performance and on ensuring that we have the financial flexibility necessary to fund our transformation and enhance value for our Shop Your Way members.

In line with our commitment to these goals, we accelerated our efforts to improve our liquidity, financial flexibility and operational performance over the last few months.

In the fourth quarter, we achieved important milestones across a range of operational metrics. We continued to tightly manage our inventory and costs, which resulted in a notable improvement in our operating performance and Adjusted EBITDA. Our Home Services business continued to deliver solid results and enhanced its capabilities with a GoToAssist mobile solution that enables technicians to provide faster and better service.

Our Sears Auto Center business introduced new solutions – DieHard Edge Maintenance Plans and DieHard 360° assessment – designed to provide more security and protection for vehicle owners. We also launched the pilot of our "Digital Tire Journey", an innovative app-based service to help customers identify the appropriate tires for their driving preferences.

In November, our Kenmore brand won five "Best of Year Awards" from the distinguished and respected consumer organization "Reviewed.com". The awards spanned across Kenmore appliances for the kitchen, living room and laundry. We were honored to be recognized for our product innovations and have built on this achievement with the release of a number of new connected appliances, including a connected refrigerator and washer/dryer.

From a member engagement perspective, we are increasingly focused on expanding frequency of usage of Shop Your Way. We are doing this through targeted marketing and member engagement initiatives that leverage our data analytics and personalization capabilities. Meanwhile, we maintained member sales penetration at over 70 percent and continued to shift our marketing and promotional efforts from traditional channels to our Shop Your Way platform.

Notably, we announced a range of significant initiatives across our Shop Your Way strategic partnerships, including:

- the launch of our new Shop Your Way MasterCard with Citi, which offers an industry-leading 5-3-2-1 rewards program that allows members to earn Shop Your Way points everywhere they shop;

- a strategic partnership with Activehours to integrate the Shop Your Way rewards program into the Activehours mobile application, enabling members to earn points as they access their paychecks on demand;
- the expansion of our rider rewards program with Uber Technologies to a total of 25 markets, building on the successful launches in New York and Chicago; and
- the addition of many new participants to our Shop Your Way dining program, which now has over 30,000 restaurants, including Burger King, Popeye's, Shoney's and Restaurant.com.

In addition, our persistent management of expenses and inventory supported an improvement in operating performance and Adjusted EBITDA. Building on this momentum, we continue to sharpen our focus on profitable areas of our business to improve our financial performance and long-term competitiveness.

As announced in early January, we have initiated the closing process of 150 unprofitable stores, comprised of 108 Kmart and 42 Sears stores. On a trailing-twelve-month basis, these stores accounted for approximately $1.2 billion in sales and approximately $60 million in Adjusted EBITDA losses. In addition to shedding operating losses associated with these stores, we expect to generate cash from the liquidation of their inventory and related assets. The closures of these stores are expected to be completed by the end of the first quarter of 2017. While these are not easy decisions, we must maintain our focus on improving our operating performance to ensure the long-term competitiveness of our Company.

Demonstrating our commitment to this goal, we have initiated a comprehensive restructuring program that is expected to deliver at least $1.0 billion in cost reductions over the next year on an annualized basis, including savings from the previously-mentioned store closures. To capture these savings, we intend to execute a number of initiatives across the organization over the next year – these include the simplification of our organizational structure, greater integration of our Sears and Kmart operations, improved merchandising, supply chain and inventory management and other cost reductions, both in field and corporate functions.

We have begun executing some of these initiatives and are in the process of identifying specific actions for others to capture operational and cost efficiencies across the Company. These actions represent a change in how we operate and deliver value to our members – and, we believe, will enable us to become a more competitive, efficient and agile retailer going forward.

Moving to our financial flexibility…

Earlier this year, we also increased our liquidity by up to $1.0 billion, including $500 million in proceeds from our Secured Loan Facility entered into on January 4, 2017, and a secured standby letter of credit facility of up to $500 million announced last December. In addition, we recently reached an agreement to amend our asset-based credit facility, which further enhances our liquidity and financial flexibility.

Looking ahead, to further strengthen our financial flexibility, we are targeting a reduction of our debt and pension obligations of at least $1.5 billion in fiscal year 2017. We anticipate profitability and working capital improvements, as well as the proceeds from a number of completed and proposed transactions, will support these efforts.

In addition, we recently completed the previously announced sale of the Craftsman brand to Stanley Black & Decker in a strategic transaction. The sale provided Sears Holdings with $525 million in cash at closing and provides an additional $250 million in cash at the end of year three, as well as annual payments on future external sales of Craftsman. As part of this transaction, we have also reached an agreement with the Pension Benefit Guaranty Corporation ("PBGC") pursuant to which the PBGC consented to our sale of the Craftsman brand.

And finally, our Board of Directors has established a Special Committee to market certain real estate properties targeting at least $1.0 billion in proceeds.

I will provide more details on the sale of Craftsman, the PBGC agreement and recent real estate transactions shortly.

So, turning to slide 5…

While we delivered notable progress in our transformation during the fourth quarter, we have more work to do.

Given the closures of non-profitable stores announced earlier this year, we expect overall revenues to continue to decline, while operating performance is expected to improve as we continue to focus on profitability.

In addition, as I have mentioned, the recently announced restructuring program is targeting to reduce our cost base by at least $1.0 billion on an annualized basis.

We continue to make progress with the planning and execution of several initiatives to capture these savings over the next year, with reductions expected to begin in the first quarter of 2017. The implementation of structural changes to our operating model and value chain management will begin in the second quarter of 2017 and are expected to benefit our operating results thereafter.

In parallel, we will continue to optimize our product assortment by leveraging data analytics to better meet our members' preferences and build on our previous efforts to focus on our Best Categories. As you know, we have significantly reduced the size of our consumer electronics and pharmacy businesses over the past several years to focus on more profitable product categories, while continuing to offer our members a broader selection of products through our online platforms.

We believe these actions will deliver significant operational efficiencies, optimize our cost structure and enable us to become a more agile and competitive retailer.

As I referenced, we have a number of avenues to unlock value from our assets and create additional financial flexibility. These include our recently closed Craftsman transaction, the liquidation of the inventory and assets associated with previously announced store closures and the marketing of certain real estate properties targeting to raise at least $1.0 billion.

To further strengthen our financial position, we are planning to utilize the proceeds from these transactions, as well as profitability and working capital improvements, to reduce our overall debt and pension obligations by at least $1.5 billion in fiscal year 2017.

Over the last 12 years, our pension plan obligations have represented a notable portion of our annual cash use. During this period, Sears Holdings has contributed nearly $4.0 billion to the plan. The elevated levels of pension expense reflect the low interest rate environment. While we cannot speculate on the outlook for the interest rate curve, for modeling purposes, I will note that a one-percentage-point increase in the assumed discount rate would reduce our pension benefit obligation by approximately $500 million, as disclosed in our 2015 Annual Report on form 10-K.

Looking ahead, we expect to continue to meet our ongoing pension and broader financial obligations, while also supporting the growth of our Shop Your Way ecosystem.

Finally, we have additional financial resources consisting primarily of longer-term inventory-based financing capacity, as well as other short-term financings which are currently untapped.

Beyond the completed and proposed transactions I have outlined, we continue to evaluate our options to generate additional liquidity and improve our capital position through asset reconfiguration, refinancing and debt reduction.

We have a valuable real estate portfolio, which at the end of the fourth quarter comprised 1,050 leases with significant optionality, as well as 380 owned stores, many in prominent locations. We will continue to assess opportunities to right-size our store footprint and inventory levels aligned to our ongoing transformation to an asset-light integrated retail model. In late January, we monetized five Sears Full-line stores and two Sears Auto Centers for $72.5 million, and we recently received an additional $105 million in gross proceeds from the sale of three Sears Full-line stores, one owned and two leased, which we will continue to operate as Sears locations for a period of up to one year.

We continue to have a high degree of flexibility across our store leases as a result of minimal base lease commitments and renewal options.

Going forward, we will also continue to evaluate strategic options to unlock value from the Kenmore and DieHard brands and our Sears Home Services and Sears Auto Centers businesses through partnerships, joint ventures or other means.

While these actions were aimed at unlocking value and creating financial flexibility, we have also continued to work towards providing a more rewarding member experience.

As we improve our operational performance and enhance our liquidity, we believe we will be able to focus our investments to fund our strategic transformation and the evolution of our Shop Your Way ecosystem through value enhancing partnerships, compelling offerings and a seamless online and in-store shopping experience for our members.

Moving to slide 6, before I cover our financial results, I would like to provide more detail on our recently closed Craftsman transaction.

Through the transaction, Stanley Black & Decker purchased the rights to the Craftsman brand, including the development, manufacturing and sale of Craftsman-branded products globally. At the same time, we will continue to sell Craftsman products in our stores and online, using the same vendors we have always used to produce the high quality Craftsman products our customers are familiar with. Our perpetual license agreement grants us use of the Craftsman brand royalty free for 15 years and with a 3% royalty thereafter.

In addition, the transaction allows Sears Holdings to participate in the future growth of the Craftsman brand through annual payments of between 2.5% and 3.5% on new sales of Craftsman products by Stanley Black & Decker for the next 15 years. We expect these annual payments to be a meaningful revenue stream given increased availability of Craftsman products across untapped distribution channels.

Upon closing, Sears Holdings also received an initial upfront payment of $525 million in cash. The remaining $250 million in cash proceeds will be paid by Stanley Black & Decker three years from now.

In connection with the closing of the Craftsman transaction, Sears Holdings and the PBGC reached an agreement on the sale of the Craftsman-related assets that had been “ring-fenced” under the March 2016 pension plan protection and forbearance agreement.

We believe the Craftsman transaction and the related agreement with the PBGC are a great example of our ability to maximize value from our assets and enhance the financial flexibility of Sears Holdings. We will realize the benefits of these arrangements for many years to come, as we continue to participate in the growth of the Craftsman brand, while ensuring we continue to meet our pension obligations.

With that, I will review key measures of our fourth quarter financial results as outlined on slide 7.

As previously indicated, we demonstrated notable improvement in our Adjusted EBITDA for the fourth quarter despite continued revenue pressures.

The retail environment remained challenging in the last three months of our fiscal year and impacted our top-line. In addition, fewer operating stores compared to last year due to our efforts to exit underperforming locations resulted in tougher year-over-year comparisons on sales, while benefitting the bottom line.

As a result, fourth quarter revenue was $6.1 billion compared to $7.3 billion in the same quarter last year. The year-over-year decline in revenues was primarily driven by fewer Kmart and Sears Full-line stores in operation, which accounted for $596 million of the revenue decline, as well as a 10.3% decline in comparable store sales for the quarter, comprised of a decrease of 8.0% at Kmart and a decrease of 12.3% at Sears Domestic, which accounted for $555 million of the revenue decline.

Against revenue pressures, we continued to tightly manage our inventory and costs, which resulted in a notable improvement in our Adjusted EBITDA. Adjusted EBITDA was a loss of $(61) million in the fourth quarter of 2016, compared to a loss of $(137) million in the prior year fourth quarter. As a reminder, reconciliations of Adjusted EBITDA to the most directly comparable GAAP financial measures can be found in the appendix of this presentation and in today's earnings release.

Looking ahead, while there are some expenses that are more difficult to reduce than others, we believe that we have the opportunity to continue reducing costs by reengineering how we run the business, while also focusing our investments on improving the member experience to drive better overall results.

Moving to the next slide, I would like to review our financial capital position and provide an update on the actions that we have taken to enhance our financial flexibility to fund our transformation while meeting our financial obligations.

At the end of the fourth quarter, we had $286 million in cash, compared to $238 million at the end of fiscal year 2015. We ended the fourth quarter with no short-term borrowings as compared to $797 million in borrowings under our domestic credit facility at the end of the prior year’s fourth quarter. The total utilization under our credit facility was approximately $464 million, consisting of letters of credit outstanding, out of a total of $1.971 billion that was available under our revolving credit facility prior to the amendment we implemented after the end of the fourth quarter.

As announced in February 2017, we entered into an amendment to our existing asset-based credit facility, which reduces the aggregate revolver commitments from $1.971 billion to $1.5 billion, while implementing other modifications to covenants and reserves against the credit facility borrowing base that improve net liquidity. The amendment also provides additional liquidity in the form of a $250 million increase in the general debt basket from $750 million to $1.0 billion.

The smaller credit facility is consistent with reduced capital requirements, as we continue to transform to an asset-light, integrated retail model with reduced inventory levels, fewer physical stores and a greater online presence.

We believe these measures demonstrate our capability to generate the financial flexibility required to fund our business needs and meet our ongoing financial obligations, while we pursue our transformation and create value for stockholders, members and our Company.

At the end of the fourth quarter, we had total equity in inventory of approximately $2.9 billion. Merchandise inventories at January 28, 2017, were $4.0 billion compared to $5.2 billion at the end of last year, while merchandise payables at the end of the fourth quarter were $1.0 billion, down from $1.6 billion in the fourth quarter of 2015.

Total long-term debt, including capital lease obligations, was $4.2 billion at the end of the fourth quarter, compared to $2.2 billion on January 30, 2016.

With that, let's turn to today's final slide.

In summary, we made significant progress on our strategic initiatives and delivered notable Adjusted EBITDA improvement during the fourth quarter. At the same time, we continued to take decisive action to improve our short-term performance and strengthen our capital position, and laid out our plans to drive the next phase of our transformation.

In 2017, we will focus on four priorities:

First, the successful implementation of our comprehensive restructuring program, which is targeting at least $1.0 billion of annualized cost savings in 2017. We are reinventing the way we operate and provide value for our members through products and services. These actions will enhance our focus on profitability and help us become more competitive and agile over the near- and long-term.

Next, we are targeting a reduction in our outstanding debt and pension obligations of at least $1.5 billion for fiscal 2017 through improving profitability, asset sales, and working capital management. At the same time, we will continue to fund our business needs and transformation.

Further, we will continue to evaluate incremental options to optimize our capital structure, unlock value across our asset base and improve our operational performance. These include ongoing reviews of our strategic alternatives for our real estate portfolio, Kenmore and DieHard brands, as well as our Sears Home Services and Sears Auto Centers businesses. At the same time, we will continue to accelerate our focus on our best stores, best categories and best members.

Finally, we will continue to pursue the growth of our Shop Your Way platform through strategic partnerships and other initiatives to further enhance value for our members as we continue to drive our transformation.

We believe these strategic actions will enable us to accelerate our operational and financial performance and significantly improve our competitiveness over the long term. We are firmly focused on successfully executing our strategy and delivering our targets. We look forward to reporting progress.