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Stock to watch: A 'misunderstood' HBC tries a turnaround

By SHIRLEY WON
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One analyst says investors are hesitant to bet on the department store company because of a lack of familiarity with its divisions

Hudson's Bay Co.

Last close: $15.87 a share

Trading range since November IPO: $14.21 to $17.25 a share

Annual dividend: 37.5 cents a share for a yield of 2.4 per cent

Analysts' ratings: There are six buys, two holds and one sell, according to Bloomberg data. Target prices range from $12 a share as estimated by ***Veritas Investment Research's Kathleen Wong*** to $21 by Canaccord Genuity analyst Derek Dley.

Recent history: Shares of the North American department store retailer have struggled since it went public last November at $17 a share. Its initial public offering price had already been slashed from a proposed original offering of $18.50 to $21.50 a share. Hudson's Bay was acquired in 2006 by New York-based NRDC Equity Partners, a major real estate player led by Richard Baker, who is chief executive officer of the retailer. (He and funds he controls still own an 80-per-cent stake in the company.) Investor skepticism about the fortunes of Hudson's Bay stock is understandable given the competitive retail landscape in Canada with U.S. rival Target Corp. now on the scene, and Nordstrom Inc. slated to come next year. Hudson's Bay, which includes Hudson's Bay stores [formerly the Bay] and Home Outfitters in Canada and Lord & Taylor in the United States, has embarked on a growth strategy that may need more traction to get investors off the sidelines.

Manager insight: Hudson's Bay is a potential turnaround story that is still "misunderstood," but there are several ways management will be able to unlock value for shareholders, suggests hedge fund manager David Lorber.

Part of the reason why this TSX-listed firm has fallen under the radar is because Canadian investors know little about its Lord & Taylor business, while U.S. investors are not familiar with the Hudson's Bay department stores, said Mr. Lorber of Stamford, Conn.-based FrontFour Capital Corp. Once the company releases fourth-quarter results next month and starts telling its story (there's a CIBC conference for retailers on Thursday), "I think people are going to understand a bit more of what we see," said the fund manager who acquired his shares in the $15 range last month.

The continued turnaround at Lord & Taylor, a mid-tier department store acquired in 2006 from Federated Department Stores Inc., is one of the shorter-term catalysts for the stock, he said. The gross margins of that business have improved, and it is now generating significant cash flows that will show up in the Hudson's Bay numbers this year and 2014, he added.

Mr. Baker is taking some of those turnaround strategies to reposition the Hudson's Bay stores by cost cutting and improving merchandising and productivity, he said. Hudson's Bay has reduced its distribution centres to four from 10, integrated a new management warehouse system and is now focused on improving sales per square foot through a new merchandising plan. Manager compensation is now aligned to drive sales so the company culture is changing, he added.

While Hudson's Bay sold about 220 of its former Zeller's chain leases in 2011, there are about 60 locations that are still a financial drag on cash flow, he said. "We think they are actually negotiating aggressively with landlords to exit these lease obligations early, and we think they are going to be successful so ... cash flow will go up."

Over the longer term, he expects that Hudson's Bay could potentially sell its Home Outfitters division, a kitchen, bed and bath superstore. "We see it as a non-core asset," he said. Hudson's Bay owns more than half of its 11 million square feet of real estate so it could spin off into a real estate investment trust to add further value to its stock, Mr. Lorber said.

In the meantime, "we think that by the end of this year, we are going to see traction with a turnaround of the Hudson's Bay stores," he said. He expects the stock, which trades at about 6.5 times his estimated 2013 earnings before interest, taxes, depreciation and amortization, could reach $20 a share over two months, and closer to $30 within two years. "There is risk in any operational turnaround," but given the embedded real estate assets, its stock is trading "below real estate value," he said.