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Kohl’s: Deteriorating credit profile, macro headwinds, and mixed event risk

Kohl’s first quarter came in somewhat weak, with sales declining 5% and net income of $14 million (.11 EPS). Seasonally, Q1 is the weakest quarter for Kohl’s, but sales are still not fully back to pre-pandemic levels. The company faced headwinds in the form of poor weather, inflationary pressures, supply chain constraints, and government stimulus wearing off. Inventory was up 40% quarter over quarter due to Sephora store openings, in-transit inventory, and pack & hold for holiday sales. Gross Margin fell 70 basis points to 38.3% compared to Q1 2021 primarily due to higher freight costs. The company plans to repurchase $1 billion of stock in 2022, in addition to dividends of $300 million for the year. A bright spot in the quarter was the strength in Sephora stores. Stores that include Sephora delivered positive low-single-digits comparable store sales growth. Currently, company strategy is to make further investments in Sephora stores. Kohl’s currently has 200 Sephora locations and plans to build another 400 by the end of summer. In addition to Sephora beauty, Kohl’s is focused on popular active and casual clothing brands to appeal to younger consumers. At the beginning of June, Kohl’s entered a three-week negotiation period with Franchise Group to finalize the acquisition of Kohl’s by Franchise group for $60 dollars per share. Franchise Group planned to do a significant number of sale-leasebacks with Kohl’s real estate to pay for most of the acquisition. In July, the negotiations fell through after Franchise Group tried to lower the acquisition price to $50.

The macro environment remains very challenging for Kohl’s. Consumer Discretionary and Retail is an extremely competitive market. Inflation levels not seen since the 1970s is putting significant pressure on the consumer. In Q1 we have seen the consumer prioritize basic expenses like food and fuel over discretionary spending. Grocery store sales increased 8.3% in June and 8.4% in Q2 compared to the prior period. On the other hand, department store sales declined 0.2% in May and 2.9% in June compared to the prior period. This is likely to continue as long as the inflationary environment persists. Supply chain bottlenecks have also caused inventory issues and created challenges for companies to keep balanced inventory levels. Retail has also had to compete with the rise of e-commerce throughout the last decade. Department stores have struggled to modernize and match the availability and convenience found in e-commerce. Non-store retail sales increased 9.6% year over year in June and 8.6% in Q2, highlighting the popularity of online sales. The secular trend towards e-commerce will continue to present a challenge to retailers. It is difficult for discretionary retailers to survive, let alone thrive against the e-commerce companies. Some have adapted and maintained profitability, but others have seen sales stagnate and profitability decline significantly, most notably JC Penney.

As mentioned earlier, Franchise Group was looking to acquire Kohl’s, but the discussions were called off after Franchise Group lowered their bid to $50 dollars per share. In wake of this news, the bond price declined significantly due to a mix of fear regarding more shareholder friendly actions by management and poor market sentiment. The company reiterated its $500 million accelerated share repurchase program to be completed in Q2. Activist investors have also been pushing Kohl’s to increase sales and cut costs. Some ideas to accomplish this have been sale-leasebacks, a spinoff of the e-commerce business, and selling itself. A sale could be credit positive if the company is downgraded due to the change of control covenant which would allow bondholders to redeem at 101% of par. In May, the entire board was re-elected, so strategy isn’t likely to change in the short term. Kohl’s has expressed their desire to create shareholder value and these negotiations are evidence that they would be open to a sale in the future. Spreads have widened but have room to widen further.

Kohl’s strategy of expanding Sephora has generated positive results. Sephora stores have generated stronger operating metrics than non-Sephora stores. The combination of clothing and beauty offerings creates a better customer experience than one or the other, as well as a larger store with more sales opportunities. The company has also optimized its rewards program. Promotions are more targeted towards what certain customers are buying rather than just general coupons. This should help sales volumes but could cause some margin pressure as promotions are utilized more. Inventory has increased quite a bit sequentially, but much of that is due to new store openings. Despite these operational successes, e-commerce and online sales growth have continued to outpace retail sales growth since the coronavirus pandemic. Kohl’s does have an e-commerce business, but it is only 30% of sales.

In terms of leverage, Kohl’s is relatively well positioned at 2.5x Net Debt/EBITDA. In addition, Kohl’s has a significant real estate portfolio which gives the credit very high asset protection. The company is rated investment grade BBB- by Fitch and S&P and Baa2 by Moody’s. Recently, S&P changed its outlook from stable to negative citing limited capacity for a less conservative financial policy barring a return to meaningful profit growth. The company is shareholder friendly, however under current management it is likely capital returns will be funded by excess cash and not debt or sale-leasebacks. If macro fundamentals were to improve, I expect the company will evaluate offers and do what is in the best interest of shareholders. M&A activity or an increase in leverage to 3x Net Debt/EBITDA could trigger a rating downgrade which would mean a crossover into High Yield. Additional issuance is likely in late 2022 or early 2023 to provide working capital and refinance some current issues maturing in 2023.

Regarding ESG, Kohl’s is an industry leader in its environmental policy. In 2014, the company published its goal of reducing all scope 1 and scope 2 carbon emissions by 50%. This includes direct and indirect emissions. The emission goal was completed at the end of 2021, 4 years ahead of schedule. The company has received numerous awards for its progressive policies and has been a member of the Dow Jones Sustainability Index since 2018. Social initiatives include support for Diversity & Inclusion, Philanthropy, Workplace benefits & resources, and working with suppliers to create an ethical supply chain. Governance is solid as well; Kohl’s has been recognized as one of the World’s Most Ethical Companies by the Ethisphere Institute since 2019.

In conclusion, Kohl’s is doing well on an operational level in the face of considerable macro headwinds. The company has significant asset value and steady performance apart from the coronavirus recession. This story is more interesting from an equity perspective, as the company seems very cheap compared to book value. Prospective buyers see this discount and think they can extract value through an acquisition. However, it seems highly uncertain from a credit perspective. If we see a recession, spreads widen because Kohl’s is very exposed to the consumer and cyclical by nature. If economic conditions improve, Kohl’s spreads should tighten, but an acquisition could be positive or negative. If the company gets downgraded to BB+ after being acquired change of control takes effect and bondholders can redeem. However, if the company maintains Investment Grade, new management will likely implement aggressive changes which could hurt the credit profile. In a soft recession, Kohl’s likely maintains profitability and keeps leverage stable to maintain BBB-. I recommend underperform due to macro headwinds, mixed event risk, and a highly cyclical business model that is recession sensitive.