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Saks: A Good Deal For All

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Disclosure: I have no positions in any stocks mentioned, and no plans to initiate any positions within the next 72 hours.

On May 22nd the financial media reported that Saks Inc. (SKS) hired Goldman Sachs (GS) to explore strategic alternatives, including the sale of the company. From a price of $11.85 the prior Friday, the stock closed that day at $15.50, an increase of 31%. While there are many hurdles to jump before closing a deal, on the surface a buyout has the potential to be a good deal for all.

Starting with an investor's perspective.

The company's actions suggest that management and board feel that a sale may create more value for shareholders than continuing as a standalone public company. Given the company's past share price performance this is not an unreasonable conclusion. If nothing else, formally exploring alternatives demonstrates good governance.

Ultimately, regardless of whether the majority of investors endorse a transaction, for all practical intents and purposes Saks' fate rests in the hands of a select few influential owners. Based on public data the company's top three investors control approximately 50% of the shares outstanding at an estimated weighted average cost base of $10/share. Therefore a buyout at the current price (before any additional acquisition premium) would yield a seemingly attractive shareholder return to them, at least relative to where the price was a few weeks ago.

Fortunately their interests are generally aligned with the "average" long term investor. Since the beginning of 2011 the company's average and median share price has been $10.80, still well below the current trading price.

What's in it for a buyer?

Conventional wisdom is that a deal that's good for the seller is bad for the buyer and vice versa. Of course, this isn't necessarily true. A well designed and executed transaction can benefit both the buyer and seller.

The acquisition of Saks' could be a good deal for either a *strategic* or *financial* buyer. An acquirer would get both an iconic brand with desirable assets and a company that has laid the groundwork for a value accretive acquisition.

Over the last several years Saks' has taken strides to improve its operating performance by reaccelerating revenue growth and increasing its profitability. Over the last three fiscal years Saks' has delivered 5% top-line growth (CAGR) compared to -4% the prior three years and expanded its Earnings Before Interest Tax Depreciation Amortization and Rent (EBITDAR) margin by nearly 400 basis points.

All-in the company's initiatives have yielded a $109M improvement in its "Residual Cash Earnings" between FY10 and FY13. (Note: Residual Cash Earnings or RCE is a cash-based measure of economic profitability. It measures Gross Cash Earnings after a Capital Charge on gross assets including an adjustment for operating leases. It's a robust measure in that it captures all operational improvements from both growth and profitability, while properly recognizing the cost of capital).

Additionally, Saks' has executed a very sound financial strategy that should make the company more attractive to a buyer. First, the company repurchased $196M of shares at an estimated average price of $10.30 resulting in a *Buyback ROI*, an annualized IRR on buybacks, of nearly 80% based on its current price.

The well timed buyback strategy accomplished two (related) goals. By reducing the share count at a price below its current price, Saks' in essence made itself "cheaper" to a potential buyer who can now pay a greater price per share than it would have previously (assuming the same price premium per share purchase price applied to fewer shares). Consequently, for the existing investors (those who remained after the repurchases) the recent price appreciation is now spread over fewer shares essentially "levering up" their total shareholder return.

Additionally, Saks improved its financial condition even further by redeeming its $230M of outstanding convertible notes. Over 90% of the note holders redeemed for a price equal to 100% of the principal plus accrued interest while the remaining holders opted to convert their notes.

The company was able to satisfy its obligation to these holders by delivering cash based on an average share price before its recent run-up.

To the benefit of the existing shareholders the company funded the redemption with cash on hand and operating cash flow rather than by issuing new debt or shares. Through this action, they were able to avoid the dilution that would have occurred had the convertible note *converted* at the now higher share price.

Consequently they also created additional debt capacity for a new buyer. Particularly for a financial buyer, the company's existing capital structure may be more attractive now without the convertible note. Including an estimated debt value related to Saks' operating leases we estimate that the company has an adjusted net debt of approximately $642M or about 1.7x last fiscal years' EBITDAR. This would presumably leave adequate room for increased leverage to make a leveraged buyout (LBO) doable.

Is there any value left?

Of course, all of the operational and financial improvements have been great for the existing shareholders (Saks' shares are up over 40% year-to-date including the anticipated take-over premium) but in order for a transaction to occur a buyer would need to feel comfortable that they're paying a reasonable price relative to any potential performance improvements or synergies.

Based on our initial analysis, even at the current share price the "embedded" investor expectations for Saks are not overly optimistic. In fact, much of the company's recent share price appreciation has been driven by a reduction in very pessimistic expectations at the start of the year.

While there are infinite combinations of growth, profitability and investment that can be reverse engineered to arrive at a current price of $15.50, consider the following forecast of embedded performance expectations that we constructed using consensus estimates for the next two years and then solved for the implied performance beyond that.

Value Driver	Actual		Consensus		Market Implied		
	1/28/2012	2/2/2013	2/2/2014E	2/2/2015E	2/2/2016E	2/2/2017E	2/2/2018E
Total Revenues	$3,014	$3,148	$3,261	$3,404	$3,553	$3,709	$3,871
Growth	*8%*	*4%*	*4%*	*4%*	*4%*	*4%*	*4%*
EBITDAR	$376	$376	$369	$404	$365	$323	$276
Margin	*12%*	*12%*	*11%*	*12%*	*10%*	*9%*	*7%*
Gross Operating Assets	$2,562	$2,724	$2,796	$2,841	$2,893	$2,951	$3,015
Asset Intensity	*0.9x*	*0.9x*	*0.9x*	*0.8x*	*0.8x*	*0.8x*	*0.8x*
Residual Cash Earnings	$72	$54	$54	$77	$50	$20	-$12
Margin	*2%*	*2%*	*2%*	*2%*	*1%*	*1%*	*0%*

PV of Residual Cash Earnings	$ 85
Current Gross Operating Assets	$ 2,746
Enterprise value	$ 2,831
Adj. Net Debt & Other	$ (581)
Equity value	**$ 2,250**
Basic Shares outstanding	145
Implied share price (Current)	**$ 15.50**

Based on the table above, we can conclude that currently investors are "pricing in" approximately 4% top-line growth a cumulative investment in CapEx and Rent of $1.2Bn and a 500 bps decline in EBITDAR margins from 12% to 7%. In total, at $15.50, investors are pricing in that the company's Residual Cash Earnings will fall to zero over the next five years and remain there in perpetuity.

Therefore there could be meaningful upside to an acquirer (assuming they buy at the current price) if they could simply sustain the current EBITDAR margins of ~11-12%. In this scenario the implied value of Saks jumps to ~$20 assuming the same level of revenue, growth and investment.

Therefore based on our initial evaluation it seems the acquisition of Saks at or near its current share price would likely be a good deal both for existing investors and the buyer. Of course the ultimate success of the deal from the buyer's perspective will be driven by the degree to which the synergies it can extract above and beyond the level of performance that was "embedded" in its purchase price.