Activists Can Create Huge Value in This Retail Turnaround

Don't believe in the "Retail Apocalypse". Despite the constant stream of negative headlines, brick and mortar retail sales continue to grow at a steady rate, as do profits for many well-run legacy retailers. Nevertheless, e-commerce has devastated poorly-run retailers: companies with weak value propositions and management that allocates capital poorly.

Given the huge amount of value we think activists can create by bringing a better focus on capital allocation to this retailer, we're making Bed Bath & Beyond (BBBY: $17/share) this week's Long Idea.

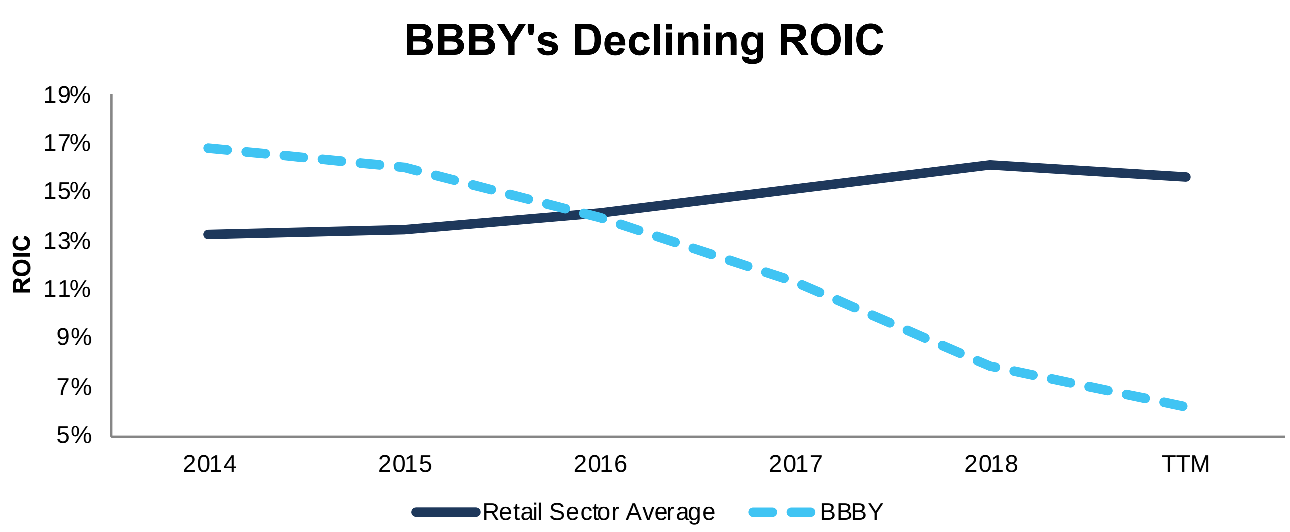
BBBY Is Ripe for an Activist-Driven Turnaround

Activist funds Legion Partners Asset Management, Macellum Advisors, and Ancora Advisors announced that BBBY was in their sights on March 26. Combined, the three funds hold ~5% of outstanding shares and are calling for a full refresh of the company's board. In their press release, the funds write:

"The Investor Group believes the magnitude of value destruction, coupled with the board's self-enriching mindset as evidenced by its excessive pay packages and failure to hold itself and management accountable, necessitate a change in a majority of the board at the Annual Meeting."

In particular, they single out the company's "alarming" decline in ROIC. Figure 1 shows that BBBY's ROIC has fallen from 17% in 2014 to just 6% over the trailing twelve months (TTM). Over the same time, the weighted average ROIC of the 117 other retailers we cover has actually increased from 13% to 16%.

Figure 1: BBBY ROIC vs. Retail Sector: 2014-Present



Sources: New Constructs, LLC and company filings

BBBY's peers in the home goods sector have shown greater resiliency in recent years. Williams Sonoma's (WSM) ROIC only fell from 13% in 2014 to 11% TTM, while RH (RH) actually increased its ROIC from 8% to 13%. The success of these competitors and the retail industry as a whole shows that BBBY cannot blame its problems on a struggling industry. The blame for the company's problems lies with management and the board of directors.

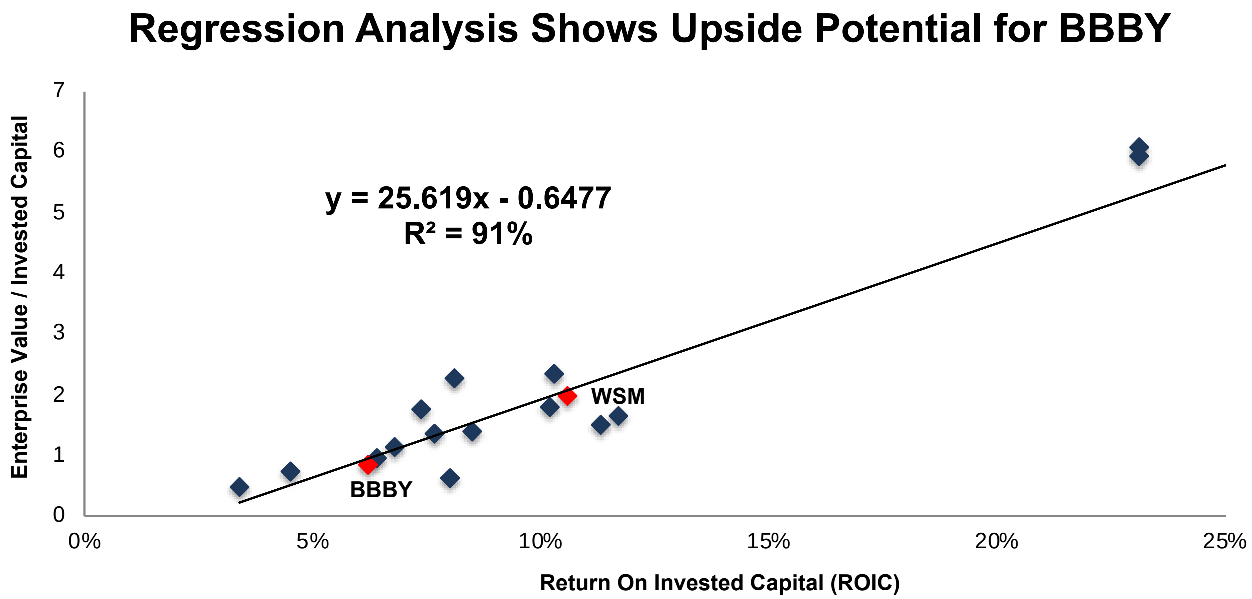
Important Disclosure Information is contained on the last page of this report.
The recipient of this report is directed to read these disclosures.

Improving ROIC Could Drive Significant Upside

Numerous case studies show that getting ROIC right is an important part of making smart investments. Ernst & Young recently published a white paper that proves the material superiority of our forensic accounting research and measure of ROIC. The technology that enables this research is featured by Harvard Business School.

Per Figure 2, ROIC explains 91% of the difference in valuation for the 18 retailers that BBBY lists as peers in its proxy statement. BBBY's stock is slightly undervalued compared to its peer group as evidenced by its position below the trendline.

Figure 2: ROIC Explains 91% of Valuation for BBBY Peers



Sources: New Constructs, LLC and company filings

If BBBY were to achieve the 11% ROIC of its direct competitor – WSM – the stock would be worth $80/share, a staggering 371% upside from the current stock price. Investors who think that level of upside is unrealistic should look at Best Buy (BBY) as an example of a specialty retailer that made drastic changes to turn around a struggling business. Since the beginning of 2013, when management started to focus on ROIC, BBY is up 487%.

Figure 3 details potential valuation scenarios for BBBY based on improvements to its ROIC. Even if the company can just maintain its current level of profitability, the stock has 28% upside from current levels. If it can regain its average ROIC over the past 10 years, it could be worth as much as $133/share.

Figure 3: Value Creation Potential for Activists

	Maintain Current Profits	Match WSM	Regain 10-Year Average
ROIC	6%	11%	15%
Implied Share Price	$22	$80	$133
% Gain	28%	371%	686%
Gain vs. Current Market Value ($mm)	$648	$2,336	$15,932

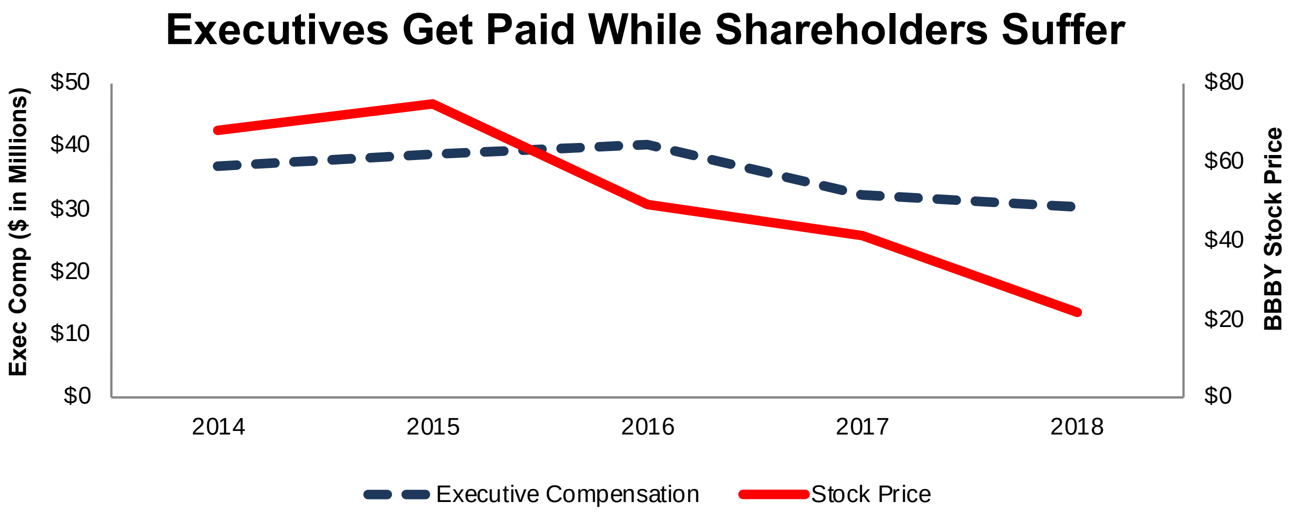
Sources: New Constructs, LLC and company filings

We don't necessarily think the third-scenario is all that likely, but it demonstrates the magnitude of upside potential that we think will keep activists engaged. BBBY has become so cheap that the potential upside, even with slight operational improvement, is enormous. The obstacle to each of these scenarios coming to fruition is the misalignment of the current management team with shareholder value creation.

Misaligned Corporate Governance Lacks Accountability & Independence

Despite the steep decline in the company's profitability, BBBY's executives have been paid handsomely. Figure 4 shows the company's key executive officers have earned ~$180 million (8% of current market cap) in compensation over the past five years as the stock has fallen by ~75%.

Figure 4: BBBY Exec Comp vs. Stock Price: 2014-2018



Sources: New Constructs, LLC and company filings

Total compensation did fall in 2017 and 2018, but that's only because the falling stock price decreased the value of stock-based compensation. Executives still managed to earn 100% of their performance-based stock awards in each of the past two years, even though those awards are tied to ROIC (which is normally a positive). Executives managed to hit their bonus targets despite the company's declining profitability through two flaws in the program's design:

1. **Using Three-Year ROIC:** Three-year ROIC can be a useful measure for some companies, but for BBBY it simply allows executives to benefit from the company's previously high profitability without holding them accountable for the recent steep decline.
2. **Manipulating the Peer Group:** For executives to earn their full bonus, the company's three-year ROIC must exceed the average of 41 retail peers. This peer group used to be 46 companies, but BBBY removed five peers from the list in 2017: Starbucks (SBUX), Advance Auto Parts (AAP), Auto Zone (AZO), O'Reilly Automotive (ORLY), and Genuine Parts Company (GPC). These five companies have an average ROIC of 17%. By removing these highly profitable peers, BBBY lowered the bar for executives to hit their bonus targets.

To make matters worse, BBBY still includes AZO, AAP, and ORLY in the peer group it uses to determine the total value of executive compensation. The company is effectively saying that its executives should be paid like these peers even though they don't have to perform as well.

Despite claiming to focus on ROIC at its top levels, BBBY does not appear to foster a culture that emphasizes ROIC. Executives never discuss ROIC on earnings calls, and the activist group noted that the company's store managers do not have any portion of their compensation tied to ROIC or any other profitability metric. However, these employees have more influence and responsibility than store managers at almost any other retail chain.

BBBY shows the importance of independent, 3rd party measurement of performance metrics tied to executive compensation. By measuring its own ROIC and defining its peer group, BBBY can manipulate its targets to remove accountability for executives.

We always encourage companies to tie executive compensation to ROIC, but BBBY shows that using the metric alone is not enough. You also need to have adequate targets, independent third-party measurement, and a corporate culture that emphasizes effective capital allocation in all major decisions.

Turnaround Efforts Have Failed Despite Management's Claims Otherwise

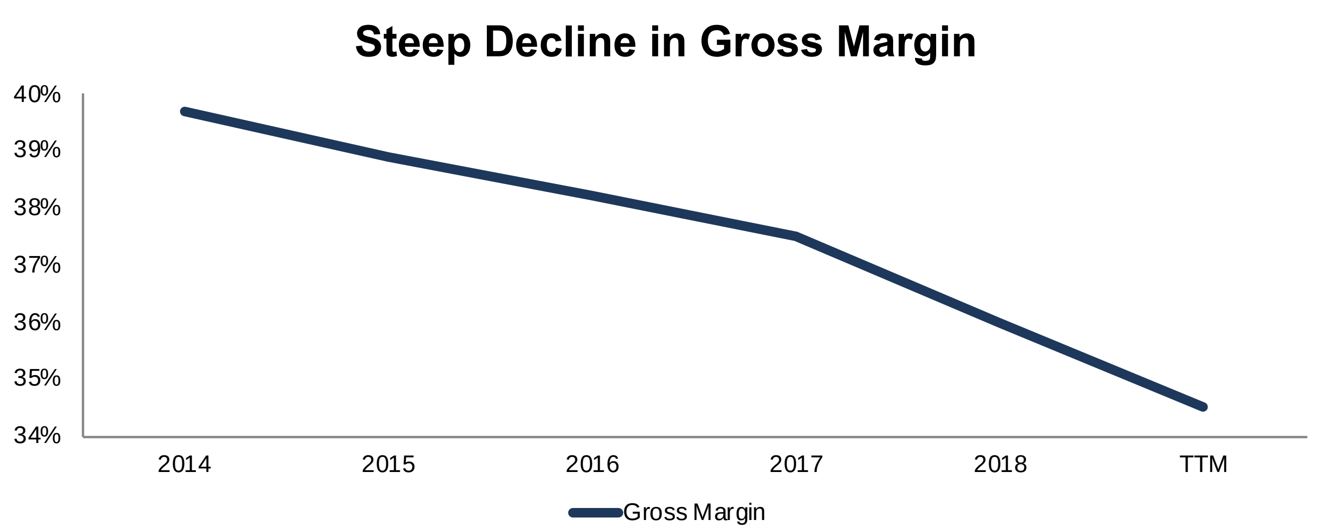
BBBY's executives responded to the activist group by claiming they are already aware of the problems highlighted by the investors and are taking steps to address them. In a press release, the company wrote:

"many of the areas highlighted by the Activist Group in its press release are already being addressed at a detailed level by the Company."

However, the data clearly shows that the company – despite its claims – has not made meaningful progress addressing these issues. We identified several problems highlighted by the activist group that are getting worse under current management, including:

- **Inefficient Merchandise Strategy:** BBBY's decentralized corporate structure – in which store managers order 70% of their store's products – has led to the company stocking an overwhelming array of products. Often, these products are similar items from different suppliers. From 2014 to 2018, the number of suppliers the company uses increased from 8,300 to 11,100 (a 34% increase), while revenue grew by just 7%. The company is making its supply chain more complex and its shelves more cluttered without adding any real value to consumers.
- **Rising SG&A:** In September 2017, CEO Steven Temares announced a cost-cutting plan to save $150 million over the next few years. Instead, SG&A as a percentage of revenue has risen from 28% in fiscal year 2017 to 32% over the past nine months.
- **Reliance on Promotional Activity:** Instead of enhancing the value proposition of the stores, BBBY has relied on excessive discounting in order to get customers in the door. This practice has led to a decline in gross margins from 40% in 2014 to 35% TTM, as shown in Figure 5.

Figure 5: BBBY Gross Margin: 2014-TTM



Sources: New Constructs, LLC and company filings

In other areas, we cannot assess the progress that management has made due to lack of transparency. The company does not disclose numbers for its online sales, saying only that they experienced "strong growth". In addition, they do not give concrete numbers to measure the success of recent initiatives such as private-label brands, new store formats, and interior design services.

If these management initiatives were actually successful, we'd expect full transparency so they could tout the numbers far and wide. The lack of transparency in these areas suggests that they are struggling just as much as they struggle with the issues for which we do have data.

Despite all these concerns, Temares told investors that the company was “ahead of plan” on its most recent earnings call. If BBBY’s dismal operating results are “ahead of plan”, it might be time for a new plan.

BBBY Still Has Value to Be Unlocked

Despite its recent struggles, BBBY averaged a 15% ROIC over the past decade. Years of mismanagement have not destroyed many of the valuable assets that allowed it to succeed in the past, including:

- **Brand Value:** While current management has struggled to draw foot traffic into stores, they haven’t diminished BBBY’s overall reputation with consumers. A YouGov survey ranks BBBY as the 9th most popular specialty retailer, and the company ranks 51st out of all consumer brands in the Temkin Experience Ratings, right next to highly successful retailers O’Reilly Auto Parts (ORLY) and Home Depot (HD).
- **High-Touch Industry:** The home goods and furnishings business is much more personalized and high-touch than most retail segments. Consumers want to test out furniture and be able to visualize how it would fit in their home. These purchases are also often tied to major life events (going to college, couple moving in together, etc.) that make consumers want a more personalized approach rather than an anonymous online shopping experience.
- **Rising Demand:** Research and Markets expects the global home décor market to grow by 4% compounded annually through 2023. The continued housing recovery and growing urbanization should contribute to rising demand for BBBY’s products.

These qualities remind us a great deal of Best Buy (BBY), another specialty retailer that rebounded spectacularly after being left for dead. From 2007-2013, Best Buy’s ROIC declined from 16% to 7%, and its stock price fell by almost 80%. However, Best Buy rebounded with its “Renew Blue” strategy that focused on making its stores more experiential and divesting non-core businesses to focus on its core competencies.

Since the end of 2012, Best Buy’s ROIC has rebounded back to 16%, and its stock is up almost 500%. Bed Bath & Beyond shares jumped almost 25% after the activists announced their stake, but the example of Best Buy shows the upside potential is much higher.

Activists Have A Strong Track Record

The track record of the activists taking on BBBY – Legion Partners Asset Management, Macellum Advisors, and Ancora Advisors – should give investors confidence. These funds have established track records of turning around struggling consumer companies.

We’ve written before about the success Macellum had in turning around The Children’s Place (PLCE). Macellum pushed PLCE to focus on ROIC and improve its inventory management. Since Macellum announced its activist position in PLCE on March 11, 2015, the stock is up 69% compared to the S&P 500 up 40%.

Legion can claim similar success in its campaign against Chef’s Warehouse (CHEF), a specialty foods distributor. Legion focused on improving transparency and independence in the company’s corporate governance and pushed the company to adopt ROIC as part of its executive compensation. Since Legion announced its activist stake on January 26, 2017, CHEF is up 97% vs. the S&P 500 up 25%.

With their track record of creating value for shareholders by optimizing retail operations and improving corporate governance, the activist group appears well positioned to lead a turnaround at BBBY.

Bear Case: Competitive Threat Is Overstated

Bears will argue that BBBY’s issues are not specific to management and the activists are wasting their time and money. Instead, they believe the company simply can no longer compete against the scale of Amazon (AMZN) and retail giants like Walmart (WMT) and Target (TGT) that are getting into the home décor segment.

We believe the success of RH and WSM in the home décor business, as well as the turnaround at Best Buy, shows a clear path to success for BBBY with new management. If the company makes the changes activists recommend, it will be well-positioned to address the competitive pressures from these larger peers.

For example, analysts have argued that BBBY can’t compete with Amazon on price. However, if the company cut costs by closing underperforming stores and reducing the redundancy in their inventory, they would be better able to match prices. The activist group also believes BBBY can convey the quality of its deals to consumers in a more efficient manner than its current strategy of flooding the market with coupons.

BBY has also been losing market share to WMT and TGT in recent years as customers have been less motivated by the company's coupons. The solution is for BBBY to focus on delivering a customer experience that these more general retailers can't match. BBBY can make its stores more experiential by showcasing model rooms, providing interior design services, and having specially-trained employees answer questions and provide advice to consumers.

If the company implements the changes that the activists recommend, it should be able to build a defensible moat where it can remain competitive on pricing while providing a level of focused service superior to AMZN, WMT, and TGT. This moat would allow BBBY to reverse its declining profitability and regain an ROIC closer to its peers.

BBBY Is Priced for Permanent Profit Decline

The long-term decline in BBBY's stock price means the company is extremely cheap even after the recent pop. The company looks cheap by traditional metrics with a P/E of 7 and a price to book of 0.8, but our analysis of its cash flows suggests that it's even cheaper than the market believes. At $17/share, BBBY has a price to economic book value (PEBV) ratio of 0.4. This ratio means the market expects BBBY's after tax operating profit (NOPAT) to permanently decline by 60%.

That valuation may be fair if the company's continues with its current plans, but if activists succeed in implementing their turnaround plans, there's tremendous upside. Even if the company can simply maintain NOPAT at TTM levels, the stock is worth $46/share today, a 174% upside.

To truly understand the upside potential at BBBY, we modeled a plausible outcome for the company's future profits if the activists successfully implement their turnaround plan. Our DCF model conservatively assumes:

- Revenues decline in the first 3 years as the company closes underperforming stores before growing by 2% annually in years 4-10.
- NOPAT margins gradually rise from 4% TTM to 7% (equal to 2017 margins) in years 5-10.
- The company earns a long-term ROIC of 11%, equal to WSM.

In this scenario, the stock is worth $106/share today, a 524% upside to the current stock price. See the math behind this dynamic DCF scenario.

The DCF model backs up what our ROIC regression suggested earlier. It won't take much fundamental improvement for investors to make a significant profit on BBBY.

What Noise Traders Miss With BBBY

These days, fewer investors focus on finding quality capital allocators with shareholder friendly corporate governance. Instead, due to the proliferation of noise traders, the focus tends toward technical trading tends while high-quality fundamental research is overlooked. Here's a quick summary for noise traders when analyzing BBBY:

- Fundamental decline is company-specific rather than related to industry trends
- Activist investors have clear plans to address the company's issues
- Valuation implies a permanent 60% decline in profits and gives BBBY significant potential upside

Activist Success Could Boost Shares

In the short term, BBBY will probably be driven by the outcome of the activist campaign. If the activists succeed in replacing the board with their own nominees and bringing in their own CEO, that should provide a significant boost to the share price.

Over the longer term, improvements in ROIC should drive the share price. As Figure 2 showed, valuations in the specialty retail sector are very highly correlated with ROIC, so we expect the market to recognize any fundamental improvements that activists are able to bring about.

Share Repurchases Plus Dividends Provide Nearly 9% Yield

BBBY has increased its dividend in each of the past three years. Its annualized dividend has grown from $0.50/share in 2016 to $0.64/share in 2018, or 13% compounded annually. The current dividend provides a 3.8% yield.

In addition to dividends, BBBY returns capital to shareholders through share repurchases. Over the past year, BBBY has bought back $115 million (4.9% of market cap) worth of shares. Combined with the dividend, BBBY's buybacks give the stock an impressive yield of almost 9%.

With a free cash flow yield of 13% and almost $400 million (17% of market cap) in excess cash, BBBY has plenty of cash available to fund further share repurchases or an increased dividend. The activists also plan to close stores, sell off non-core businesses, and reduce inventory, which could free up further capital to be returned to shareholders.

Insider Trading and Short Interest Trends

There is little insight to be gained from recent insider trading trends, as they have been minimal. Over the past 12 months, 170 thousand shares have been sold and 40 thousand have been purchased for a net sale of 130 thousand shares. These sales represent less than 1% of shares outstanding.

Short interest trends are more insightful. As of March 15, there were 46.5 million shares sold short, which equates to 34% of shares outstanding and 10 days to cover. Short interest has more than doubled over the past year.

This high short interest likely explains part of the stock's gain on the day the activists announced their stake. It will be interesting when we get updated numbers to see how many shorts covered that day, and how many shorts remain for a potential squeeze in the future.

Critical Details Found in Financial Filings by Our Robo-Analyst Technology

As investors focus more on fundamental research, research automation technology is needed to analyze all the critical financial details in financial filings. Below are specifics on the adjustments we make based on Robo-Analyst[1] findings in Bed Bath & Beyond's fiscal 2018 10-K:

Income Statement: we made $292 million of adjustments, with a net effect of removing $158 million in non-operating expense (1% of revenue). We removed $67 million in non-operating income and $225 million in non-operating expenses. You can see all the adjustments made to BBBY's income statement here.

Balance Sheet: we made $2.8 billion of adjustments to calculate invested capital with a net increase of $2.5 billion. The most notable adjustment was $2.6 billion in off-balance sheet debt due to operating leases. This adjustment represented 52% of reported net assets. You can see all the adjustments made to BBBY's balance sheet here.

Valuation: we made $4.5 billion of adjustments with a net effect of decreasing shareholder value by $3.7 billion. Despite this decrease in value, the stock remains undervalued. You can see all the adjustments made to BBBY's valuation here.

Attractive Funds That Hold BBBY

The following funds receive our Attractive-or-better rating and allocate significantly to Bed Bath & Beyond.

1. SkyBridge Dividend Value Fund (SKYIX) – 2.6% allocation and Very Attractive rating.
2. Oppenheimer S&P Ultra Dividend Revenue ETF (RDIV) – 2.4% allocation and Attractive rating.

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

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[1] Harvard Business School features the powerful impact of our research automation technology in the case New Constructs: Disrupting Fundamental Analysis with Robo-Analysts.

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To fulfill the Duty of Care, research should be:

1. **Comprehensive** - All relevant publicly-available (e.g. 10-Ks and 10-Qs) information has been diligently reviewed, including footnotes and the management discussion & analysis (MD&A).
2. **Un-conflicted** - Clients deserve unbiased research.
3. **Transparent** - Advisors should be able to show how the analysis was performed and the data behind it.
4. **Relevant** - Empirical evidence must provide tangible, quantifiable correlation to stock, ETF or mutual fund performance.

Value Investing 2.0: Diligence Matters: Technology is Key to Value Investing With Scale

Accounting data is only the beginning of fundamental research. It must be translated into economic earnings to truly understand profitability and valuation. This translation requires deep analysis of footnotes and the MD&A, a process that our robo-analyst technology empowers us to perform for thousands of stocks, ETFs and mutual funds.

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