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'It's chaos'

On Thursday, Sept. 7, a radical course of financial engineering culminated in a 45% levitation in the price of RH in frenzied New York Stock Exchange trading. Now in progress is a speculation on the consequences of the financial decisions that caused the shares to erupt. In preview, *Grant's* resumes its fatwa on the company that, until Jan. 1, when it renamed itself after its own stock ticker, was known as Restoration Hardware Holdings, Inc.

RH is the home-furnishings curator (*not* retailer) best known for its 17-pound source books (*not* catalogues), 40,000–60,000 square-foot next-generation design galleries (*not* stores), highly burnished self-image ("we're building a brand with no peer") and innumerable rooms done in beige.

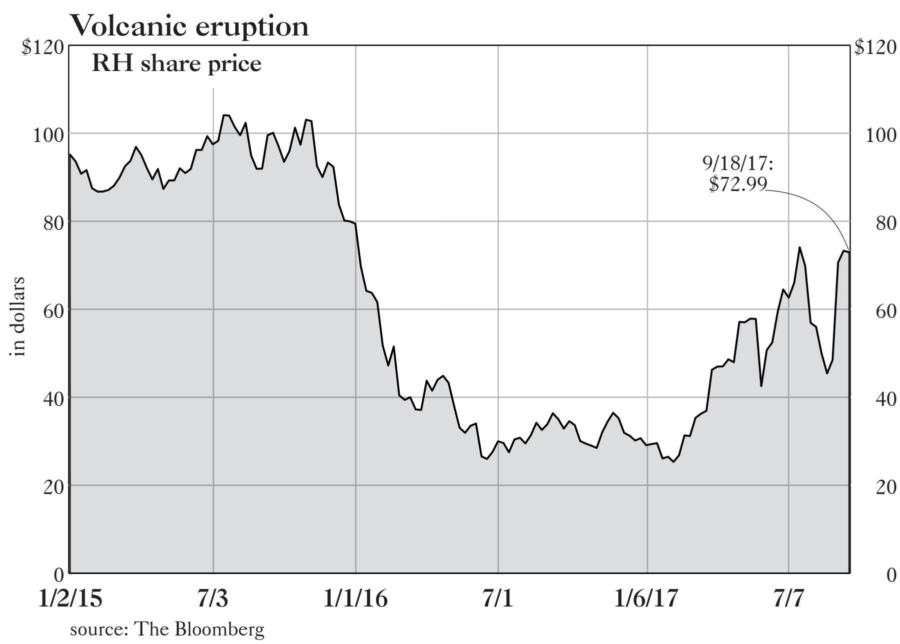
Constant readers know a thing or two about the company already. They have surely not forgotten its inimitable CEO, Gary Friedman, whose words are quoted directly above. RH curates (*not* sells) high-end furniture at 14 design galleries, as well as 50 smaller legacy galleries, one RH Modern Gallery, five RH Baby & Child Galleries, 28 outlets and—through the 2016 acquisition of Waterworks—a chain of 15 bath and kitchen furnishing stores.

On the Sept. 6 earnings call—whose slightly-better-than-expected sales message was the match that lit the fuse that set off the Sept. 7 share-price explosion—Friedman provided a succinct history of the company in which he himself owns a 10.5% equity interest:

> We're really, like, seven years old. I got here in 2001, and the company had a $20 million market cap. It was about ready to go bankrupt. We had to raise money three times to keep the company out of bankruptcy. And the first five to seven years, we were just on the edge of bankruptcy, trying to make it; and we took the company from $300 million, losing $40 million a year, to $700 million, making $40 million a year, and we're taking the company private and then the economy collapsed in 2008-2009 and that set us back to a $500 million company and losing money again, right? And when we came out of that, really in 2010, is when we made this significant pivot to the luxury end of the market and really emerged as a kind of a new company, if you will. So I look at this, and I'd say we're really early stage. . . . We're 14 galleries into a 60–70 gallery transformation.

Next day found Friedman addressing a Goldman Sachs retail conference in New York City. Front and center, naturally, was that fast-ascending RH stock price (on its way to a high of $73.22). It would have required almost super-human self-control for the recent recipient of options on one million shares of RH with a purchase price beginning at $50 a share (with vesting to take place over the next four years at rising strike prices) not to exult a little. Friedman was that man, and he did his best: "Fifty-two percent of our shares were short, for God's sake," he exclaimed. "Okay, honestly. And the shorts—listen, I don't care. Everybody can gamble the way they want to gamble, honestly."

Whatever could the short-sellers have been thinking about? The bearish contention was, and remains, that RH is overextended in operations and finance



alike. We quoted a critic along these lines in the issue of *Grant's* dated Jan. 23, 2015: "So the idea that you're going to appeal to a high-end customer—and I'll give them credit for doing a good job merchandising-wise, and building the brand in a way that appeals to the upper-end customer—it's hard to fill a huge store with upper-end customers because, frankly, there [are] not as many of them. The other related fact is that people in those neighborhoods don't want to all have the same furniture." Valid points, then and now.

No sooner had the bear said his piece (and we ours) than growth decelerated. The top line expanded by 1.2% in the fiscal year ended Jan. 31, 2017, down from 12.9% the year before. Between Jan. 23, 2015 (the date of our first bearish salvo) and Feb. 7, 2017, the RH share price fell by 73%, to $25.08.

As any company would, RH took countermeasures. To clear inventories, it lowered prices and, in fiscal 2017, opened 12 outlets. To draw customer traffic, it instituted a membership program with a $100 annual fee offering savings to card holders of 25% and up (more on sale items). In the 12 months through July 29, inventories dropped by $199.3 million. Not that this promotional activity has come for free. In the first six months of fiscal 2018, RH showed a net loss of $11.2 million, or $0.31 per share.

The costs associated with Friedman's drive to generate positive free cash flow are widely distributed. The suppliers bear some of it as, over the past four quarters, payables jumped by $29.5 million, to $160.5 million. What we may call the corporate future is absorbing another part of the cost. Through the 12 months ended July 29, RH spent $126.2 million on capital projects, down from $133.8 million and $158 million in fiscal years 2016 and 2017. Still and all, over the past four quarters, RH did, in fact, generate positive free cash flow, to the tune of $360.6 million. The previous fiscal year to feature such black ink was 2010.

"Certainly," observes colleague Evan Lorenz, "the drop in capex reflects no cessation in RH's drive to build new design galleries. The reason for the decline is rather a change in financing technique. On the liability side of RH's balance sheet, you'll find a line item called 'financing obligations under build-to-suit lease transactions.' This liability has grown to $226.2 million from $156.9 million between the second quarters of 2017 and 2018. In essence, it's the cost that developers—not RH—have sunk into the building of design galleries. In exchange for shouldering these costs, developers lock RH into very long-term leases. As of Jan. 31, the future value of build-to-suit lease payments was $797.4 million, implying lease terms of around 20 years based on future build-to-suit-related payments. Friedman had better be correct about market demand for these palatial emporia. After all, how many other retailers are expanding in the age of Bezos to take over a lease if RH stumbles again? And what other retailer could even fill a 60,000 square-foot store with 100-year-old olive trees sheltering weathered granite roofs?"

Such adjustments to corporate strategy are calculated to boost the share price over time. They are unlikely to lift it to the heavens in one short trading day. For that purpose, stronger medicine is indicated—a heavy course of share buybacks, for instance.

In two separate authorizations this year, the RH board cleared the way for $1 billion in buybacks. Nor did management hang back from spending the approved funds. On July 14 came news of the purchase of 20.22 million shares—in something like five months, the company sawed the share count in half.

Cash flow funded some of the purchases, debt the rest: a $283 million first-lien term loan priced at 1.5% above Libor, $100 million from a second-lien loan priced at 8.25% above Libor. Such borrowing has raised RH's leverage to 7.3 times trailing earnings before interest, taxes, depreciation and amortization (EBITDA), from 4.7 times at the close of January.

Now that the running of the bears is over or ending, Friedman can resume the laborious business of running a leveraged retailer in the digital age. RH is fitting out three to five new design galleries a year, each at considerable cost (estimates range from $20 million to $30 million). It takes some doing, as the CEO reminded dialers-in on the Sept. 6 call. "We're in the development business now," said Friedman. "We're really not in the kind of mall leasing business where you're taking 50 feet of frontage in an already built box. . . . It's not what we do. We have to find pieces of property or existing historic buildings and go through entitlements and go through city councils and all these things that take longer."

Growth in the number of potential buyers of high-end RH furniture is one critical unknown in the corporate equation. The willingness of RH's put-upon suppliers to make further contributions to Friedman's free cash-flow metrics is another. The chief curator, while assuring his conference-call audience that his managers and he are smarter and better informed than ever, readily acknowledged difficulties in making the retail trains run on time. "Anybody who hasn't worked inside a retail business probably doesn't have the appreciation of the chaos you manage in a weekly, monthly, promotional kind of business," he allowed. "When you have different promotions, do you—did you pull business forward, did you push business out, how are you lapping, and then people are adding promotions. It's chaos."

Maybe, then, the Street is simply expecting too much. Analysts have penciled in $3.62 in adjusted earnings per share for the year ending Jan. 31, 2019. It's sobering to consider that this forecast is substantially lower than the consensus guess of $6 when we first published on RH more than two years ago, the subsequent halving of the share count notwithstanding. So RH is trading at 19.3 times fiscal 2019 earnings, the unleveraged Williams-Sonoma, Inc. at 14 times trailing earnings.

"Maybe the trouble with Friedman's financial engineering is that it didn't go far enough," Lorenz reflects. "Most of the company's $1.1 billion in debt takes the form of two convertibles: the $350 million zero-percent coupon issue of June 15, 2019 and the $300 million zeros of July 15, 2020. The conversion prices for the 2019 and 2020 notes are $116.09 and 118.13, respectively, some 65% above the current share price. Probably, then, the converts will be refinanced on less advantageous terms, a likelihood that the sell side (as far as we have seen) is not factoring into its earnings models. If the unrated RH were able to issue new debt at a 5% interest cost (somewhere between the price of the first- and second-lien loans), the incremental interest expense would amount to $37.5 million. For comparison, adjusted net income is expected to amount to $109.2 million and $132.3 million in fiscal years 2020 and 2021."

The competition will have a say in what the future holds for the new, leveraged, share-price-centric RH, of course. Friedman's 2017 10-K report relates that company-owned stores generate just 55% of sales, with 11% sourced from phone orders and 34% from the internet. Does RH actually need its palatial galleries with their decades-long leases? Wayfair, Inc., the online-only furniture retailer, expanded sales by 42.7% in the second quarter, bringing trailing 12-month revenues to $3.9 billion, nearly twice the $2.3 billion that RH produced over the same period. Wayfair's offerings span the price gamut, from affordable to luxury.

"More and more consumers are willing to buy more and more types of things online," a hedge-fund analyst with no position in Wayfair or RH tells Lorenz. "My wife and I did a significant remodel over the past several years, and we bought a lot of furniture, most of it from various Wayfair sites. There is so much choice relative to going to local design districts. We found it is easy to send things back."

The 21 analysts who cover RH have reached a split decision: Three rate the stock a buy, 17 a hold and one a sell. While Bloomberg reports that 54% of the float is sold short, this likely overstates short interest following the Sept. 7 spike. Prior to that jolt, there were no shares to borrow; today there are plenty, albeit at a 15% borrow rate (RH pays no dividend).

On Sept. 14, Friedman bought 14,000 shares of the company he knows best, paying almost $71 apiece for a consideration of not quite $1 million. It was the only open-market transaction by any insider for over a year. Momentum, not value, would appear to be the preferred RH investment style.

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