ORCHARD SUPPLY HARDWARE STORES (OSH) - $7.30 on 2/14/2013 by Kevin Duffy

			2012	2013
Price:	$7.30	Earnings Per Share:	$0.00	$0.00
Shares Outstanding (in M):	6	P/E:	0.0x	0.0x
Market Cap (in $M):	44	P/FCF:	0.0x	0.0x
Net Debt (in $M):	218	EBIT (in $M):	$0	$0
TEV (in $M):	279	TEV/EBIT:	0.0x	0.0x

Orchard Supply Hardware (OSH) is a specialty retailer primarily focused on selling home repair equipment in the California market. It was spun off from SHLD on December 31, 2011 and is down 52% since it started trading. I am recommending a short position in the common equity because OSH is in an untenable competitive position and over-leveraged.

Retail hardware is highly competitive and OSH has a very weak competitive position

It's hard to see that management's self-described "convenience" niche is working when their performance is compared against the big box hardware stores (HD, LOW) and the neighborhood hardware stores (True Value, ACE Hardware). To thrive in the middle of these entrenched operators, OSH must sell its products at a high margin and nail the inventory mix. OSH doesn't have the square footage or scale to credibly compete with the big box home improvement stores like HD and LOW and isn't nimble enough to match the expertise of an ACE or True Value. *Note: ACE and True Value are privately held, so disclosure is limited.*

Sales Comps

	Stores	LTM Sales per Sq Ft	Avg Sq Ft/Store	B&M SKUs	Avg Ticket
LOW	1,750	$258.43	113,000	40,000	$63.11
HD	2,250	$251.81	128,000	35,000	$54.55
OSH	89	$139.54	52,000	39,000	$26.00

Inventory Comps

	LTM Inventory Turnover
LOW	5.81
HD	4.46
ACE	6.14
TRU[1]	5.81
SHOS[2]	4.40
OSH	2.43

[1] FY '11

[2] Includes Sears Outlet

OSH's turnover has persistently been in the 2.4-2.5x range while competitors have markedly higher turnover. The high number of SKUs at each store is the source of this problem, but this is consistent with the goldilocks convenience strategy that they are pursuing. Personally, when I need a tool or material for home improvement, I want to be sure that the hardware store will have what I need and not be stocked out. It's possible that OSH is working this out, because they fired their executives responsible for operations and supply chain management on December 18th, but I strongly doubt it.

	FY Ending Jan 2011	FY Ending Jan 2012	LTM 10/27/2012
Revenue	660.7	660.5	645.8
Cost Of Goods Sold	401.5	406.8	403.1
Gross Profit	**259.2**	**253.6**	**242.7**
SG&A	190.0	208.8	216.7
Depreciation & Amort.	31.2	29.4	31.0
Other Operating Exp., Total	**221.2**	**238.2**	**247.7**
Operating Income	**38.0**	**15.5**	**(5.0)**
Interest Expense	(17.4)	(23.4)	(24.8)
EBT Excl. Unusual Items	**20.6**	**(7.9)**	**(29.9)**
Gain (Loss) On Sale Of Assets	-	(14.8)	0.2
Asset Writedown	(0.7)	(3.5)	(76.3)
Legal Settlements	(5.6)	2.1	0
Other Unusual Items	-	(1.2)	(1.2)
EBT Incl. Unusual Items	**14.3**	**(25.3)**	**(107.2)**
Income Tax Expense	5.6	(10.8)	(15.1)
Net Income	**8.7**	**(14.5)**	**(92.1)**
Diluted EPS	$1.45	($2.4)	($15.29)

Management's turnaround plan is advisable, but not terribly realistic, which is why they have not been able to execute

Management has a five point plan to turn things around:

1) *Project a consistent and compelling brand identity*: Easier said than done. Sales are following and OSH took a $65MM impairment charge of its trade name in the last quarter.

2) *Drive sales through merchandising and marketing initiatives*: They have seen fewer tickets but at higher revenues. However, COGS are up and gross margins are down on a QoQ basis as a result of the marketing effort. They have begun a store remodeling campaign that is in its early stages. It remains to be seen whether they can grow their way out of losses with declining gross and operating margins.

3) *Improve operational efficiencies*: They are starting to sort out supply chain issues and it's too soon to judge results.

4) *Align resources and talent*: This is standard; they have fired executives and will probably continue to shake things up.

5) *Strengthen the company's financial position*: They have been working on it, but it could be too little, too late for common equity investors.

OSH is over-leveraged and is running out of bullets with sale lease-backs

OSH is currently in violation of a leverage covenant on their senior secured term loan. They warned in their most recent 10-Q that they would likely still be in violation at the end of Q4 (2/2/2013) and that the loan could be considered in default unless they could restructure the loan or pay it down. A $55.2MM tranche matures in December and other loans have cross default provisions, so OSH is running out of time. There have not been any additional disclosures since quarter end and IR has not returned my inquiries. OSH has not generated positive operating cash flow in the last 12 months and has used sale lease-backs to pay down debt. OSH currently owns 7 stores and based on previous sale lease-back transactions, they could get approximately $77MM in proceeds, of which 75% would be required to pay down the term loan. This would be ideal for OSH because it would completely knock out its December 2013 principal payment. They are currently running 7.64x leverage and the $55MM term loan pre-payment would bring leverage down to 5.77x, which is just above the 5.75x covenant. This doesn't account for the hit to EBITDA because of rent expense because we don't have visibility into the rent arrangements with these landlords, so the leverage ratio would be higher than 5.77x. Of course, once they sell these stores, they will not have any more stores to sell to meet future financial obligations.

DUE WITHIN 1 YEAR	Type	Principal Due (USD)	Coupon/Base Rate
Senior Secured Credit Facility	Revolving Credit	46	3.500%
Senior Secured Term Loan First Tranche	Term Loans	55.2	5.000%
Senior Secured Term Loan Second Tranche	Term Loans	72.5	7.000%
Total debt due within one year		$173.7	
Total long-term debt & capital leases		$54.7	

Management has not met their own guidance of ameliorating their financial distress by the fall of 2012. Clearly, they are having difficulty selling their stores for the required price or arranging alternative financing. On the most recent conference call, management attributed the delay to the complexity of the transaciton and "lots of moving parts." With the recent downgrade by Moody's of the term loan to Caa2 and questions about market access, I don't think a debt (HY bonds) issuance will happen. If a sale lease-back transaction cannot be arranged, I believe the most likely path is to raise a secondary equity offering or a back stopped rights offering if Fairholme, Ares, or Eddie Lampert are interested. Regardless, this will be dilutive to holders of the common equity and likely hurt OSH's plans to remodel existing stores.

Management incentives are not aligned with shareholders or any capital providers

Shareholders of a distressed retailer would want their executives to have some skin in the game, but this is not the case at OSH. According to the most recent proxy, the CEO and CFO did not hold *any* stock options or stock. Although I don't doubt management's effort to solve OSH's business problems, they don't have their personal wealth tied to the company like shareholders and are less likely to make a heroic effort to successfully address these problems with the ingenuity that might be required.

Conclusion

OSH is an over-leveraged, poorly position retailer that is trying to mount a turnaround. Its turnaround plan is reasonable, but management has struggled to execute thus far. Strict loan covenants restrict the company's flexibility and OSH is running out of options to recapitalize the balance sheet. I expect the common equity to continue to fall as OSH fails to convert its promises to performance and its financing struggles further erode the equity base.

Update 2/18/2013

I had a chance to review the updated filings and I think things are quite bad for OSH. The stock was down 11% on heavy volume (156,000 shares).

OSH got a waiver on their 5.75x leverage test until Aug 2013. What the press release did not mention was that the waiver was conditional and contingent upon "i*ncluding achievement of a mutually acceptable agreement with the Term Loan lenders by May 1, 2013 relating to refinancing or modifications tothe Company's capital structure in a way that serves the best interests of all of the Company's stakeholders.*"

The filing goes on to say:

"While the Company anticipates continued compliance with the terms and conditions of the Waiver, including reaching a mutually acceptable agreement with the Term Loan lenders by May 1, 2013 with regard to refinancing or modifications to the Company's capital structure, failure to comply with the terms and conditions of the Waiver could cause the effectiveness of the Waiver to terminate. Upon such a termination, there would be a default under the Term Loan and, as a result, the lenders under the Term Loan could declare the outstanding indebtedness to be due and payable, in acceleration of the current maturity dates of December 21, 2013 and December 21, 2015. As a result of the cross-default provisions in our debt agreements, a default under the Term Loan could result in a default under, and the acceleration of, payments in the Credit Agreement. There is no assurance that the Company will be able to comply with all of the terms and conditions of the Waiver, including reaching the above-referenced agreement with the Term Loan lenders, and any such agreement is likely to be significantly dilutive to the Company'sstockholders."

The Hail Mary for OSH is their remodeled stores, which they claim are doing moderately better than older stores. I think they will try to push this story to potential investors/landlords to sell them on a sale leaseback transaction. Based on the calculations I did in the write-up, a successful sale leaseback gets them to 5.75x, which would probably be good enough for the lenders. I can't put any probability on that happening, except that it hasn't yet happened which is telling. The press release cites their success since 2011 with sale leasebacks but is silent on the prospects of selling the remaining owned stores.

If OSH had good news, they would have included it in the release, which leads me to believe that the situation is dire. Bottom line is that they don't generate operating income or cash flow from operations and I can't think of any capital provider who would want to step in to recapitalize the company and relieve the pressure that teh lenders are exerting. I think this could be a zero.