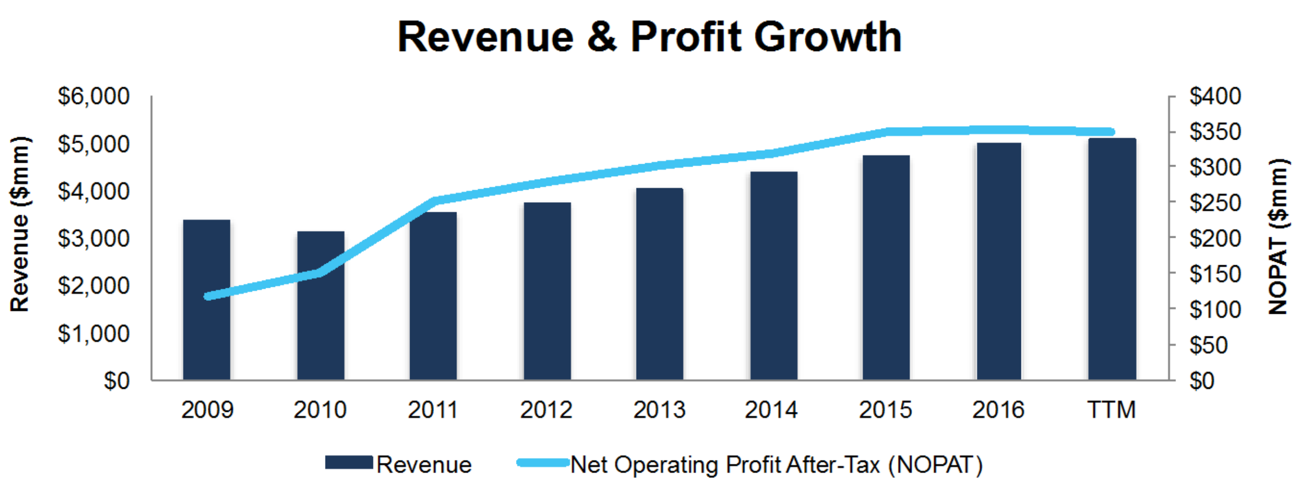
Long Idea: Williams Sonoma (WSM)

Lately, retail has been an unloved industry due to economic concerns coupled with the continued and growing pricing pressures of e-commerce. However, we think there are a few diamonds hidden in the retail rough. With a strong and growing e-commerce presence, history of profit growth, and an undervalued share price, Williams-Sonoma (WSM: $49/share) is this week's Long Idea.

William Sonoma's Growing Profits

William Sonoma's after-tax profit (NOPAT) has grown by 17% compounded annually since 2009 and by 12% compounded annually since 1998. The company's revenue has grown by 6% compounded annually since 2009 as well, per Figure 1.

Figure 1: Williams-Sonoma's Growing Profits



Sources: New Constructs, LLC and company filings

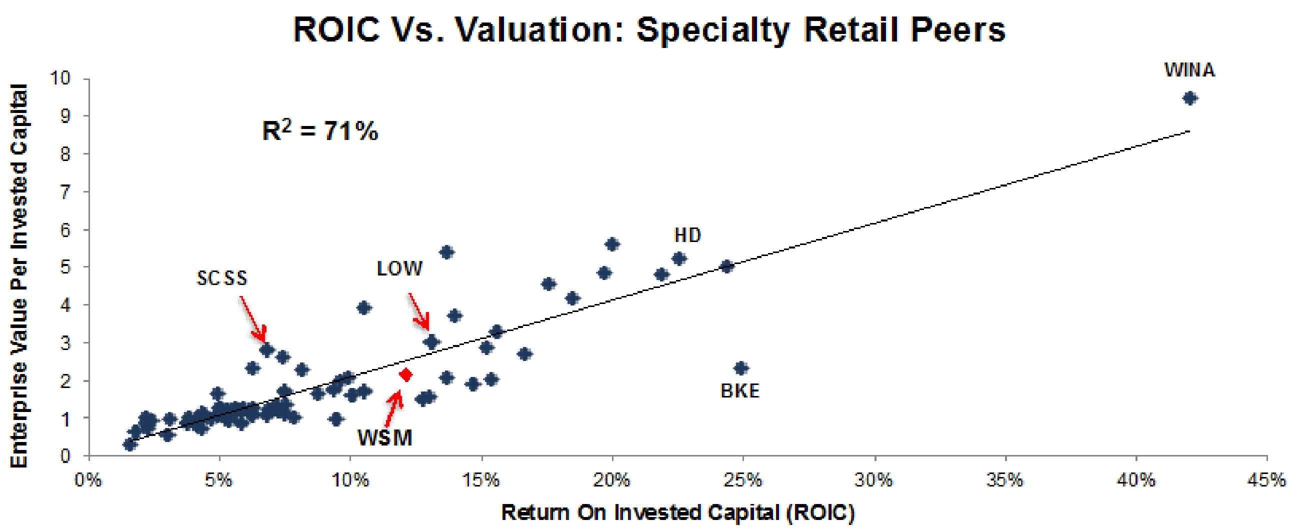
William Sonoma's NOPAT margin has doubled, from 3.5% in 2009 to 7.1% in 2016. Its return on invested capital (ROIC) has improved from 4% in 2009 to 12% TTM. Further highlighting the strength of WSM's business, the company has generated positive free cash flow every year since 2006 and a cumulative $1.1 billion in free cash over the last five years.

The profit growth achieved at WSM has come on the back of consistent revenue growth across the company's brands and not from one brand masking weakness in others. Since 2010, the Pottery Barn, Pottery Barn Kids, and PBTeen brands have grown revenue by 8%, 7%, and 8% compounded annually. The Williams-Sonoma, West Elm, and Other brands have grown revenue by 1%, 25%, and 35% compounded annually over the same time.

Improving ROIC Correlated With Creating Shareholder Value

William Sonoma's 12% ROIC is above the 8% average of the 81 Specialty Retail companies under coverage. Companies with a high ROIC tend to have wider moats and, on average, premium valuations. However, WSM has not been awarded such a premium valuation. Figure 2 shows that ROIC explains 71% of the changes in stock valuation for these 81 Specialty Retail companies. Note how undervalued WSM looks compared to peers.

Figure 2: ROIC Explains 71% Of Valuation for Specialty Retail Stocks



Sources: New Constructs, LLC and company filings

Williams-Sonoma's Profitability Tops Nearly All Direct Competition

Williams-Sonoma operates in multiple segments of retail sales including high-end furniture, furniture for kids and teens, home goods, home renovation, and personalized gift creation. The firm has multiple direct competitors: Bed Bath & Beyond (BBBY), Restoration Hardware (RH), and Haverty Furniture Companies (HVT), among others. As can be seen in Figure 3, WSM earns a higher ROIC and a higher NOPAT margin than all of its competitors, excluding BBBY. However, the trend in WSM and BBBY's fundamentals clearly signifies two businesses heading in opposite directions. BBBY's NOPAT has declined four of the past five years and its ROIC has fallen from 21% in 2012 to 13% TTM. Meanwhile, WSM's NOPAT has grown each year since 2012 and its ROIC was 12% in 2012 and remains 12% TTM.

Apart from BBBY, Williams-Sonoma recognizes the competitive advantage its increased profitability provides. Management notes "we are uniquely positioned to continue to acquire customers profitably without chasing our competitors with unprofitable investments." With greater margins comes increased pricing power and, as alluded to above, greater operating flexibility. WSM can be more selective about its growth opportunities and only pursue those with the greatest returns on invested capital.

Figure 3: Williams-Sonoma's Profitability

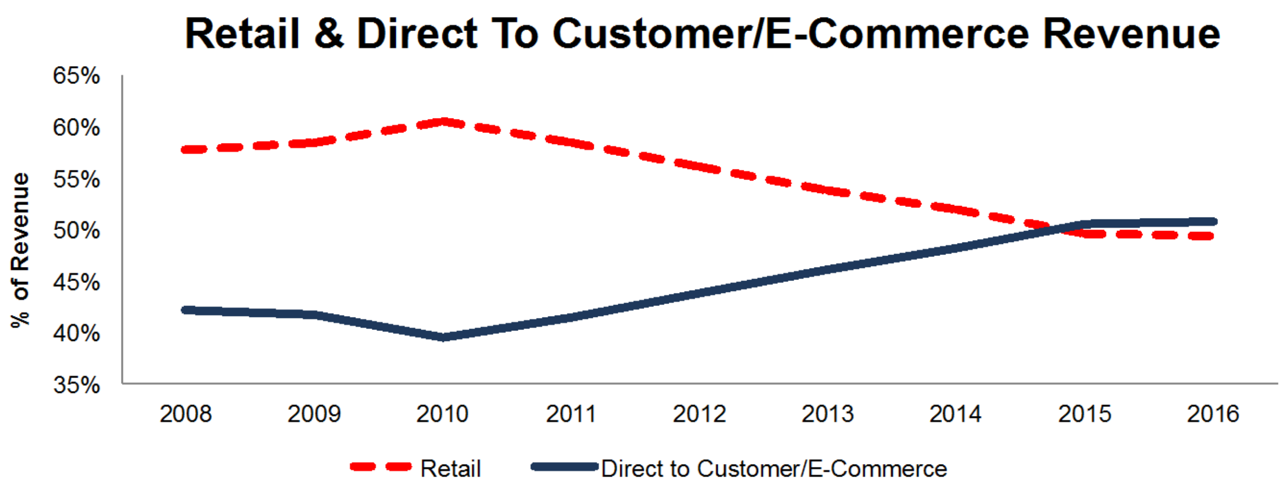
Company	Ticker	Return On Invested Capital	NOPAT Margin
Bed Bath & Beyond	BBBY	13%	8%
Williams-Sonoma	WSM	12%	7%
Restoration Hardware	RH	6%	5%
Haverty Furniture Companies	HVT	6%	4%
Kirkland's	KIRK	5%	4%
Pier 1 Imports	PIR	4%	4%

Sources: New Constructs, LLC and company filings.

Bear Case Ignores WSM's Ability To Compete Online

The largest bear concerns, as with any consumer discretionary firm, are (1) e-commerce will send profit margins to zero and (2) the consumer's ability to spend on non-essential goods. First, e-commerce is a strength at WSM as the company has grown its business through e-commerce. Per Figure 4, Williams-Sonoma's direct to customer/e-commerce revenues as a percent of revenue have been growing since 2010. In 2015, WSM's e-commerce revenues surpassed that of traditional retail revenues. Not only has Williams-Sonoma grown revenue by 6% compounded annually since 2009, it has done so by emphasizing e-commerce sales. Bears could argue e-commerce was threatening WSM's business model if either overall revenues were down, or the firm wasn't enjoying so much growth in its e-commerce segment. However, in either case, these arguments fall flat.

Figure 4: William-Sonoma's Revenue Breakdown

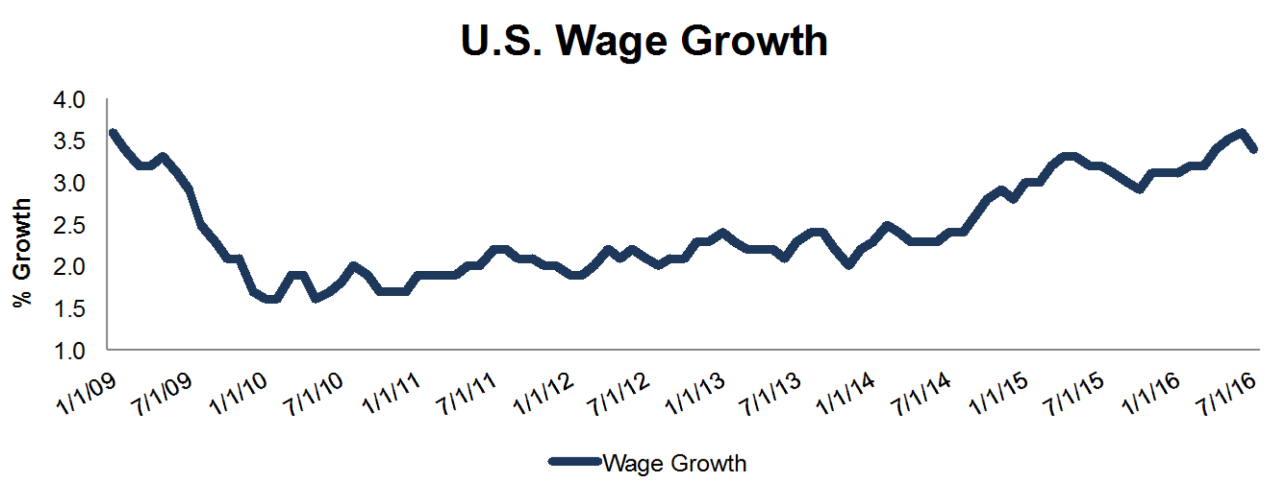


Sources: New Constructs, LLC and company filings.

Success in e-commerce leverages the attractive look and feel of the firm's traditional brick-and-mortar locations. From Williams-Sonoma's CEO, "the ability to physically experience our products allows our customers to know and trust our brands and make better shopping decisions. Our store is an important driver to sales across both the retail and e-commerce channels." When it comes to large purchases such as furniture, the physical aspect cannot be understated. WSM's intelligent approach to e-commerce turned a potential weakness into a strength.

When it comes to the macroeconomic concerns about consumer purchasing power, despite month-to-month fluctuations, the average wage growth in the United States continues to rise since bottoming in 2010, per Figure 5. As a discretionary retailer, WSM is reliant upon a strong consumer and continued wage growth could provide a positive backdrop for all retailers.

Figure 5: U.S. Wage Growth – 3-Month Moving Average



Sources: Federal Reserve Bank of Atlanta, Current Population Survey, and Bureau of Labor Statistics

Valuation Implies A Retail Crash

WSM is down nearly 16% year-to-date, as the market remains skeptical about retail in general. The price decline of WSM has created a disconnect between the fundamentals of the business and its share price. At its current price of $49/share, Williams-Sonoma has a price to economic book value (PEBV) ratio of 1.1. This ratio means that the market expects Williams-Sonoma's NOPAT to only grow by 10% over the remainder of its corporate life. This expectation seems awfully pessimistic for a firm that has grown NOPAT by over 10% compounded annually since 1998.

If Williams-Sonoma can maintain 2016 NOPAT margins of 7% and grow NOPAT by just 4% compounded annually for the next decade, the stock is worth $62/share today – a 27% upside. This scenario assumes that WSM can grow revenue by consensus growth rates in EY1 and EY2, and by 4% each year afterwards. 4% represents Kiplinger's 2017 estimate for retail sales and the compounded annual growth rate in retail sales over the past two years, as measured by NRF. This scenario also assumes that Williams-Sonoma's spending on working capital and fixed assets will be 2% of revenue, which is the average change in invested capital as percent of revenue over the past five years.

Buy Backs Plus Dividend Provide 7% Yield

In March 2016, WSM's board announced a new $500 million repurchase authorization with intentions to execute it over the next three years. In 1Q16, the company repurchased $41 million worth of stock and in 2Q16 it repurchased $36 million. These repurchases represent nearly 2% of WSM's market cap. If WSM continues its repurchase activity consistent with the first half of 2016, the company's remaining authorization will last another three years and the firm would repurchase $154 million in stock in 2016. $154 million represents almost 4% of WSM's market cap, which provides investors with a total yield of 7% when combined with Williams-Sonoma's 3% dividend yield. 7% compares pretty well with short and long-term interest rates available in the market.

Fundamental Strength And Innovation Could Propel Shares

While history is not always a reliable indicator of the future, we think Williams-Sonoma management's track record is impressive. Their ability to execute in e-commerce where others, like Wal-Mart (WMT), have struggled shows real leadership skills. We like management's strategies for continuing the profit growth:

(a) Adjust marketing mix to reach new customers,
(b) Bring in new products at different price points to spur increased interest in the brand, and
(c) Test new store concepts in its Pottery Barn brands.

We think management's focus on value creation means they will execute these plans well. We also think they are innovators that know how to build and maintain brand better than many of their peers. For example, the company recently announced a deal with online mattress retailer Casper to bring their online products into West Elm's physical stores. Not only does this deal provide Casper a brick-and-mortar presence, it also allows West Elm to expand its mattress offerings without significant investment. Finding innovative ways to provide an already popular product should only spur the already impressive revenue growth being achieved at West Elm. While these initiatives will take time to show results, and the economy continues it slow growth, investors are getting paid pretty well (7% per above) to invest in WSM.

Insider Purchases Are Null While Short Interest Remains High

Over the past 12 months, insiders have purchased zero shares and sold 356 thousand shares for a net effect of 356 thousand insider shares sold. This amount represents less than 1% of shares outstanding. Additionally, short interest sits at nearly 18 million shares, or 20% of shares outstanding. It's clear that investors are expecting the worst at WSM, despite the fundamentals of the business moving in the opposite direction. Any positive surprise against expectations could see a short-squeeze and send shares rising.

Executive Compensation Could Be Improved, But Raises No Alarms

Williams-Sonoma's executive compensation plan, which includes annual bonuses and long-term stock units, is largely tied to multiple metrics. Annual bonuses are awarded by achieving a target EPS goal along with individual performance goals, which vary by executive. Long-term stock units are awarded for achieving EPS and operating cash flow goals. While we would prefer to see executive compensation tied to ROIC, since there is a strong correlation between ROIC and shareholder value, WSM's current exec comp plan raises no alarms. Without a heavy focus on non-GAAP or management created metrics, WSM's compensation plan doesn't lend itself to easy manipulation that results in executives getting paid while shareholder value is destroyed. In fact, over the past decade, the company's economic earnings, the true cash flows of the business, have grown from $49 million to $179 million.

Impact of Footnotes Adjustments and Forensic Accounting

In order to derive the true recurring cash flows, an accurate invested capital, and a real shareholder value, we made the following adjustments to Williams-Sonoma's 2016 10-K:

Income Statement: we made $110 million of adjustments with a net effect of removing $42 million in non-operating expenses (<1% of revenue). We removed $76 million related to non-operating expenses and $34 million related to non-operating income. See all adjustment made to WSM's income statement here.

Balance Sheet: we made $1.7 billion of adjustments to calculate invested capital with a net increase of $1.3 billion. Apart from operating leases, a notable adjustment was $91 million (6% of net assets) related to asset write-downs. See all adjustments to WSM's balance sheet here.

Valuation: we made $1.5 billion of adjustments with a net effect of decreasing shareholder value by $1.5 billion. Despite this decrease in shareholder value, WSM remains undervalued. The largest adjustment to shareholder value was the removal of $1.5 billion in total debt, which includes $1.4 billion in off balance sheet operating leases. This operating lease adjustment represents 32% of WSM's market cap.

Attractive Funds That Hold WSM

The following funds receive our Attractive-or-better rating and allocate significantly to Williams-Sonoma.

1. State Street SPDR S&P Homebuilders ETF (XHB)– 4.4% allocation and Attractive rating
2. Monongahela All Cap Value Fund (MCMVX) – 3.4% allocation and Attractive rating
3. Papp Small & Mid Cap Growth Fund (PAPPX) –3.0% allocation and Attractive rating.
4. Goldman Sachs Focused Value Fund (GFVUX) – 2.5% allocation and Attractive rating.
5. ValueShares U.S. Quantitative Value ETF (QVAL) – 2.5% allocation and Very Attractive rating.

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Disclosure: David Trainer and Kyle Guske II receive no compensation to write about any specific stock, style, or theme.

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Our stock rating methodology instantly informs you of the quality of the business and the fairness of the stock's valuation. We do the diligence on earnings quality and valuation so you don't have to.

In-depth risk/reward analysis underpins our ratings. Our rating methodology grades every stock, ETF, and mutual fund according to what we believe are the 5 most important criteria for assessing the quality of an equity. Each grade reflects the balance of potential risk and reward of buying that equity. Our analysis results in the 5 ratings described below. Very Attractive and Attractive correspond to a "Buy" rating, Very Dangerous and Dangerous correspond to a "Sell" rating, while Neutral corresponds to a "Hold" rating.

QUESTION: Why shouldn't fund research be as good as stock research? Why should fund investors rely on backward-looking price trends?

ANSWER: They should not.

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2. Standard for all companies.
3. A more accurate representation of the true underlying cash flows of the business.

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