Signet Jewelers – Strong balance sheet & cash flows, capable management with a plan, and a crazy low valuation coupled with a huge short interest

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Market outlook

We believe some of the companies in the US omnichannel retail industry are currently trading at unsustainably low valuations, courtesy of overly pessimistic perception by the investor community and algorithmic traders preying on the weakness of their stocks. Short interests on these companies are currently well above 30%, even exceeding 70% in a number of cases, with short costs usually well over 30% p.a.

It should be noted that, despite declining or flattish revenues and margins, these companies are all cash flow positive, command strong balance sheets, and are in the process of executing on business turnaround plans, with some of them being led by new management or activist investors.

We believe these companies have a good chance of staying relevant and not going out of business within next couple of years, a scenario the shorts seem to betting on. A number of long positions in these companies take up a significant portion of our assets under management at firm level.

Summary

One of them, Signet Jewelers, is a good example of the above – a profitable business with a solid balance sheet, decent margins, diversified product portfolio, high market share, growing omnichannel presence, bloated costs, and top management with a defined plan of optimizing the business at the helm. The company is currently priced to a scenario of significant revenue reduction over the next 6 years, zero terminal growth, failure to execute on cost cutting initiatives, and barely positive free cash flows.

We believe the overall current market sentiment to be the key reason for Signet's low valuation – nowadays, revenue growth is king, and a good number of traditional retailers transforming their business models and optimizing costs are implied to go bust within next 5 to 10 years.

The above, in our opinion, is a gross underestimation of the company's current position and potential. It is true that retail is an industry undergoing major structural change, with the strongest players growing online presence, cutting redundancies, adjusting product lines and introducing various customer loyalty programs. We believe, however, that retailers with solid fundamentals and competent management have a good chance of not only surviving but thriving under the omnichannel paradigm, and Signet is definitely a horse to bet on.

We will show that the profitability and stability of the business remain strong, and, due to a number of clearly identifiable factors, the company enjoys an inherent multiplying effect on any positive news or actual changes to its operations.

Our target price

For the sake of simplicity and margin of safety, we kept most of the market implied assumptions, having made the following adjustments:

- The average revenue per store would eventually recover and stay at a level of $1.78 million as sales accretion from store closures kicks in;
- The management would deliver on about half of its cost cutting efforts, reducing annual operating expenses by $137 million by 2024;
- The terminal revenue growth rate would be 0.16% p.a.

Given the above scenario is highly unlikely, we believe that the stock is a good long position for a fundamental investor not minding the current negative market sentiment and willing to wait for 3 – 5 years for the company to at least partly solve its costs issues. We will show that if they manage to deliver on the above numbers, the company should be valued at circa $28 per share, 55% above current market price.

Company financials

Below are key points on Signet's financials that outline the challenges the company faces and somewhat disprove the market implied scenario of imminent collapse in the near future:

- Revenues have decreased by circa 6.6% (1.3% p.a.) from their peak in 2016 on relatively stable gross margins. As of Q2 2020, eCommerce revenue was up 4.4% YoY, accounting for 11.5% of Q2 2020 revenues.
- Operating expenses (OPEX) have been climbing steadily at 3.8% p.a. over the observed period, taking up 31.4% of revenues, up from 24.2% in 2017.
- CAPEX had been falling by 17% p.a., with cash from operations (CFO) and free cash flow (FCF) growing at 3.6% p.a. and 18.8% p.a., respectively, since 2016.
- CFO and FCF margins are currently at 8% and 6% of revenues, respectively. The company was free cash flow positive in every single year over the last 18 years. The vast majority of the company's stores are free cash flow positive.
- Total debt had been declining at a rate of 17.6% p.a., bringing total current net debt load to $356 million, or 20% of equity.

It is evident that Signet has a problem with operating costs that needs to be addressed in order to post convincing cash flow improvements. We believe that the market greatly overstates the magnitude of this problem and will show that if Signet manages to cut its annual operating costs by circa $140 million or 7% on falling revenues, its resulting bottom line profitability would justify a much higher valuation.

The management believes this could be done as they progress with the Path to Brilliance transformation plan, which states achieving net cost savings of $200-$225 million by fiscal 2021 as a key priority. It is our opinion that the above numbers are certainly plausible, given the right cost cutting intentions and willingness to execute.

Business description

This section of our report is an edited excerpt from the company's annual report for the fiscal year 2019 available here: https://www.signetjewelers.com/investors/financial-reports/default.aspx.

Signet Jewelers is the world's largest retailer of diamond jewelry operating through a number of wholly owned subsidiaries with sales primarily in the US, UK, and Canada. The company operates over 3 300 stores, of which circa 2 700 are located in the US, over 100 in Canada, and over 400 in Europe.

The North America reportable segment operates across the US and Canada. Its US stores operate nationally in malls and off-mall locations principally as Kay (Kay Jewelers and Kay Jewelers Outlet), Zales (Zales Jewelers and Zales Outlet), Jared (Jared The Galleria Of Jewelry and Jared Vault), James Allen and Piercing Pagoda, which operates through mall-based kiosks. Its Canadian stores operates as the Peoples Jewellers a store banner. The segment also operates a variety of mall-based regional banners, such as the Mappins Jewellers.

The International segment operates stores in the United Kingdom, Republic of Ireland and Channel Islands, primarily in shopping malls and off-mall locations under the H. Samuel and Ernest Jones banners.

The North America segment generated $5.64 billion in revenues in fiscal 2019, 90% of total revenues. As of Q2 2020, bridal and fashion products accounted for circa 45% and 36% of revenues, respectively.

The company has a diversified portfolio of brands catering to a wide variety of customers differentiated by disposable income, marital status, age, and shopping patterns:

- **Kay**, the largest specialty retail jewelry store brand in the US based on sales, accounted for 39% of revenues. It operates in malls and off-mall stores, with the latter primarily located in outlet malls and power centers.

- **Zales**, which operates primarily in shopping malls and offers a broad range of bridal, diamond solitaire and fashion jewelry, accounted for 20% of revenues. Its sub – brand, Zales Outlet, operates in outlet malls and neighborhood power centers. The brand is positioned as "The Diamond Store" given its emphasis on bridal and fashion diamond jewelry.

- **Jared** is the fourth largest US specialty retail jewelry brand by sales, offering the broadest selection of merchandise of all Signet's brands. It is a leading off-mall destination store chain with largely free-standing sites with high visibility and traffic flow, positioned close to major roads within shopping developments. It ties for second place with 19% of revenues.

- **Piercing Pagoda** operates through mall-based kiosks generally located in high traffic areas that are easily accessible and visible within regional shopping malls, offering a selection of gold, silver and diamond jewelry in basic styles at moderate prices. It accounted for 5% of revenues.

- **James Allen** is an online retailer acquired by Signet in fiscal 2018 as part of the R2Net acquisition. Unlike the rest of the company's brands, James Allen does not principally operate in physical retail stores. Its products and distribution are catered towards younger audiences, bringing in 4% of Signet's revenues.

- **Peoples Jewellers** is Canada's largest jewelry retailer, offering its products at affordable prices. Peoples is positioned as "Canada's #1 Diamond Store" emphasizing its diamond business while also offering a wide selection of gold jewelry, gemstone jewelry and watches. It accounts for 3% of revenues.

- **Regional brands.** The North America segment also operates 32 mall stores under a variety of established regional names, such as JB Robinson, Marks & Morgan, Belden and Gordon's, in the US, and Mappins in Canada. The company's strategy is to reduce regional brand locations through conversion to national store brands or through closure upon store lease expiration.

- **H.Samuel and Ernest Jones** are two largest brands in the UK by number of stores. The former focuses on inexpensive fashion-trend oriented everyday jewelry, while the latter serves the upper middle market, with a target customer focused on high-quality, timeless jewelry

Recent developments and plans

During the first quarter of fiscal 2019, Signet launched a three – year transformation plan with the goal of repositioning the company to be a market share – gaining omnichannel wearable jewelry industry leader. The plan is expected to deliver $200 - $225 million in net cost savings and cost the company between $200 and $220 million, with $105 to $115 million in cash charges.

Key components of the plan are rejuvenating Signet's product assortment, closing underperforming stores, and developing the omnichannel capabilities with the goal of growing ecommerce to 15% of revenues by fiscal 2022:

- **Optimizing real estate footprint.** Signet intends to reposition its portfolio to drive greater store productivity, including development and implementation of innovative store concepts to improve the in-store shopping experience, and execution of opportunistic store relocations and store closures. The company has closed 397 net stores (mainly mall – based and regional brands) as of Q2 2020. Approximately three-quarters of closing stores are within the same mall as another Signet banner, and the company expects approximately 30% of revenue from closed stores to transfer to remaining Signet stores. Regional brands are in the process of being either converted into Kay or Zales or closed and all stores are expected to be either converted or closed by the end of fiscal 2020.
- **Reducing non-customer facing costs.** The Company is implementing initiatives across its operations, including strategic sourcing, distribution and warehousing, and corporate and support functions to drive cost savings and operational efficiencies. These include initiatives to reduce costs related to logistics, information technology, third party contracts and corporate expenses. The plan has generated $85 million in net cost savings in fiscal 2019 with additional $70 – $80 million expected in 2020.
- **Enhancing ecommerce and omnichannel capabilities.** Signet intends to invest in enhancing the customer experience across platforms and becoming the leading jewelry retailer across channels. New initiatives to drive increased digital traffic and improve conversion include using product image visualization across banners, personalization of content and product offering, expanding the omni-channel wish list, bridal configurator, online appointment booking, and enabling ability to view local store inventory online. Online sales were 11.5% of revenues as of Q2 2020, compared to 8% in Fiscal 2018.
- **Leading innovation and customer value.** Signet's goal is to develop new solutions to consumer jewelry needs and become the disruptor of innovation in its category. In addition, investments in data analytics and consumer insights including a system to track customer scores are expected to result in improved product assortment and faster time to market as well as greater marketing and promotional effectiveness. The company is in the process of completing its brand positioning and will clearly differentiate its banners with Kay standing for celebrating the treasured

relationship, Zales highly fashion oriented emphasizing style and self-expression and Jared celebrating one of a kind love and uniqueness. The company has written off a significant part of its inventory inventory to reduce its assortment of branded and third-party products as they expect to launch new product lines in Q3 2020.

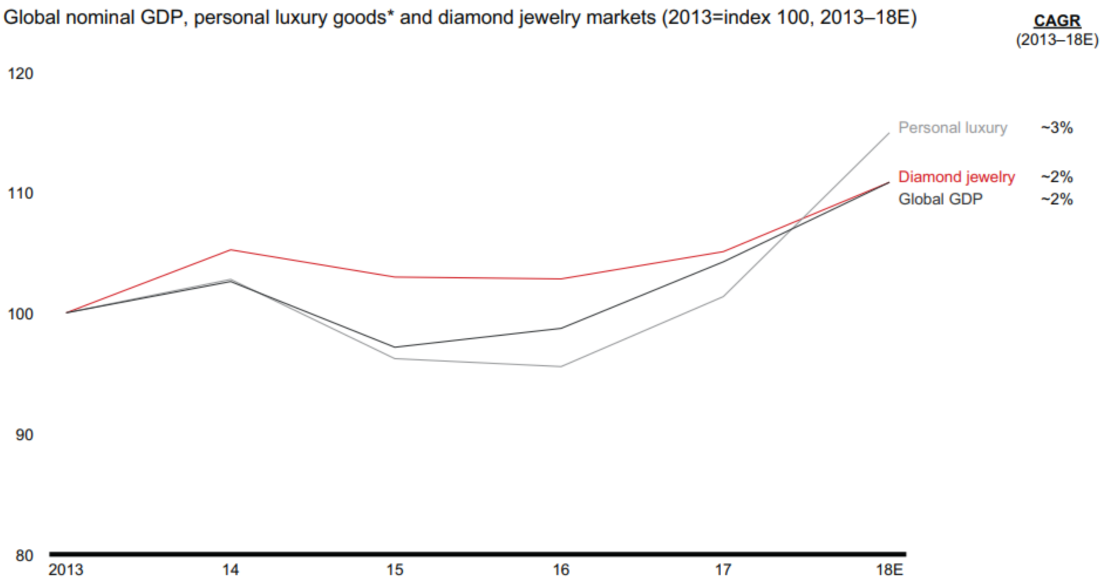
- **Strengthening employee engagement and building capabilities.** Signet believes that its team and organization will be key to accomplishing the company's transformation goals. It has hired and promoted several executives to fill key leadership roles, is investing in building ecommerce, analytics and innovation resources and is focusing on rebooting employee engagement in store operations and throughout the entire organization through training and development opportunities.

We believe the above plan makes sense, it is focused and concise, and the management is showing clear progress towards its goals. It is therefore highly likely, to our minds, that the above goals will be achieved, at least partly, disproving the market implied scenario of failure.

Jewelry market trends and competition

Revenue in the wearable jewelry segment in the US amounted to [$18 billion in 2019] with diamond jewelry, Signet's bread and butter, accounting for about 42% of the segment's revenues. The market is expected to grow by 1% p.a. over the next 5 years. Personal luxury and diamond jewelry spending remained stable relative to global GDP over the past five years:

Exhibit 4



**Source: Bain & Company*

In general, a [recent study] found that e-commerce currently represents 19% of all retail sales in the US with 10% of those coming from e-tailers with no brick – and – mortar presence and the remaining 9% stemming from traditional retailers. Online sales are expected to account for 25% of retail by 2021, with physical stores involved in 81% of all retail fulfillment.

We have spoken to a number of industry experts when preparing this research, all of whom have confirmed the following points on the industry:

- Higher – end jewelry retailers, especially ones selling bridal products, enjoy a relatively high customer stickiness in terms of brand loyalty, personal attachment, and insensitivity to slight price increases.
- Online stores are supplementary to physical ones and are not likely to ever replace them. The total "amazonification" of higher end jewerly, especially bridal, retail in the sense of sales moving online completely is a highly unlikely scenario in the foreseeable future. People prefer to "see & feel" jewelry items before buying them, besides the fact that a good deal of personification and tailoring is typical for this industry.
- Online margins are substantially lower than physical store margins, hence the omnichannel model seems to be the most optimal and stable at the time.
- Current consumer sentiment seems to be strong and industry expects Q4 2019 to be better than a year ago. Credit card delinquiency rates are relatively low.
- A significant part of sales (up to 40% in mall-based locations and 20% in freestanding stores) is driven by impulse buying.

- Synthetic diamonds do not pose a significant threat to the retail industry. Most of the major retailers already offer products made from synthetics, it is a niche product for the right customer. Should that change, they will certainly be able to adapt and sell lab – grown diamonds on a much larger scale. It is likely that retailers would capture the majority of the margin on synthetics as production costs continue to drop (wholesale prices have already fallen threefold over the last 3 years).
- Millenials and Gen Z are not likely to disrupt the industry with significantly different spending patterns. While they do tend to marry later and spend less on diamond jewelry, the demand for other categories, such as colorful stones, remains strong.
- In order to cater to the above mentioned consumers, retailers must maintain significant online presence, both in terms of stores and social media. Personalized marketing, loyalty campaigns, in – store assistance, and "growing your customers" by connecting with them early and maintaining that relationship throughout their life are all crucial components to being successful.

When asked about Signet, the experts had the following to say:

- The company is a well – run business and an adversary to be reckoned with. The current management team are viewed as able – bodied, experienced professionals with a deep understanding of the industry.
- The company's transformation plan certainly makes sense and is likely to succeed, at least on the cost cutting side. Excess cost and loss centers are relatively easily identified as the company employs good management reporting practices. Closing underperforming stores/liquidating local brands is a good way of achieving their goals.
- Signet's online presence and an early customer engagement policy is up to the task of staying relevant with millennials and Gen Z. A number of its competitors are trying to replicate Signet's approach as it delivers good customer retention.
- The employees are compensated adequately and their motivation system is based on transparent KPI's such as store net income. Key employee churn seems to be quite low and headhunting has proven to be difficult on certain occasions.

The US wearable jewelry market is relatively concentrated with a small number of largest players responsible for over 80% of total revenues. There is a trend to further consolidation as a large number of smaller, mostly local, players have either gone out of business of have been acquired in recent years. Some of the largest players seem to also be looking to consolidate, as LVMH has recently reached a buyout deal with Tiffany at $135/share, valuing the company at circa 3.5x revenues or 30x normalized free cash flow.

The table below outlines a number of metrics with the goal of showing how Signet compares to its peer group in terms of financial stability, operational efficiency, and current market valuation. We have included a couple of Chinese companies not in direct competition with Signet for illustrative purposes.

Exhibit 5

2018 or 12 month trailing	EV	Revenue	CFO	FCF	CAPEX as % of Revenue	5Y annual revenue growth	CFO margin	Gross margin	FCF margin	EV/S	EV/CFO	EV/EBIT	P/E	P/B	Net Debt/Revenue
Signet	1 191	6 143	492	362	2.12%	-2.25%	8.01%	36.00%	5.89%	0.19	2.42	4.24	4.83	0.84	0.06
Tiffany	15 234	4 385	595	292	6.89%	2.22%	13.57%	62.70%	6.66%	3.47	25.60	20.59	27.14	4.73	0.07
Pandora	4 954	3 295	1 017	934	2.53%	3.00%	30.86%	75.70%	28.35%	1.50	4.87	5.85	9.21	6.56	0.27
Movado	475	713	49	37	1.75%	5.23%	6.87%	54.50%	5.19%	0.67	9.69	5.79	8.72	1.11	-
Richemont	41 768	16 445	2 350	1 512	5.08%	10.37%	14.29%	61.80%	9.19%	2.54	17.77	17.73	27.60	2.29	-
LVMH	227 429	58 766	10 050	6 973	5.23%	14.08%	17.10%	66.66%	11.87%	3.87	22.63	19.29	29.98	5.89	0.11
Chow Tai	10 044	8 500	1 042	871	2.01%	5.23%	12.26%	27.90%	10.25%	1.18	9.64	11.41	14.91	2.22	0.16
Chow Sang	875	2 397	59	13	1.91%	4.96%	2.44%	25.80%	0.54%	0.37	14.96	4.56	6.01	0.56	0.04
Average/Mean	42 968	13 500	2 166	1 519	3.6%	6.4%	13.9%	53.6%	10.3%	1.94	15.02	12.17	17.65	3.34	0.13

**All data from company's financial statements and Bloomberg*

This comparison is not key to our analysis, as we estimate the value of the company based on a DCF model with conservative inputs, but the following can seen from the table:

- Signet is the cheapest company in the sample by EV/S, EV/CGO, P/E, and P/B;
- It is the only company in sample with falling revenues;
- Its CFO and FCF margins are significantly below average, clearly indicating the need to cut costs.

The competition is formidable, with a number of strongest competitors having significantly greater financial power. We believe, however, that having a solid foundation of large market share, good balance sheet, positive cash flows, and in – progress optimization program, Signet has a good fighting chance.

Valuation

We will first show that current market valuation implies a continuous deterioration of the business over the next 6 years, essentially voiding all of the management's plans and efforts.

We will then showcase our own valuation based on a set of modestly pessimistic assumptions, arriving at a target well over 70% above the current market price.

Valuation model

We believe a simple two – stage DCF based on assuming the revenue growth, CFO margin, terminal growth rate, and cost of capital would be sufficient to accurately demonstrate the market implied scenario and then provide us with a conservative target price.

As always, we are keen on reducing the amount of assumptions in the valuation model and the complexity of the analysis to a bare minimum, since we can clearly see an obvious misvaluation here and there is no need to overly fine tune things.

We will then present a number of catalysts that we believe will most certainly have a significant impact on the company's top and bottom lines, turning the market's perception around within the next 3 – 5 years.

Market implied assumptions and valuation

In order to arrive at a valuation of 15.8$/share, an insignificant deviation from the current market price, we had to assume the following over the next 6 years:

Exhibit 6

Item	Current value	Terminal value
Total Revenue, 000 $	6 143	5 423
Revenue growth rate	-	0.0%
Revenue 6 year CAGR	-2.1%	-
Operating expenses, 000 $	1 944	1 848
OPEX 6 year CAGR	-	-0.8%
OPEX margin	31.6%	35.0%
CFO, 000 $	492	172
CFO 6 year CAGR	-	-16.1%
CFO margin	8.0%	3.4%
Capex, 000 $	130	114
Capex 6 year CAGR	-	-2.2%
Capex as % of revenue	2.1%	2.1%
FCFF, 000 $	362	82
FCFF 6 year CAGR	-	-21.9%
FCFF margin	5.9%	1.5%
Tax rate	5.0%	22.0%
Cost of capital	6.3%	5.4%

**All applicable data from company's financial statements and Bloomberg*

The total number of stores should decrease by 140 with average revenue per store dropping by 1% p.a. (5% in total). Total revenues are implied to contract at 2% p.a. to $5.4 billion, decreasing by 12%, resulting in Signet losing circa 5% of its market share. There would be no terminal revenue growth.

Gross profit margin is implied to drop by circa 150 bp to 34.5% from the current level of 36%.

Cash flow from operations is implied to fall at 16% p.a., with the CFO margin decreasing to 3.4% from the current level of 8% as operating expenses remain largely unchanged in absolute numbers, growing from 32% to 35% of revenues.

CAPEX would contract on par with revenues, at a rate of 2% p.a. The resulting free cash flow should drop at a rate of 22% p.a., with the FCF margin collapsing to 1.5% from the current level of 6%.

Debt levels would remain unchanged, costing the company circa 4.6% p.a. The cost of capital should go down from an actual level of 6.3% to 5.4%., which is a generous assumption given the above scenario of falling revenues and collapsing profitability.

Our own assumptions and valuation

In order to obtain a conservative price target, we did a valuation on set of assumptions that seem to us as being pessimistic for a number of reasons outlined in the summary and conclusions section. We believe that the resulting numbers justify opening a fundamentally sound long position.

We have kept most of the market implied assumptions, having made the following adjustments:

- The average revenue per store would eventually recover and stay at a level of $1.78 million as sales accretion from store closures kicks in;
- The management would deliver on about half of its cost cutting efforts, reducing annual operating expenses by $137 million by 2024;
- The terminal revenue growth rate would be 0.16% p.a.

Exhibit 10

Item	Current value	Terminal value
Total Revenue, 000 $	6 143	5 678
Revenue growth rate	-	0.2%
Revenue 6 year CAGR	-1.3%	-
CFO, 000 $	492	227
CFO 6 year CAGR	-	-12.1%
CFO margin	8.0%	4.0%
Operating expenses, 000 $	1 985	1 848
OPEX 6 year CAGR	-	-1.2%
OPEX margin	32.3%	32.5%
Capex, 000 $	130	119
Capex 6 year CAGR	-	-1.4%
Capex as % of revenue	2.1%	2.1%
FCFF, 000 $	362	132
FCFF 6 year CAGR	-	-15.5%
FCFF margin	5.9%	2.3%
Tax rate	5.0%	22.0%
Cost of capital	6.3%	5.5%

**All applicable data from company's financial statements and Bloomberg*

Revenues would contract at 1.3% p.a. to $5.7 billion, decreasing by 8%, resulting in Signet losing circa 4% of its market share over the observed period.

As cost cutting initiatives kick in, operating expenses would drop at a rate of 1.2% p.a., staying at 32.5% of revenues.

Cash flow from operations would fall at 12% p.a., with CFO and FCF margins decreasing to 4% and 2.3% from current levels of 8% and 6%, respectively.

CAPEX would contract on par with revenues, at a rate of 4% p.a. The resulting free cash flow should drop at a rate of 21.3% p.a., with the FCF margin collapsing to 2% from the current level of 6%.

The above model results in an estimated target price of circa 28$, 55% above current market price.

Conclusion

As of now, the market clearly underestimates the true potential of the company to exist in the modern world, discounting it to oblivion on fears of management failing to deliver on its promises. We believe such perception is wrong to a high degree of certainty and that current market valuation implies an unrealistically harsh scenario.

It is evident that a significant portion of brick and mortar retailers that have sufficiently good balance sheets, margins, market shares, and smart management are fighting to stay relevant and adopt to the structural changes in the industry by employing a variety of means at their disposal. It is therefore safe to assume, to our minds, that retail will not become an industry dominated by a few huge players, but will continue to be a vibrant space of intense competition and innovation.

The market's pessimism, coupled with the company's strengths and our vision of the future of the retail industry as a whole, allow us to think of Signet as a coiled spring – lots of potential ready to be released once the management succeeds in reducing costs and showing an uptick in revenues. A significant short interest of 37% will see to it that the stock price shoots up when good news do arrive, something we have already witnessed in a number of retailers this year.

We also believe that our target price of circa $28 is a safe bet, since the assumptions that went into it are quite conservative. We estimate an investment horizon to circa 3 years, as that is sufficient time to see our scenario play out.

Potential risks to the position

We see the main risk to be the management not delivering on their plan and seizing the opportunities for unlocking significant value, for example, not cutting costs meaningfully, not bringing in any new revenue streams, and not authorizing the buyback program and punishing the shorts,.

There will most certainly be significant price volatility as progress reports are revealed, as business restructuring almost never goes completely smoothly, and we would strongly recommend for potential investors to be aware of that beforehand and be patient.

Related research

When preparing this report we have used a number of external research reports and statistics:

https://www.statista.com/outlook/13010200/109/jewelry/united-states

https://www.nationaljeweler.com/blog/8027-debunking-the-myth-of-the-retail-apocalypse

https://www.bain.com/contentassets/a53a9fa8bf5247a3b7bb0b10561510c2/bain_diamond_report_2018.pdf

https://www.refinery29.com/en-us/2017/03/145374/color-stone-millennial-engagement-ring-trend

https://www.bain.com/contentassets/a53a9fa8bf5247a3b7bb0b10561510c2/bain_diamond_report_2018.pdf

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