GRANT'S
INTEREST RATE OBSERVER®
Vol. 31, No. 17c | Two Wall Street, New York, New York 10005 • www.grantspub.com | SEPTEMBER 6, 2013

Floor to ceiling

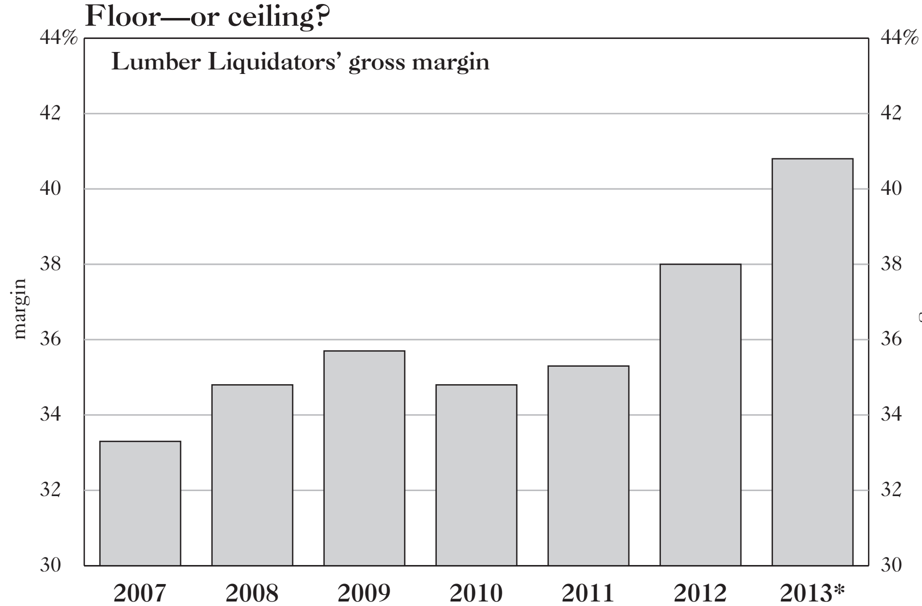
Since May, when the updraft in mortgage interest rates began, home-building stocks have fallen by as much as 30%. Sales of new, single-family homes have dropped off, and the rate of rise in house prices has flattened. Contracts to purchase not-new houses fell for a second straight month in July. All of which frames the continued rise in the share price of Lumber Liquidators (LL on the Big Board), a top specialty retailer of hardwood flooring in North America (*Grant's*, May 17). The question before the house: Where's the ceiling?

Many a skeptic would like to know. Ceilings—and roofs—continue to rise in this fine bull market, the occasional pullback notwithstanding. Like the stock market itself, LL seems an expression of the Newtonian law that a body in motion tends to stay in motion. As mortgage rates have risen, the company's margins have expanded. Senior executives continue to sell, but Wall Street keeps saying "buy." Quoted at 90 in mid-May, the stock tops $99 today, a price representing 30 times the consensus 2014 earnings estimate.

Listening to the second-quarter conference call on July 24, the Lumber Liquidator bulls must have pinched themselves. Gross margin, i.e., revenue minus cost of goods sold divided by revenue, fattened to 41.3% in the second quarter vs. 37.3% in the year-earlier period. Operating margin, i.e., operating income divided by revenue, expanded to 12.9% in the second quarter vs. 9.4% in the year-earlier period. Management credited lower net product costs, higher net retail prices, a shift in the sales mix and operational efficiencies across the organization. Up, therefore, went 2013 guidance: Expect net sales in the range of $940 million to $963 million, up from the previous range of $913 million to $942 million, the company said; expect earnings per diluted share of $2.45 to $2.60, up from the previous range of $2.10 to $2.35.

Lumber Liquidators, with its modest $2.7 billion market cap, competes with Home Depot and Lowe's Cos., with their enormous $105.9 billion and $48.5 billion market caps, respectively. It competes, as well, with the 1,000-plus card-carrying members of the National Wood Flooring Association; their closely held financial status is known only to themselves. Against all comers, LL has excelled. The two home-improvement giants produce stable gross margins in the mid-30s, well below LL's. And while each pays a dividend, and each is in the market repurchasing stock, neither can match the share-price performance of Lumber Liquidators over the past 24 months: up 554% vs. an average of 135% for the two heavyweights, including the reinvestment of their dividends. In the six months to June 30, LL generated a 13.1% return on equity vs. 19.5% and 11.4% for Home Depot and Lowe's. The comparison is tilted against LL; while the heavyweights average between them a ratio of long-term debt to equity of 71.5%, Lumber Liquidators is unencumbered.

Floor—or ceiling?



*through June 30, 2013
source: company filings

So, when Jefferies LLC issued its maiden report on the company last month predicting long-term growth in earnings per share of around 30%—way above the Street's average guess of 18%—along with a share-price target of $119, the market shrugged. Great things are what it has come to expect from LL.

As for the bears, the skeptics and the believers in the gravitational pull of rising interest rates, they—we—must ask, "What's the catalyst"? What could possibly break the virtuous circle of rising sales, expanding margins and increasing advertising outlays? As it is, the company has 305 retail outlets; it's aiming for 600. What earthly force can stop it?

On the July 24 earnings call, Robert Lynch, president and CEO, held forth on the sources of LL's operational strength. "Sourcing directly from the mill provides the foundation for our entire value proposition," he said. "Due to our scale, we often purchase the majority of our mill partner's capacity. And, as a result, we have insight and visibility throughout the sourcing process. This provides a significant competitive advantage compared to the distributor model of many of our competitors."

As the company bought 43% of its flooring from Asia last year—and most of that from the People's Republic—one potential point of vulnerability is product safety. Non-prime goods, in any case, are the company's stock in trade. It sells "seconds" or "mismills," as these cast-offs are known, at half the price, or less, of better quality merchandise. "We face an inherent risk of exposure to product liability claims in the event that the use of our products is alleged to have resulted in personal injury or property damage," the 2012 10-K report says. "In the event that any of our products prove to be defective, we may be required to recall or redesign such products. Further, in such instances, we may be subject to legal action. We maintain insurance against some forms of product liability claims, but such coverage may not be adequate for liabilities actually incurred."

All hands, perhaps—bulls and bears and neutrals—will concede that quality control isn't China's strong suit. One must therefore wonder if the risk of an LL product-liability scandal is adequately discounted. One of the few air pockets the soaring LL shares have hit came in late June following a report on the Seeking Alpha Web site that some of the company's products tested for formaldehyde levels above the legal limit. "If you Google 'Lumber Liquidators Formaldehyde,'" colleague David Peligal relates, "you can read some acerbic reactions to the story from LL's competitors." Maybe they're just jealous.

"Sourcing product in China seems an important contributor to LL's stellar margin growth," Peligal goes on. "In September 2011, the company invested $8 million in a buyout of Sequoia Floorings in Shanghai in the People's Republic. Just how much the Sequoia transaction has meant comes through in the LL 10-K: 'We believe our cost of product was reduced, primarily in 2012, due to both the net cost reduction of owning those services and the benefits of working directly with the mills.' It might not be purely coincidental that the LL share price has really taken off since the Sequoia acquisition."

The informed judgment of the insiders, though not in itself a short-sale catalyst, might turn out to be a leading indicator of a yet-unidentified catalyst. The top inside holders, as noted, continue to sell. On Aug. 22, Thomas Sullivan, founder and chairman, sold 100,000 shares at prices ranging from $100.49 to $102.37; he retains 608,998 shares. On July 24, the day of the second-quarter earnings call, CEO Lynch, exercised and sold 20,000 shares as part of a 10b(5)-1 plan at prices ranging from $94.99 to $95.75. On July 31, Lynch exercised and sold an additional 30,000 shares, also as part of a 10b(5)-1 plan, at prices ranging from $96.50 to $97.90; he retains 34,216 shares.

Our counsel remains: Follow the leaders.

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