Rediscover Hudson's Bay

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By JACK WILLOUGHBY | Barron's

The famous Canadian retailer's recent IPO didn't generate much traffic among skeptical investors. Why the stock is worth another look.

Formed in 1680 to manage British fur-trade interests in North America, Canada's Hudson's Bay has a rich history on which to draw. Originally housed in forts near the bay, the retailer's outposts have been selling one of its customer favorites—tricolor blankets—for two centuries. Investors don't have nearly the same loyalty.

Local investors are understandably skeptical about Hudson's Bay and other Canadian retailers. Department-store giant T. Eaton & Co. went public in 1998, only to file for "creditor protection" 15 months later. The real-estate machinations of Hudson's Bay's previous owner, the late Jerry Zucker—who sold its profitable credit-card operation to fund his purchase and then allowed its stores and management to deteriorate—left a bad taste. The most recent owner is from a prominent real-estate family in the U.S., which tends to raise investors' suspicions.

So it wasn't too surprising that when Hudson's Bay came public last month at 17 Canadian dollars ($17.27), the shares already were marked down by 15% from the original asking price of C$20. The stock (ticker: HBC.Canada) quickly settled afterward at C$16.75. ***Kathleen Wong***, an analyst at Toronto-based ***Veritas***, doesn't think that's cheap enough and has a C$12 target price.

That seems too negative, based on Hudson's Bay's recent successes.

Close

Courtesy of Hudson's Bay Company

The retailer entered a new era in 2007 when a private-equity partnership bought it for C$1.1 billion. The partners' fund was spearheaded by Richard A. Baker, whose father, Robert, owns one of the biggest shopping-mall developers in the world and serves as chief executive of the fund.

The department-store company they created today generates about C$4 billion in annual revenue, gathered from operating about 25 million square feet of store space under three banners—the Hudson's Bay Company (also known as The Bay), with 90 Canadian stores; Home Outfitters, a bed and bath superstore with 69 locations in Canada; and U.S.-based Lord & Taylor and its 48 stores, which the firm purchased in 2006.

The younger Baker, who now heads the retailer, also can use Lord & Taylor as a guide. On a recent tour of the chain's famous Fifth Avenue flagship in Manhattan, he explained that Lord & Taylor has expanded its portfolio of designer brands and upgraded its technology to track everything from women's shoes to men's fashion to help drive sales. Despite a lot of initial skepticism from rivals, Lord & Taylor sales have grown to $210 per square foot in 2011, up 20% from $175 per square foot in fiscal 2009 (Lord & Taylor figures are in U.S. dollars). Adjusting for the roughly $20 million negative effect of Hurricane Sandy, Lord & Taylor's same-store sales would have jumped 3.7% in November.

"Rather than dealing in real estate and pricing his way out, Baker repositioned Lord & Taylor in New York, working with the brands to create a whole new retail environment," says Vince Camuto, a fashion designer for shoes and clothes.

Baker is trying to get similar momentum from Hudson's Bay. He hired Bonnie Brooks, a former merchandising chief at Canada's higher-end Holt Renfrew chain to restore the Bay's fashion sense and replaced management. It's refurbishing anchor stores and working more closely with important brands like Michael Kors and Burberry.

"We have world-class management people in every chair, the right vendor mix, and capital expenditure necessary to raise our sales per square foot," Baker says. The new executive team has a 14.6% equity stake.

What's intriguing is that the bar isn't set too high for Hudson's Bay to succeed. "We're not trying to invent anything new like J.C. Penney (JCP)," says Michael Culhane, chief financial officer of Hudson's Bay. At major department stores, sales average $240 per square foot, but Hudson's Bay's averages a measly $137 a square foot. The Canadian chain's three-to-five-year goal is $178 a square foot. "It's about using the existing space more productively," says Culhane.

The far-flung regional outposts remain the biggest worry to specialists like John Andrew, real-estate professor at Queen's University, in Kingston, Ontario. "Nobody goes to the centers in Kingston and Ottawa," he says. "You almost can't believe they're in the same franchise" as the more urbane stores in Montreal and Toronto, he says. Baker insists significant changes are being made at these stores.

It's also facing new competition from Target (TGT) and Nordstrom (JWN).

At C$16.75, Hudson's Bay is valued at 6.9 times enterprise value—market value plus net debt—divided by management's 2013 estimate of C$451 million in earnings before interest, taxes, depreciation, and amortization. That's near the top end of the roughly five to seven times that comparable retailers get. But for each 5% annual gain in revenue per square foot, annual cash flows are estimated to grow by 10%. Based on the 6.9 multiple, with net debt unchanged, the stock would be worth more than C$20. The company has also instituted a C36 cent dividend, for a yield of 2.2%.

Baker does have a real-estate card to play. He could create a real-estate investment trust that would cash in on the structure's recent popularity. Just a couple weeks ago, Loblaw (L.Canada), the big Canadian grocery chain, announced it would create a REIT in 2013, sending its shares 24% higher. Baker concedes his interest but says it's years away if it does occur. Hudson's Bay stock could be worth as much as an extra $8 a share, by ***Wong's*** reckoning, if it followed the Loblaws model.

That's a nice kicker for shareholders, but we'd prefer to see some fundamental gains at the northern outposts first.

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