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Not so 'cheep'

Irwin L. Jacobs, the Minneapolis entrepreneur who earned the moniker "Irv the Liquidator" in the 1970s, tells *Grant's* that the clogging of unsold merchandise in retail channels "far exceeds anything I've seen in my 50 years in the business." With that authoritative observation in mind, we turn to the closeout retailing business in general and to Ollie's Bargain Outlet Holdings, Inc. (OLLI on the Nasdaq) in particular. On Ollie's, perhaps the greatest retail stock of the 21st century, we make bold to be bearish.

The closeout business is off-price retailing without the frills. Like the cigar-butt investor, the closeout merchant finds stock where it's cheapest: in discontinued merchandise, canceled orders, modified orders, liquidations. He buys low, sells a little higher. He caters to value-minded customers but also (at least in the case of Ollie's) to momentum-minded investors.

Ollie's was founded in Harrisburg, Pa., in 1982 and built its first store in nearby Mechanicsville. It takes its name from one of its four co-founders, Oliver Rosenberg, a beloved local real-estate investor and entrepreneur who happened to be the spitting image of Albert Einstein. Rosenberg lives on in caricature as the face of Ollie's. He's the cut-up who's driving the jeep (labeled "cheep") in a promotional cartoon urging shoppers to enlist in "Ollie's Army"—spend a dollar, earn a reward point. Ollie's Army is more than eight million strong.

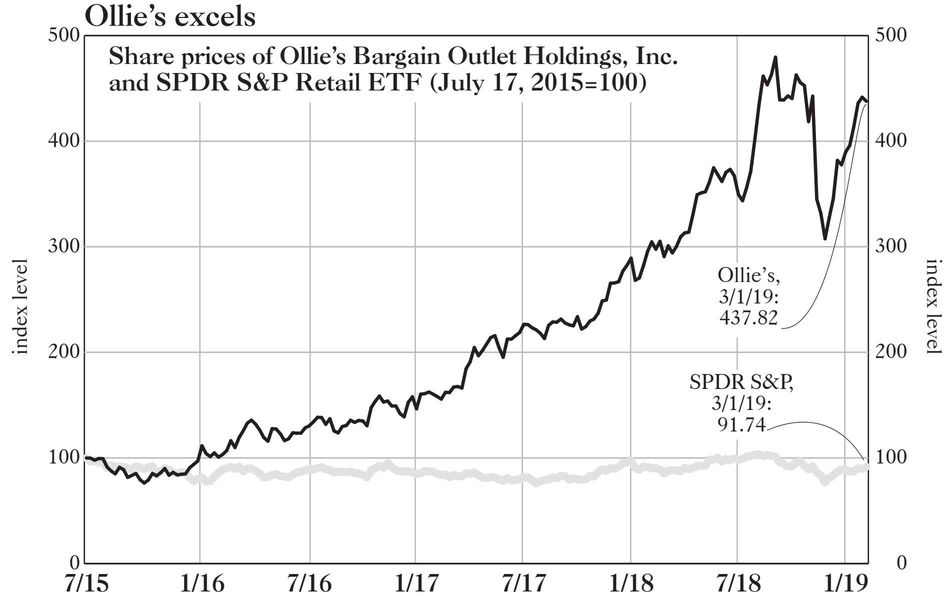
Ollie's went public in July 2015 at $16.00 a share. From that day till this, the stock has returned 58.4% a year compared with minus 1.3% for the SPDR S&P Retail ETF and 10.3% for the S&P 500. At a price of $85.5 each, the shares command a $5.4 billion market cap and Mr. Market's deep (if sometimes fickle) admiration, expressed in the trailing price-earnings ratio of 52 times and the forward one of 43 times. Unless something has gone terribly wrong, Ollie's will shortly report its 19th consecutive quarter of positive comparable-store sales.

"It's the hundred-billion-dollar opportunity that only a couple hundred millions have been invested in," says Burt P. Flickinger, III, paid-up subscriber and founder and managing director of retail consulting firm Strategic Resource Group, of the closeout business in general. "While the rest of retail is going through a retail ice age, and ultimately an epic retail collapse that'll trigger a recession of epic proportions in the U.S. and elsewhere, everybody's missing mining for the last major vein of gold left in all of the U.S. and worldwide retail."

It took Ollie's two decades to build its first 28 stores. Since 2003, when Mark Butler, another Ollie's co-founder, assumed command, the store count has vaulted to 309 in 23 states with new openings coming at the rate of three to four per month, each bearing a price tag of about $1 million. Ollie's doesn't sell online, and all its locations but one are leased.

"There are only about a thousandth of the number of closeout stores that satisfy the demand to close out all the merchandise and the consumer demand for closeouts, because in 2019 the U.S.

Ollie's excels



source: The Bloomberg

consumer is paying higher prices in all 10 monthly key expenditure areas," Flickinger declares. "The only place the consumer can save is closeout and off-price merchandise for essentials."

Lest there be any doubt, Ollie's is a wonderful success story. However, to borrow from Warren Buffett, at a very low price most businesses can be a good investment, but at an excessively high price every business can be a bad investment. We submit that the Ollie's share price is excessively high.

As no proper bear case rests on valuation alone, our bill of particulars goes well beyond that FAANG-like multiple. Among its highlights: rising competition, operational shortcomings, low inventory turnover, high exposure to financially vulnerable consumers and accounting problems.

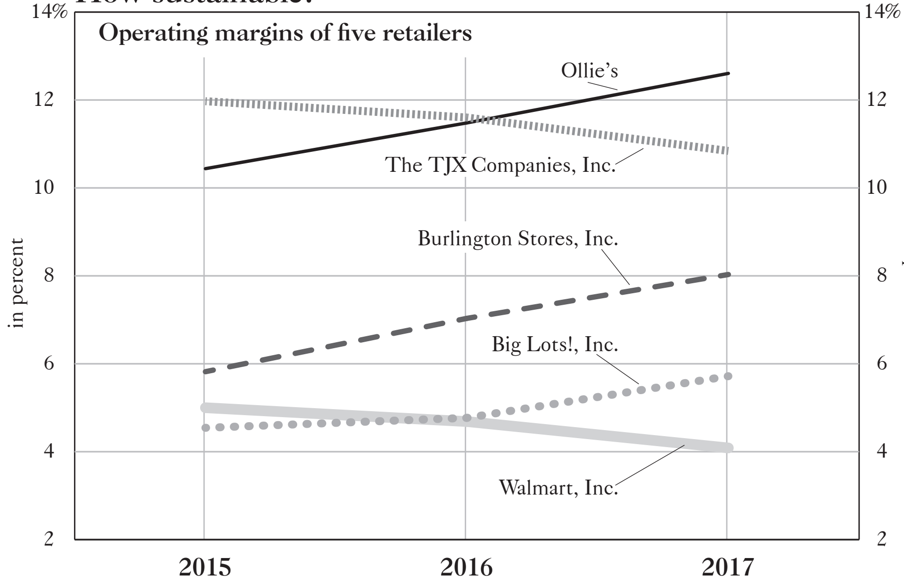
Ollie's picks its locations as opportunistically as it does its merchandise. When Kmart or Toys "R" Us or Payless moves out, Ollie's may move in. The shopping experience resembles—is intended to resemble—a treasure hunt.

"Miscellaneous" is the merchandising theme. On the hunt, you'll see blankets, pillows, kitchenware, George Foreman grills, toys, lots of rugs; also, toothbrushes, deodorant, shampoo, K-cup coffee pods, peanuts, junk snacks, cookbooks, popular novels, the King James Bible, the Christian Standard Bible, comics, DVDs. Housewares, at 13.7% of sales, was the top revenue-producing product category in 2017, with bed-and-bath, food and books not far behind.

If Wall Street is on the beam, Ollie's will disclose adjusted earnings of $120 million, or $1.81 a share, on revenues of $1.24 billion for the fiscal year ended Feb. 2, up from $95.5 million, or $1.25 a share, on $1.07 billion in revenues the year prior. For a frame of reference, in 2013, before the initial public offering, net income weighed in at $19 million, sales at $540.7 million. It's growth in stores that drives results, and Ollie's wants more stores.

Management funds its growth internally, and the balance sheet is pristine. Or, rather, it's pristine for the present. Like every other public company, the virtually unleveraged merchant must shortly begin to classify operating leases as debt. Given the company's aversion to owning its real estate, this might appear burdensome, but the recorded lease liability, at about $250 million, will amount to only 1.1 times adjusted earnings before interest, tax, depreciation, amortization and rent, as we estimate.

How sustainable?



source: The Bloomberg

You stop and stare not only at the Ollie's balance sheet but also—perhaps, especially—at its operating margins. They averaged 12.4% in the past two years, more than double those posted by Walmart, Inc. and Target Corp. They likewise top the margins reported by The TJX Companies, Inc. (11%), Big Lots!, Inc. (4.4%) and Dollar General Corp. and Dollar Tree Stores, Inc. (about 9%) over the same 24-month span.

"I'd say that Ollie's is doing better than most [closeout retailers]," says Jacobs in response to a question from colleague Fabiano Santin about those fabulous margins. "We do business with them. Well, we do business with just about everybody in the world of secondary markets, and they're very sharp buyers."

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Late last month—it was a Monday—Santin visited four Ollie's outlets in New Jersey and Pennsylvania. "The stores were big boxes, 30,000 square feet or so," he reports. "In some, there was hardly a customer in sight. At two, the staffing consisted of one employee at the cash register and a store manager who paced the aisles with a clipboard and pen. At the other two, I saw three or four employees. Shelves were mostly decently organized, although a few more hands could have done a better job of piling similar products next to each other. You sometimes feel overwhelmed by the cluttered, old-warehouse look, with various 'sales' signs on walls and shelves. Apple stores, they're not.

"In a sort of 3G Capital style," Santin goes on, alluding to the Brazilian cheapskates who pull the strings at Kraft Heinz Co., "Ollie's lean and low-cost labor force is meticulously scheduled to minimize overtime. In 2013, J. C. Penney Co., Inc. and Walmart each suffered a plague of shrinkage that investigators traced, in part, back to a decrease in store employees that typically leads to a rise in shoplifting. A disgruntled store manager complained to me that, since Ollie's went public, corporate management has been raising the performance targets it sets for calculating bonus payments."

Ollie's first ventured beyond its native Northeast in the early 2000s. By 2015, the year of the IPO, it had built a presence in the Midwest and Southeast. In 2016, it entered Florida and Mississippi; in 2018, it debuted in Texas, Louisiana and Arkansas.

Rapid sales growth is a blessing, to be sure, but a mixed blessing in operational terms. "This is where Ollie's is falling a little bit behind," a mid-level executive at the company tells Santin. He asks to go nameless. "We have a massive problem with people returning things seven or eight months after they purchase them. The item is no longer viable—it has fallen apart. Well, these people come back and expect to be able to replace it or get their money back. Why? Because this is also a demographic in which 40% of the population is on some form of public assistance."

The opportunistic nature of close-out-inventory sourcing brings its own special problems. When Santin asked a cashier how many Chefman air fryers were in store, the answer came back: "Unfortunately, we can't do that. Our computer is very old. It doesn't do that type of tracking." A store manager said there is nothing unfortunate about the seeming paucity of inventory-control software: "Our inventory is constantly changing with new products arriving by the truckload every week." A third employee, no more eager to speak for attribution than the first two were, called the Ollie's inventory-control system an "absolute mess. I mean, we're supposed to manage the inventory, but we have no idea what inventory we have." Requests for comment to Harrisburg headquarters went unanswered.

On Oct. 31, 2015, inventory as a percentage of assets stood at 22.2%. By Nov. 3, 2018, that figure had reached 29.4%, a post-IPO record. A rough and ready check on the fidelity of reporting on shrinkage rates and inventory markdowns is available with a glance at the financials. The telltale datum is the ratio of net income to free cash flow. A rising ratio properly sows suspicions. What the conscientious analyst may suspect is that the C-suite has neglected to take into account the appropriate inventory-related charges and that, in so failing, has inflated GAAP earnings.

For the past five fiscal years and for the first nine months ended Nov. 3, 2018, the average ratio of net income to free cash flow (even excluding the recent one-time costs associated with the acquisition and/or lease of certain vacant Toys "R" Us locations) comes to 178%. It's far higher than the 118% for TJX, 105% for Ross Stores, Inc. and 96% for Five Below, Inc.

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Ollie's gross margins, like its operating margins, have consistently been best of class. The question is whether the accounting behind those stellar numbers also measures up. To generate net income, management must have an accurate handle on inventory shrinkage and markdowns. The policies that govern the collection and calculation of these data typically find a place in the management discussion and analysis section of the 10-K report. Yet, though inventory represented 70% of tangible assets on Feb. 3, 2018, the MD&A section of fiscal 2017's 10-K was silent on the accounting for inventory. The Securities and Exchange Commission, noticing the omission, issued a comment letter to Ollie's in August 2018.

"Such SEC letters," Santin notes, "have become relatively rare. In 2008, 27.5% of public companies received one, according to research firm Audit Analytics; in 2018, just 7.9% did. Last year, Ollie's became the only company in a peer group of 24 tracked by the research company to eliminate all disclosure of its critical accounting policies from the MD&A section. If it has no such policies, that, too, would be remarkable."

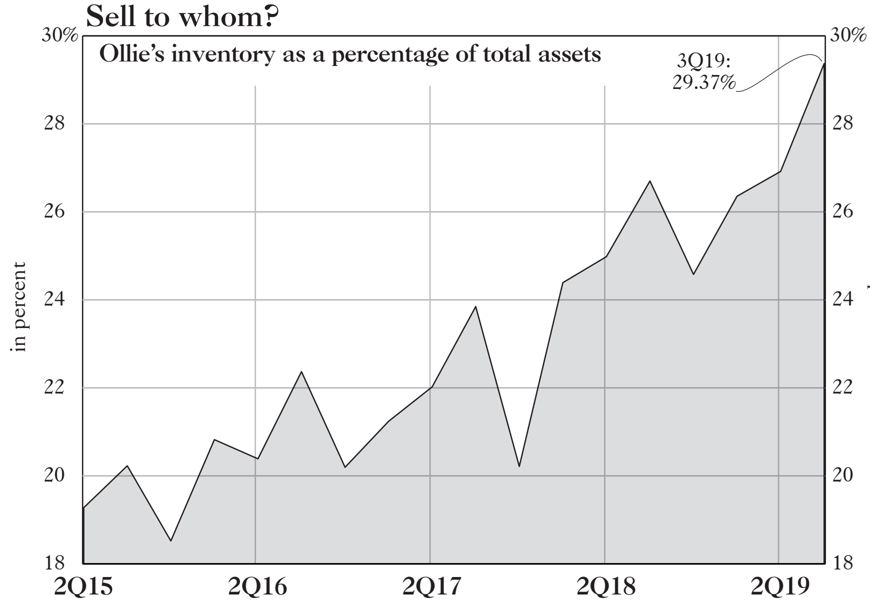
The 2015 prospectus asserted that each Ollie's store had been profitable in every year since the 1982 founding. "Notably, then," Santin relates, "management closed one store in July 2015 and another in October 2018. And new in the Nov. 3 10-Q was the definitional change of the line item 'pre-opening expenses,' which encompasses, as one would suspect, grand-opening advertising costs, payroll expenses, travel expenses, employee-training costs, rent expenses, store-setup costs, inventory-transportation costs. As one would not necessarily expect, 'pre-opening expenses' also covers store-closing costs."

Excluding Ollie's, only one of 23 retailers analyzed by Audit Analytics included store-closure costs in its "pre-opening expenses" line item. The exception was Target, which explicitly labeled them "pre-opening and exit costs." The latest Ollie's 10-Q said that inventory write-offs will be categorized in "store-closure costs." It would do the investors no good if Ollie's buried inventory losses in "pre-opening expenses" rather than forthrightly acknowledging them in the form of downwardly adjusted gross profit margins.

If anyone is more alert to Ollie's success than the company's shareholders, it must be the Ollie's competitors. The field includes KKR's Channel Control Merchants, which operates more than 100 Dirt Cheap and Treasure Hunt stores; Ocean State Job Lots, which, though founded in 1977, has fewer than half the number of Ollie's locations; and Nashville, Tenn.-based Bargain Hunt, in which Thomas H. Lee invested in 2015 and which has since steadily expanded to 87 stores from 39 four years ago, mainly in the South.

"Oddly," notes Santin, "the customarily aggressive private-equity firms are taking a more careful approach to expansion than Ollie's is. This goes back to the p.e. firm that forehandedly invested $344 million in Ollie's in 2012 but seemingly couldn't wait to get out. CCMP Capital Advisors, L.P. realized some of its profit in 2013, within six

Sell to whom?



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months of its investment. The cashing out continued in 2014 and 2015. CCMP had made a clean break within a year of the IPO. I emailed to ask why, but they declined to comment."

The internet cuts both ways, bullish and bearish, for the closeout merchants. In the bullish vein, customer returns of digitally ordered goods are running in the neighborhood of 20%. The merchandise is none the better for its journey through the mail. When it completes its round trip back to, say, Amazon.com or BarnesandNoble.com, what becomes of it? Perhaps a final shipment to Ollie's at a suitably knocked-down price. Or perhaps, directly to a competitor, including the entrepreneurial start-up business in the garage next door. After all, anyone with an internet connection can bid for closeouts at online auctions.

"They are good buyers," says Jacobs of Ollie's. "They know what they're doing, but I don't believe they could sustain those types of margins just based on what I see ahead in the marketplace from a competitive point of view."

Ollie's is an outlier not only in share-price performance and in gross and operating margins but also, less flatteringly, in the speed at which it turns over inventory. It takes nearly 160 days, longer than Walmart (48 days), Big Lots! (125) or even Sears (101).

It could mean that Ollie's is outgrowing the closeout market. Or that it must buy straw hats in September and Christmas sweaters in January, trusting that neither changing fashions nor a bump in the business cycle will cause it to regret the investment.

It speaks to what Ollie's has accomplished in the past—and to the risks of failing to execute in the future—that many have fallen short in the closeout business. Sam Walton didn't live to see his heirs throw in the towel on Bud's Discount City stores in 1997 after a frustrating eight-year demonstration of how hard a seemingly easy business can be. Boston-based Raymond's Department Store was a closeout retailer that itself closed out in 1972. James Schaye, CEO of Eaton Hudson, Inc., specialists in store closings and asset recovery, is a member of the family that owned Raymond's. Addressing the Ollie's inventory-turnover rate, Schaye thus speaks with first-hand knowledge: "That is a problem with those particular types of retailers. That is what has put a lot of them out of business over the years. There are a lot of these guys that have come and gone over the years."

"Neither," Santin relates, "is the Ollie's store concept, filled with funny, self-deprecating cartoons, unique. The Hingham, Mass.-based Building #19, Inc., founded in 1966, anticipated it, only to file for bankruptcy protection in 2013. 'Since much of Building 19's inventory consists of surplus, salvage goods, overstocks, closeouts and irregulars that become available erratically,' said the Chapter 11 filing, 'Building 19's business model relies, in part, on having sufficient working capital on hand to make erratic inventory purchases.' Such capital was unavailable, said the owners, who also cited the shift of manufacturing to foreign countries and the rise of e-commerce as factors in their downfall."

Unlike Building #19, Ollie's is debt-free, though that doesn't make it any easier to find closeout merchandise at the right price. Just last month, Ollie's hosted its first ever buyout event of wedding and formal dresses, a gala that happened to coincide with the company's purchase of 11,000 wedding gowns and 18,000 formal, prom and bridesmaid dresses. Perhaps Ollie's said yes to the dresses because the dresses were what was available. The greater the store count, the more random the treasure that may await Ollie's Army.

Then, too, the sellers of closeout merchandise often exert control by restricting dispositions to certain buyers, such as exporters, or only to retailers with stores more than 50 miles away from the seller's shop, as *The Economist* first reported in 2016. Perhaps, if those restrictions are no longer in force, the suppliers might choose to revive them. There has to be some reason why general-merchandise closeout retailers have never before achieved national scale.

Ollie's is supposedly en route to 950 stores nationwide, and it's this prospective growth that supports the stock's fancy multiple. The market seems to discount management's guidance for long-term comparable-sales growth in the 1% to 2% range, down from the 4.4% increase expected for 2018. Ollie's currently pays no dividend, and perhaps few of today's holders would want one in lieu of the now customary 58% per annum share-price appreciation.

Insiders are not waiting for the next 600 stores to open. In the past two years they have bought no stock, but in the past 12 months they have sold \$201 million's worth, led by CEO Butler (\$173 million's worth). Since the 2015 IPO, Butler has pared his stake in the company down to 8.5 million shares (13.5% of shares outstanding) from 13.2 million (24.5% of shares outstanding). At the age of 59, the retailing visionary has certainly earned the right to diversify, but what about the rest of the C-suite?

Selling Ollie's has usually been a mistake. Dollar Tree invested \$4 million in 2003 and cashed out with a \$60.8 million gain in 2012. Maybe the Dollar Tree people, operators of 14,835 stores throughout the 48 contiguous states and Canada, decided that nobody ever went broke taking a stupendous profit. Or perhaps, seated on the Ollie's board, they saw limitations that others have continued to overlook.

Certainly, the Street envisions few problems. Eight analysts say buy, six say hold and not one says sell. Since reaching a record high of 42.5% of the equity float in February 2016, short interest in Ollie's shares has dwindled to a near record low of 7% today.

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