RESTORATION HARDWARE:
BUY THESIS WITH ASYMMETRICAL RISK REWARD PROFILE

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The RH story is that of a large scale transformation. Everything from the type of stores, to the merchandise, to distribution centers, to reverse logistics, to organizational hierarchy, to home delivery networks, to leasing policies, and more have been changed. The strategies appear to be working. That which started out as a crusade to reinvent RH from a failing kitschy furniture store to a highly profitable luxury brand that sells furnishings is almost complete. Customers are thronging the company's key retail locations in large numbers, the name is becoming synonymous with luxury furnishings amongst people that matter, and revenues and earnings are growing as never before. We believe the company has reached an inflection point where the previous risk embedded in the story has been replaced with an asymmetrical risk reward profile – investors that Buy RH shares are likely to experience substantial gains with comparatively low risk of drawdowns. We have a Buy Rating on RH with a 1-year Price Target of $370/share.

About the Author:

Poonam is an investment analyst and co-portfolio manager for Seamist Capital. She has more than 10 years of experience in equity research, having followed the biotechnology, pharmaceuticals, and medical technology sectors at the Stanford Group in Boston, and at Roth Capital Partners, Madison Williams, WR Hambrecht, and the Maxim Group in New York. During her tenure on the sell-side, she covered small-cap and large-cap healthcare companies based both in the United States and Europe.

Poonam has served as stock advisor to sell-side analysts associated with Canaccord Genuity, Think Equity, Global Hunter Securities, and WBB Securities and buy-side analysts at hedge funds that will remain anonymous due to confidentiality agreements. She has significant experience in stock picking and trading in healthcare companies both as an analyst and individual investor.

Her claim to fame is her persistently accurate analysis of Puma Biotechnology, a stock she has a sell rating on since March 2014. She subsequently published 6 more sell rating articles on the stock even when shares were trading at roughly $280, and sell-side analysts had Price Targets of over $300/share. The company reached a bottom of ~$20/share and is now trading at ~$50/share. The analysis among others can be read on Seeking Alpha.

Poonam earned a masters in finance from Hofstra University in New York and a bachelors in business administration from Northern Arizona University in Flagstaff. In addition, she has earned credits in biotechnology and pharmaceutical related content from several Ivy League universities. Poonam has passed the Series 7, 63, 86, and 87 but is not currently registered. She publishes her views on healthcare stocks on Seeking Alpha. Poonam has been ranked as 22nd of over 4,100 financial bloggers by TipRanks for 2014.

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We suggest that investors consider investing in shares of Restoration Hardware (RH) on pullbacks. Not only has the firm generated strong overall financial performance since going public in 2012, it is poised to substantially improve on those results over the next several years. Although, RH might face volatility in short term earnings due to the late cycle nature of the economy, the long term trend is likely to remain higher revenues, higher earnings, and higher free cash flows. The company's almost decade long transformation from a failing kitschy furniture store into a highly profitable luxury brand that sells furnishings is almost complete. Customers are thronging RH's key retail locations in large numbers, the name is becoming synonymous with luxury furnishings amongst people that matter, and revenues and earnings are growing as never before. In our opinion, the organization has reached an inflection point in its development where investment in its stock represents an asymmetrical risk reward opportunity. We are Bullish on the firm's prospects and rate shares a Buy with a 1-year Price Target of $370/share.

Investment Thesis

RH is in the process of reinventing itself into a highly profitable luxury brand that markets furnishings. In order to rebuild the company from the ground up, top leadership has implemented several radical strategies.

They began by starting the process of transforming the firm's showrooms into opulent design galleries. Presently, roughly 20 new design galleries have replaced previous retail locations. RH plans to open a total of approximately 70 design galleries to replace legacy showrooms. The company's design galleries typically generate significantly higher revenues than its legacy showrooms.

In addition, RH has changed the merchandise to mostly curated high quality products (sourced from top designers from all over the world) which were previously only available to the extremely wealthy through exclusive private galleries and high end interior designers. It is the first company to provide these types of luxurious furnishings at scale to the masses, at relatively affordable prices. The major addressable market for RH's products now is the demographic that has an annual income in excess of $200,00.

The firm has claimed the niche, luxury high quality designer furnishings at affordable prices category for which there is zero competition, both domestically and internationally. Therefore, the problem of losing market share to competitors is not an issue. In addition, given the continued growth of affluence in the Western Hemisphere, there is a significant total addressable market for the class of products RH markets and at their price points.

Moreover, the organization has switched from a promotional model to a membership model, thereby limiting the number of annual promotions, including those that are typically run seasonally. In exchange, for an annual payment of $100, customers can avail of a 25% discount on most RH merchandise as well as the firm's in-house interior design services, all year round. The strategy has resulted in reduced rates of: returns; exchanges; and cancelled orders.

Furthermore, the company has divested a number of distribution centers with a view to improve efficiencies. RH now has two distribution centers, one on the west coast and the other on the east coast. The strategy aligned with the firm's decision to reduce SKUs and dispose of the non-performing and/or redundant inventory. Not only is this approach resulting in improved availability of most required inventory and higher inventory turnover, but also reflecting in cost savings through lower occupancy costs and overhead expenses.

By positioning itself as a luxury brand with showrooms that are highly productive and by including (in many cases) traffic generating hospitality areas in floor plans for potential design galleries, RH is securing lower rents per square feet for properties the company is considering to develop into retail locations.

In order to secure better collaboration between team members, so that they reach decisions faster, be more focused, and hold each other accountable, the organizational structure has been streamlined.

An additional strategy has been to redesign the company's reverse logistics. Returns and exchanges of products are now sent directly from the customer's home to in-market alternatives such as outlets for resale. The policy prevents the delicate merchandise from having to first be returned back to the distribution center, before being reshipped to outlets. Not only does this approach reduce the times the products are handled and hauled around that reflects in better resale margins, but also results in cost savings related to transportation and handling.

With the objective of lowering expenses related to the development of new design galleries, RH is deploying financial engineering concepts such as sale lease backs, pre-selling the property, and joint ventures in deals with landlords.

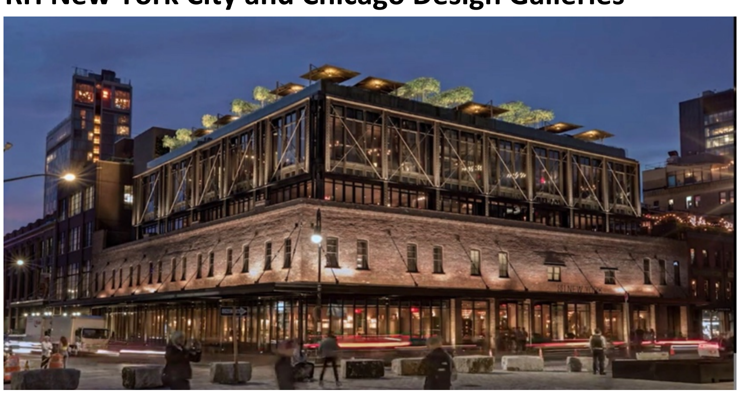
Ultimately, the firm is running a pilot program to investigate running its own white glove home delivery network. Although, the organization now manages and controls the transportation of its products to to its regional home delivery hubs, the ultimate delivery to the customer's home is carried out by third party providers. RH believes that by using its own trucks, drivers, and personnel to deliver its products into the customers home will: enhance customer experience and reduce the number of returns, damages, and deliveries per order; as well as result in cost savings related to transportation and overhead.

In our opinion, the strategies the company has implemented to achieve its vision of a highly profitable luxury brand have succeeded and will continue to deliver. For FY2018, on a year over year basis revenue grew 3% to $2.5 million, operating margin came in at 11.5%, and Earnings Per Share (EPS) was $5.68. For 3Q2019, revenue expanded 6.4% over the prior year to $678 million, operating margins was 13.2 %, and EPS came in at $2.17. FY2019 guidance on an adjusted basis is for revenue growth of 8% to ~$2.7 billion, operating margins of ~13.7%, EPS of ~$10.65, and free cash flows of ~$355 million. Long term adjusted guidance (provided by RH) is for revenue growth in the range of 8% to 12%, operating margins in the range of high teens to low twenties, and earnings growth of 15% to 20%. Given the guidance, the company has substantial runway to improve revenues, earnings, and cash flows.

RH has several opportunities to expand revenue growth. Some key revenue drivers include:

New Design Gallery Openings. RH has plans to replace all legacy stores with opulent design galleries. At present, roughly 20 new galleries have been opened with approximately 50 more expected to be introduced over the years. Current plans are to open five to seven of such showrooms every year. Importantly, the galleries are larger, providing substantially more space to showcase the RH furnishings collection than in legacy galleries, which typically present only 10% of the RH assortment. The firm has expansive galleries in key metropolitan areas such as the 90,000 square feet location in New York, slightly smaller but bespoke design galleries in the second home markets such as the Hamptons, prototype design galleries that range between 29,000 to 33,000 square feet in area in cities such as Columbus, Ohio and Charlotte, North Carolina, as well as design galleries that measure between 10,000 to 18,00 square feet in secondary markets such as Jacksonville, Florida, and Hartford, Connecticut. Given that company statistics suggest customers are more likely to purchase items presented in its showrooms, a larger assortment footprint in stores could reflect in improved revenue generation capacity.

RH New York City and Chicago Design Galleries



Source: Architectural Digest; Seamist Capital Presentation, December, 2019

International Expansion. RH has indicated plans to introduce design galleries in key international locations such as London, Paris, Frankfurt, Milan, Madrid, and Brussels, among others. As per the company's top leadership, the London and Paris locations are likely to be launched in 2021. Given that a majority of the world's millionaires reside outside of the U.S., RH's key addressable market is located internationally. In addition, based on our analysis, there does not appear to be a single luxury furnishings retailer in Europe that sells mass produced high quality luxury designer furnishings, providing RH a large addressable market with zero competition.

Embedded Hospitality Areas. The company is embedding restaurants, wine vaults, and coffee bars in its largest design galleries with a view to drive traffic into the stores, and to establish itself as a luxury brand. In our opinion, the hospitality areas provide a superior opportunity to get a large number of the firm's addressable market to interact with the furniture as they walk across, even if they are currently not looking to purchase items. The hospitality areas are easy promotion vehicles for RH, in our view, and because they are being developed to be ultimately accretive to the bottom line, a good source of earnings and return on invested capital.

RH Restaurants at the New York City and Chicago Design Galleries

Source: Restoration Hardware Website; Seamist Capital Presentation, December, 2019

New Products. In 2019, RH introduced new products under the RH Beach House and RH Ski House collections. In 2020, the company is scheduled to release new merchandise under its RH Color collection.

Merchandise From the RH Beach House and RH Ski House Collections

Source: Restoration Hardware Website; Seamist Capital Presentation, December, 2019

Embedded Interior Design Centers. The ultimate objective for RH is to graduate from selling furnishings to conceptualizing and selling spaces that deploy their furnishings. Presently, the firm provides complementary interior design services to customers that are enrolled in its annual membership program at RH design galleries. The interior designers at the firm are closely vetted professionals that make design (not decoration) suggestions, such as palettes for fabrics and leathers employing the RH Design Atelier. In the future, RH has plans to expand its interior design business and also to charge for services rendered.

In addition, the margin expansion RH has experienced due to the sweeping changes to the company's business model is expected to grow as the company continues to transform. Management has guided to longer term operating margins in the range of high teens to low twenties. In FY2018, RH reported operating margins of 11.5%. For 3Q2019, operating margins came in at 13.2%. Clearly, RH has significant runway to reach its operating margin goals.

Gross margins at the firm have increased substantially over 2018 and 2019. The gross margin expansion is likely to continue, driven predominantly by:

Lower Merchandise Costs. As revenue increases, the cost of the product assortment is likely to decline as larger quantities of merchandise is procured.

Reduced Rents. Occupancy costs per square feet are lower (for new showrooms as compared with legacy stores) as landlords continue to offer among others, favorable anchor tenant rents to RH, and the company deploys financial engineering and additional strategies such as sale lease backs to secure favorable occupancy terms.

Two Distribution Centers. Inventory turnover has increased and inventory risk reduced due to the smaller number of distribution centers. In addition, the company is saving occupancy charges and overhead expenses associated with the distribution centers that were disposed off.

Increase in Number of Outlets. Transportation and handling costs are lower and product margins higher as a result of the firm's policy to reroute returns to in-market alternatives such as outlets, instead of first shipping products back to a distribution center, and then from there on to an outlet.

Membership Model Flow Through. Ratio of returns, exchanges, and canceled orders are down due to the change from a promotional model to a membership model, leading to significantly higher gross margins.

In-House Home Delivery Hubs. Transportation and handling costs are lower as transportation of the company's products to home delivery hubs has been bought in-house.

Expected Final Mile Delivery Business. Transportation as well as handling costs will decline and margins associated with lower rates of: returns; exchanges; and cancelled orders will increase as RH expands its service to deliver products into the customers home. Currently, the firm for the most part deploys third party delivery services to transport products to customers.

Operating margins, per se, will continue to increase based on economies of scale related to:

Overhead costs. Fixed expenses per unit will remain the same as the organization continues to grow.

Advertising costs. Costs for promoting the brand and its products will decrease per unit as the number of new design galleries, product assortment, and sales volume expands.

Personnel costs. Roughly same number of team members will be involved in strategy, back office activities, and customer care as the company grows.

In addition, net profit margin and EPS will continue to improve because of:

Flow Through Effect. Improvements in gross margins and operating margins will flow through to the bottom line.

Share Buy Backs. Shares outstanding are likely to shrink further as RH management is likely to continue with its share repurchase program (as they believe their stock is undervalued at current levels).

Free cash flows will continue to increase not only because of growing earnings but also due to:

Lower Capital Expenditure. In order to lower capital expenditure associated with the development of its new design galleries, RH is developing the properties itself. In addition, with the objective of limiting the firm's capital expenditure commitments in building the new design galleries, it is entering into financial engineering deals such sale lease backs, pre-selling properties, and joint ventures to secure substantial funding from landlords to develop the retail locations.

The Estimated Value of a RH Share One Year from Today

We utilized Discounted Cash Flow (DCF) analysis including a perpetual growth based terminal value, to arrive at a 1-year Price Target of $370/share for RH. We assume a normalized 10 year domestic revenue growth rate of 7.5% (vs. Q32019 revenue growth rate of ~6.4% and an annual revenue growth rate of ~3% in FY2018). International sales estimates are normalized at $4 billion/year beginning in 2021. In addition, we derive our net income for 10 years using a net profit margin of 10% (vs. ~8% in 3Q2019 and ~6% in FY2018). Based on our analysis of RH's historic financial reports, we model straight line capital expenditure as 5% of revenue/year, normalized changes in working capital of 1.5% of revenue/year, and depreciation as 4% of revenue/year. Furthermore, we deploy a perpetual growth rate of 2% and a cost of capital of 9% to reach our terminal value and present value of free cash flow figures. We utilize the current outstanding share count of 18.7 million to arrive at our Price Target. We believe there is upside to our Price Target as our assumptions related to free cash flow are aggressive, and our international normalized revenue estimates and perpetual growth rate are conservative

RISKS

The Upcoming Recession. The next recession is likely to impact RH sales as a significant amount of the company's customers are high net worth individuals with investments in the financial markets. However, given its strong fundamentals, longer term, RH will continue to grow revenues, earnings, and free cash flows.

The CEO is the company. RH's Chief Executive Officer (CEO), Gary Friedman appears to be the brains behind the company's predominant strategies. In case he is no longer with RH, it highly improbable that the firm will be able to achieve long term revenue, earnings, and free cash flow targets. However, given that Mr. Friedman owns 27% of the company's publicly traded shares, the development is unlikely.

Establishment of 50 More Design Galleries Might Be Overly Ambitious. At the rate of five to seven design galleries every year, it will take between seven to ten years to launch 50. In addition, capital outlays to develop 50 galleries, even if landlords provide some financial support, will be large. However, it is important to note that the RH transformation started in 2010 and is still going strong. Moreover, annual capital expenditures have been declining, even though the company has launched several new design galleries over the past few years.

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