**Floor & Décor**

NYSE: FND

BUY – Target price: $103.95 – Upside: 27.2%

April 2022

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| --- | --- | --- | --- | --- | --- | --- | --- |
| Actual Price | | |  | | $81.73 | | |
| 52w High/Low | | |  | | $145.89/$79.38 | | |
| Market Cap (M) | | |  | | $9,380.4 | | |
| Enterprise Value (M) | | |  | | $10,666 | | |
| Cash (M) | | |  | | $139.4 | | |
| Debt (M) | | |  | | $1,423.5 | | |
| Shares Out. (M) | | |  | | 105.8 | | |
| Yield (%) | | |  | | 0% | | |
|  | | | | | | | |
| **Key Financials** | | | | | | | |
|  |  | **2021** | | **2022E** | | **2022E** | **2023E** |
| Revenue ($M) |  | 3,433.5 | | 4,334.9 | | 5227.7 | 6222.8 |
| EBITDA ($M) |  | 485.1 | | 588.2 | | 756.9 | 935.3 |
| EV/EBITDA |  | 17.28 | | 16.05 | | 12.47 | 10.09 |
| GAAP EPS ($) |  | 1.00 | | 2.90 | | 3.75 | 4.83 |
| PE |  | 32.79 | | 30.42 | | 23.32 | 18.36 |
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**Company Description**

Floor & Décor is a hard-surface flooring and accessories retailer with operations spanning 33 states. Their operations include 160 warehouse format stores, 4 design stores, and 4 distribution centres strategically located in port cities. The company provides a selection of hardwood floors, including laminate, tile, decorative accessories, wood, natural stone, and adjacent categories (vanities, shower doors, etc). Floor & Décor also sells products through its website, FloorandDecor.com.

Floor and Décor uses a direct sourcing model to undercut prices in its industry. The company has its own merchandise procurement team that ships products directly from its manufacturer, cutting out brokers, importers, and distributers.

FND’s customer base mainly consists of residential home construction with 15% do-it-yourself (“DIY”), 45% buy-it-yourself (“BIY”), and 40% professional contractor (“Pro”).

With the acquisition of Spartan Surfaces (“Spartan”), FND now serves the commercial market, including architecture & designer firms, general contractors, building owners and developers.

Floor and Décor has experienced rapid growth in the past 5 years from ’17 – ’21 since going public. Its compound annual growth rate of stores has been 17.8%. Total sales, Adj. EBITDA, and Adj EPS have grown at a 25.5%, 32.2%, 37.1% CAGR respectively.

**Market**

The Floor Covering industry is highly fragmented in the US, with over 17,000 individual businesses competing in the space. FND has an 8% market share and is by far the largest player (IBIS World, Management Estimates). Hard surface flooring has taken market share from soft surface flooring, gaining 13% from 2012 to 2021 and represents a $41B TAM opportunity for the company.

**Investment Thesis**

**The US is facing a secular shortage of housing exacerbated by homebuilder supply constraints.** Prices have risen over 10% YoY on strong housing demand, particularly in popular areas like Texas and Arizona. While the Housing Market Index (HMI), a survey of builders who rate market conditions for the sale of new homes for the next six months, has ticked down from its highs, this likely due to supply constraints and not demand destruction caused by higher interest rates.

“Production disruptions are so severe that many builders are waiting months to receive cabinets, garage doors, countertops and appliances. These delivery delays are raising construction costs and pricing prospective buyers out of the market. Policymakers must make it a priority to address supply chain issues that are harming housing affordability.”

* NAHB chairman Jerry Konter, a builder and developer from Savannah, Georgia.

There are 60% less active listings vs 2017 – 2019 as of December 2021. In total, the US housing market is facing a deficit of between 500k – 750k active listings when compared to 2017- 2019 inventory levels.

**There are secular trends driving permanent demand as well.** Millennials are now a major driver of housing demand. The fraction of home renters aged 20-45 who transitioned to home ownership last year was the highest since the Great Recession, despite housing prices up 35% cumulatively since the pandemic. 18–30-year-olds have also returned to their own households, as the largest fraction of this demographic become household heads. Homeowners are trading up for larger homes; new single-family home sizes have increased in ’21, reversing a downward trend from ’15-’20. Purchases of second homes have increased; second home purchase loan originations have increased to 5% vs the 3.5% average from ’14-’19.

**Despite huge gains in home prices, mortgage borrowers have stronger balance sheets than in the mid-2000s and can handle a drop in home prices.** They also have the equity to afford cost increases. According to mortgage analytics firm Black Knight, tappable home equity has jumped by $2.6T to a record total of $9.9T in 2021. Homeowners tapped their equity at the highest rate in 14 years, with cash-outs making 54% of all refinances. The average mortgage holder has $185k in equity available to them before a loan-to-value ratio of 80% and increase of 45k YoY. The homeowner is in the best position it has been in the last 20 years.

**Floor and Décor is the hard-surface category-killer and is poised to take market share away from a fragmented hard-surface flooring competitive landscape.** Management estimates it can capture 33% of the $41B hard-surface flooring market primarily as it takes share away from its competitors, consisting of 1/3 independents, 1/3 home centers, 14% specialty retailers and 14% distributors. Floor & Decor has numerous competitive advantages over smaller players.

**Its large, 78,000 sq ft warehouse stores allow FND to provide the best in-store experience.** FND has the largest in-stock selection at 1,700 SKUs versus 10-60 in specialty competitors (60% of competition) and 400-450 for home improvement (40% of competition). They have 250 options of tile versus 55-60 in a home improvement centre. Home improvement centres only have 3,000 – 5,000 selling square footage, which limits their ability to invest in the category. Many independents operate stores are 5,000 – 15,000 square feet with little room to invest in their stores. Moreover, warehouse stores are visually inspiring and allow customers to see how the hard-surface flooring would look, an important aspect of hard-surface shopping. Free designer services are also a major lever for higher ticket sales. The average designer ticket is much higher than the average consumer ticket because they can sell the entire home project including installation material and project-related goods/adjacent categories. This results in 2-3x higher ticket than the average associate. With economies of scale, FND is in a unique position to build a career track in designer and offer these services for free.

**By vertically integrating its supply chain and its value chain, Floor and Décor will have cost-leadership in its industry while yielding a variety of other benefits.** It has secured long-term (5-6 years) ocean carrier contracts because of its strategically placed distribution centers (DCs) in port cities and warehouse storage inventory space. It works directly with manufacturers to procure SKUs ahead of shifts in consumer tastes. For example, management was able to anticipate the demand for laminate, now the #1 category over tile.

**New store economics will continue to get better and enterprise margins will be much better 3+ years from now.** Year 1 sales average $14-16 million, 8-10 million total net investment, 2.5 million in four-wall EBITDA, and have a payback of 2.5-3.5 years. In the same period from 2011-2015, average sales were 9 million, 3.5 million total net investment and $900,000 in four-wall EBITDA. The average FND store is 2.2 years old. In year 5, a store will have $26-27 million in revenues, a 25% 2-year ROI, 50% third year cash-on-cash return, and $6-7 million in four-wall EBITDA, implying a mature 24.5% store EBITDA margin ($6.5/$24.5). **However, management is chronically understating Floor & Décor’s long-term store margin potential due to its owned and operated real-estate strategy.** Because FND can self-fund and source development of its stores, it will save $7-10 million per year in rent over the next 10 years, representing a 15% discount to general contractors in less time, and will yield 30% energy savings. The store financials cited are taken as averages of previous years; they do not consider savings from owned-and-operated store models which *only stand at 3 owned stores and management has provided guidance that they will own 7 more*. Currently, Floor and Décor store growth is comping at 20% year-over-year; once long-term targets are met (I predict they will continue to be revised upwards) and store growth decelerates, Floor & Décor will see improved EBITDA margins in the 24.5% range after it leverages its SG&A, G&A and owned & operated store savings. It is spending 10-25% of CapEx on DCs which will yield well above 20% ROIC. Management sees gross margin operating leverage in ’23 and ’24, as 225-250 million fixed payroll, marketing, rent, depreciation is leveraged. This is compared with current EBITDA margins at low-mid teens (<15%).

**Drivers**

**FND is poised to benefit from home spending and construction.** 60% of FND’s customer base consists of homeowners with a median income of $96,000; they have been living in their homes for 7 years and have an average home value of $300,000. In addition, over half of their homes are build prior to the 1980s. With wealth at all-time highs, consumers are opting to upgrade their homes and are approaching a replacement cycle in the near-term. As a result, purchases are trending towards “better” and “best” which drive average tickets higher.On a percentage basis, there is a big step-up in price; since consumers are simply remodeling a small room (ie, bathroom), nominal price step-ups are not as big.

**Adjacent Categories are estimated to be an $8-13 billion TAM opportunity.** Installation materials and accessories are a significant incremental opportunity for Floor & Décor as sales within the category are driven by core hard surface sales. They include grout, caulk & silicone sealants, sealers & cleaners, moldings, adhesives, mortor and thinsets, vanities, shower accessories, lighting, mirrors, countertops, and installation tools such as saws and mallets.Adjacent categories were 2% of sales in FY’21 or around $68.67M. Management is aiming for 5% of sales going forward and at its targeted 33% market share, adjacent categories will bring in ~$500M in revenues.

**The commercial TAM opportunity, valued at $17B, is even more fragmented than the residential market according to management.** Floor and Décor entered the market with the acquisition of Spartan Surfaces. 60% of the commercial market is driven by architecture & designer (A&D) firms, general contractors, building owners and developers. The remaining 40% is “Main Street”- small business owners, builders, downstream pros, and contractors. The top 60% request a “hard specifier”, where an architecture designer has specific requirements that Spartan would bring a flooring solution for. The remaining 40% are not as strict and management expects them to be able to flip the customer to a Floor & Décor product. Spartan will leverage Floor and Décor’s DC, product, supply chain, and supply agreements (Floor and Décor has negotiated much lower rates than Spartan) which will allow FND to expand Spartan’s tile and insulation materials. Management has indicated it will continue to roll-up adjacent companies in the space.

**Inflation and supply chain issues are beneficiary to FND.** FND has shown a willingness to raise prices dollar-for-dollar with cost increases. With a 2 cent increase in cost, FND will raise the associated product by 2 cents as well. This is not a proportional increase, which means gross margins will decline in FY’22. FND is the cost-leader in its category, with the largest scale and access to manufacturers. It is adequately stocked with 90% of SKUs (of 340) in stock. It carries inventory in stores and can service most sales out of existing stores in the suburbs. It has a faster fulfillment time versus smaller competitors (3-4 weeks vs 6-8 weeks), crucial when costs are increasing day-by-day. Independents will lose on market share as Pros seek retailers with inventory on-hand. If supply chain constraints ease, GMs will increase as the dollar-for-dollar passthrough reverses.

**Risks**

**Higher Interest Rates**

Higher mortgage rates have decreased housing affordability as mortgage payments become a larger share of income in households. Revenue growth rates have slowed during the last hiking cycle and multiples have compressed. In the next month, you could see further downside as investors adjust for rising rates. However, homeowner wealth will still be materially higher than in 2019, and FND believes that should act as a buffer for sales. Mortgage rates are generally tied to the interest rates. While the fed has signalled it will continue to raise interest rates, benchmark bonds have done most of the heavy lifting. The 2-year T-Bill has the widest divergence from the fed funds rate *ever* as a result of forward guidance. However, with high gas prices, low consumer confidence, a declining savings rate, lower-than-expected ISM PMIs, and fiscal stimulus rolling off, it’s possible the fed may reverse course, which it indicated it may do in its last FOMC meeting. Moreover, QT results in 10-year yields *declining*, likely because of a reduction in long-term growth prospect. Should the fed begin QT in May as it hinted, we may see a much lower 10-year treasury yield as they sell their assets. By extension, I expect mortgage rates to be much lower and refinance activity to pick back up as yields reverse course.

**Store expansion execution**

While peers have raised prices by 8%, FND has kept prices much lower to increase market share. By matching industry price hikes, FND could have a high-teens EBITDA margin business, but management wants to keep prices suppressed to capture market share. FND faces execution risk should lower margins do not result in increased market share and customer retention. However, management has consistently captured market share through their low-cost, best experience strategy.

**Valuation**

FND is currently trading at a premium to peers… but it has *always* traded at a premium, especially since it’s store count is comping at 20% YoY vs >1% for the home improvement stores. Its 2023 Adjusted PEGY is $103.95 representing a 27.2% upside from closing prices, and I believe this is more representative of the market’s misunderstanding of FND’s true earning potential.

Graphical user interface

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Graphical user interface, text

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**Chart, histogram

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**Conclusion**

While I believe FND is undervalued, there may be further downside risk due to increasing mortgage rates. I recommend purchase at or above FND LTM P/E and EV/EBITDA reflect 2018’s valuations at ~20-25x P/E and ~15-20x EV/EBTIDA. I would put in 100 BPS as these valuation levels (treating them as a floor) and continue to do so as the long-term story is very compelling.

**Appendix**

Graphical user interface, chart

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Chart, histogram

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Chart

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