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HBC and Macy's: What's behind their surging stock prices?

DAVID MILSTEAD, Dec. 06 2013

Christmas sales are in full swing, but there are few deep discounts to be had among the biggest names in department store stocks.

Hudson's Bay Co. is up nearly 20 per cent since its September earnings report and is now the most expensive department store stock in North America. In the United States, shares of Macy's Inc. have climbed nearly 10 per cent after a mid-November earnings report revealed resilient sales despite a supposedly cautious consumer.

The surge in these stocks flies in the face of what used to be the conventional view of the new world of retailing. Pundits said we had entered a polarized world, with mass discounters like Wal-Mart on one end and higher-end retailers like Nordstrom on the other. There was little room in the middle for department stores, or so theory had it.

But Hudson's Bay and Macy's – the biggest department-store retailers in Canada and the United States, respectively – are demonstrating that there is a market for retailers who can cater to the middle-class shopper while mixing in the right blend of upscale elements. Both are setting the stage for a period of solid performance that will help justify their robust share prices.

"I think the middle is big," says analyst Paul Swinand, who covers Macy's for Morningstar.

To be sure, there are dangers in betting on a return of mid-tier merchants. Some "broadline" retailers, as department stores are called, have followed the script and turned into basket cases. But in the worst cases – think Sears Holdings and J.C. Penney – the major culprit was operational error.

In contrast, Hudson's Bay appears to be doing some significant things right. The company, which completed its acquisition of luxury retailer Saks Inc. last month, seems poised to capitalize on the No. 1 Canadian retail trend of 2013: goosing its share price by spinning off properties into a real-estate investment trust.

It is also making progress in improving sales per square foot at the Bay. Same-store sales – a key retail metric that tracks sales at locations open for at least one year – rose 6.2 per cent in the quarter that ended in August. (To be fair, discounting seems to have played some role as well, as gross profit margins fell more than a full percentage point from the prior year's quarter.)

The news for the quarter was otherwise mixed. Same-store sales at Lord & Taylor, the company's U.S. chain, fell 1.2 per cent, and Hudson's Bay missed its overall earnings expectation. The quarter, says Credit Suisse analysts David Hartley and Daniel Battiston, with understatement, "was not necessarily demonstrative of future success in executing the profit growth plan."

In the near term, however, investors are focused on a spinoff of the bulk of the company's real estate in a REIT, which could be unveiled as soon as Wednesday's earnings announcement.

CIBC analyst Perry Caicco, in a July note analyzing the Saks acquisition, estimated the U.S. retailer's real estate was worth $1.5-billion (U.S.) of the $2.9-billion purchase price. (The flagship Fifth Avenue location in New York City could be worth $800-million by itself, he figures.)

Placing those properties into a REIT along with the Canadian real estate would add several dollars per share to Hudson's Bay's share price, analysts figure – or, at least, they did three months ago, when the shares were trading at $16 to $17 (Canadian) apiece. With the stock topping $21 in recent trading sessions, it's bumping up against their target prices, suggesting the boost from a REIT announcement will be much smaller than the ones seen earlier this year. The seven analysts with "buy" ratings on the stock have an average target price just under $22, according to Bloomberg data, with the most bullish at $24.

The sole dissenter, ***Kathleen Wong*** of ***Veritas Corp***., noted that even at $17 a share, Hudson's Bay was trading at a valuation above its U.S. peers, although its profit margins were lower and its debt levels were twice as high. The valuation premium is even greater at current levels.

She calculated the company's fair value at $14, or $19 in the event of a REIT spinoff, saying "the competitive landscape is intensifying, with Target on track to open 124 stores by the end of 2013 and Nordstrom's plans to open five stores in Canada beginning in fall 2014 … merchandise at the Bay stores will be squeezed by Target at the lower end and Nordstrom at the higher end."

Of course, that was what was supposed to happen to Macy's, too. But the company, with more than 800 stores and $28-billion (U.S.) in sales (including its Bloomingdale's nameplate) has been a "steady Eddie" as the U.S. has emerged from recession, Mr. Swinand says. "They've steadily increased same-store sales and maintained margins, and they've done it all with internal programs that I call blocking and tackling."

Macy's calls the initiatives MOM. The first M is for My Macy's, a reference to how the retailer tweaks the merchandise mix in every single store to suit local preferences. O is for "omnichannel": making it easier for customers to shop in stores, online or through mobile devices. The final M is for another acronym, MAGIC selling, which includes getting salespeople to be nicer to customers.

This seems like obvious stuff, but it also seems to be working. Third-quarter earnings easily beat expectations and were 31 per cent above prior-year levels. Same-store sales increased 3.5 per cent.

Macy's "has significant buying power, strong relationships with its vendors, unique merchandise offerings, and strong national brand recognition, which we believe will help to achieve market share gains," says analyst Richard Jaffe at Stifel, Nicolaus & Co. Inc. He has a "buy" rating and target price of $55, slightly above Friday's close of $51.83 (U.S.).

Morgan Stanley's Kimberly Greenberger has an "overweight" rating on the stock and a $54 target price, saying she believes "the market underappreciates Macy's continued market share gain potential, as well as the retailer's best-in-class free cash flow yield and share buyback capacity."

Her "bull case" for the stock, which involves market-share gains accelerating, expanding profit margins and a higher price-to-earnings ratio, is $70.

Indeed, Macy's "steady Eddie" status suggests there may not be much downside to the shares, and more solid surprises may drive the price higher. Hudson's Bay seems a bit more of a gamble. The news at the Bay appears good, but the share price is being driven by retail-REIT mania. Once a spinoff occurs, Hudson's Bay stock will rise only so long as management continues coaxing more dollars from Canadian shoppers.