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House of mirrors

Gary Friedman, chairman and CEO of Restoration Hardware Holdings, is seated on a high-backed beige chair, looking into the camera and speaking over a track of New Age (or is it Minimalist?) piano music. "There's a saying in our business that people buy with their eyes," says Friedman, tanned and fashionably stubbled, in a video which the company distributed last month in conjunction with third-quarter earnings. "That our first response is visual and everything else is secondary. That you can't sell what you can't see. That what we see shapes our perception of what we believe."

As for *Grant's*, what we see in Restoration Hardware (RH on the New York Stock Exchange) is an accident waiting to happen. What we believe is that the equity of this greatest of recent retail success stories is about to slip and fall. As ultra-low interest rates have facilitated RH's bloated inventories and grandiose building plans, the aggrieved bulls (when they do become aggrieved) can take their complaints, or some of them, to Janet Yellen.

The bulls will stop and stare. RH is the only known retailer to achieve the feat of four consecutive years of 25% growth in comparable-brand revenue. The stock, which doubled in 2013 and was up by 43% in 2014, is quoted at 30 times forecast 2016 earnings, a forecast into which is built a 28% jump in profit. "While still in the early stages of building RH into the leading luxury home brand," Friedman writes in the third-quarter earnings release, "we see a clear path to $4 billion to $5 billion in North American sales, mid-teens operating margin and significant free cash flow." For perspective, the company is currently producing $2 billion in annual revenue, a 9% operating margin and negative free cash flow.

No reader of Susan Berfield's superb profile of Friedman in the Feb. 27, 2014, issue of Bloomberg *Businessweek* will underestimate Restoration's business leader, curator-in-chief and guiding light. Friedman started in retailing in the Gap stockrooms in 1977; in a flash he was the company's youngest and most gung-ho store manager, answering to the peppy nickname Gary Gap. Today, he wears a woven brown bracelet on which you can read the word "Believe." And in the aforementioned video clip, he allows the viewer to compare him to Steve Jobs, Mickey Drexler (his retailing mentor), and Albert Einstein. CEO since 2001, Friedman has overseen the company's fall from grace in the Great Recession, its subsequent sale to a private equity group in which Friedman himself participated (in June 2008), and an IPO flawlessly timed to ride the wave of the housing recovery (in November 2012), a ride materially enriched by Friedman's own shrewd eye for design. Affirms Drexler: "He basically took a moribund business and made it a relevant business." Relevant, yes, and for the investors—not least for Friedman, owner of 5.9% of RH shares—hugely profitable.

The Corte Madera, Calif.-based retailer is a design and housewares cornucopia. It sells—catering especially to the high-end consumer—furniture, lighting, textiles, bathware, household decorations ("décor"), outdoor and garden apparatus, tableware and children's furnishings. It operates 59 conventional-size stores, which it calls "Galleries," and in which it says it feels cooped up; a half-dozen immense stores of tomorrow, which it calls "Full Line Design Galleries"; three "Baby & Child Galleries," 18 outlet stores, and the occasional pop-up location at which the deluxe retailer is prepared to let down its high-end hair and hold a garage sale, like the one advertised in the banner ad shown nearby. The grand design is to replace the Galleries with Full Line Design Galleries, to expand product assortments, add new product categories—and, of course, to continue publishing catalogues so lush and backbreakingly heavy that they draw protests from UPS drivers.

And how does the company propose to realize this vision, in particular the projected 600 basis-point improvement in operating margin? Returning to the videotape, we watch Karen Boone, RH's chief financial officer, explain: "We believe we have the world's largest collection of luxury home furnishings under one brand trapped in undersized 7,000 square-foot legacy stores," says Boone. "And the key to unlocking the value of our company is to transform our real estate. Our next-generation galleries will present six to eight times the product assortment of our legacy galleries and we expect retail sales to increase two to four times in each market as we continue to expand our product offering into new categories and businesses." Even allowing for delays in construction, Goldman Sachs says that it expects RH to end calendar 2015 with 30% more square feet than it started with. Visions of $6 per-share earning power—say by the year 2018—are dancing in the bulls' heads. And if a skeptic counters with the observation that Friedman has presided over more money-losing years than profitable ones since he took charge in 2001, the enthusiasts have a ready-made reply. That fact is true but irrelevant, they will say. And right as rain they have been.

Still, it's a curious boom over which Friedman has presided. For instance, observes colleague David Peligal, fixed assets expanded in line with sales during the four magical years of blistering revenue growth, 2011-14. Which is to say that "asset turnover" was flat. "The reason that people care about comparable sales growth is that it represents a directional indicator of operating leverage," he points out. "There's not much operating leverage when assets grow right along with sales. By the numbers, net property and equipment jumped to $332 million in November 2014 from $93.7 million in October 2012. One could say Friedman & Co. were spending like drunken sailors even before the Full Line Design Gallery push started in earnest. So as they begin aggressively to grow square footage as store sizes increase from 7,000 square feet to something as high as 60,000 square feet, there will be ample opportunity for things to go wrong. Bulls are assuming that the plan will go off without a hitch."

Friedman admits to no doubts. "We've created spaces that blur the lines between residential and retail, indoors and outdoors, physical and digital," he tells his video audience. "We've created spaces where guests [sic] who visit our new homes [sic] are saying, 'I want to live here.' I've been in retail almost 40 years, and I've never heard anyone say they wanted to live in a retail store—until now. Most retail stores are archaic windowless boxes that lack any sense of humanity. There is no fresh air or natural light. Plants die in a typical retail store. And if we are building those, I too would be worried about the threat of online. But we don't build retail stores. We are creating inspiring spaces with garden courtyards and rooftop parks with reflecting pools, trickling fountains, and fireplaces."

About a year from now, if the analysts know what they're talking about, RH will be reporting 12-month sales of $2.24 billion and $3 per share in earnings—as noted, implying increases of 20% and 28%, respectively, in revenue and net income. Restoration is clearly taking market share. Unclear is how much share there is to take. The home furnishings' industry is fragmented and sleepy. It rang up sales of $91.2 billion in 2000; it did all of $101.4 billion in 2013, making for compound annual growth over that span of years of just 0.8%. Williams-Sonoma, a $7 billion market cap company, thinks it has a 4% market share. With such brands as Pottery Barn and West Elm, the company is projected to generate $5 billion of revenue in the fiscal year ended January 2016, up from about $4.7 billion this year. Williams-Sonoma's stock

Restoration Hardware Holdings, Inc.
(in thousands of dollars, except per-share data)

	12 months to 11/1/2014	2/1/14	2/2/13	1/28/12	1/29/11	1/30/10
Net revenues	$1,756,389	$1,550,961	$1,193,046	$958,084	$772,752	$625,685
Cost of goods sold	1,108,781	994,081	756,597	601,735	501,132	412,629
Selling, general and admin. expenses	498,947	502,029	505,485	329,506	274,836	238,889
Income (loss) from operations	148,661	54,851	(69,036)	26,843	(3,216)	(25,833)
Interest expense	(13,149)	(5,733)	(5,776)	(5,134)	(3,150)	(3,241)
Income (loss) before income taxes	135,512	49,118	(74,812)	21,709	(6,366)	(29,074)
Income tax expense (benefit)	60,393	30,923	(62,023)	1,121	685	(423)
Net income (loss)	75,119	18,195	(12,789)	20,588	(7,051)	(28,651)
Adjusted net income (loss)	89,173	69,101	37,739	26,451	3,025	(18,483)
Cash and cash equivalents	157,127	13,389	8,354	8,512	13,364	13,186
Merchandise inventories	610,497	453,845	353,329	245,876	206,406	149,026
Net property and equipment	331,988	214,909	111,406	83,558	76,450	62,192
Total assets	1,452,323	1,025,103	789,613	586,810	501,991	431,528
Total debt (including current portion)	282,669	87,621	87,029	131,040	116,995	61,652
Comparable brand revenue growth	19%	31%	28%	26%	26%	-10%
Asset turnover	1.56	1.71	1.73	1.76	1.66	1.45
Income from operations /interest expense	11.3	9.6	(12.0)	5.2	(1.0)	(8.0)
Capital expenditures	105,936	93,868	49,058	25,593	39,907	2,024

source: company filings, the Bloomberg

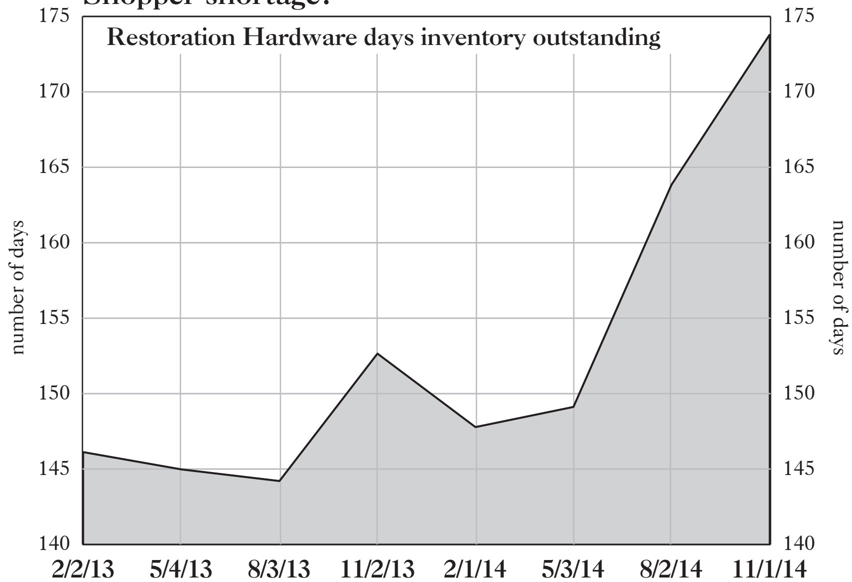
trades at 21 times the projected consensus earnings estimate for the fiscal year ending January 2016; the dividend yield is 1.7%. Restoration, as noted, trades at 30 times; it pays no dividend.

"I contacted a retail-focused portfolio manager I know and asked him about RH," Peligal writes. "He was short the stock and wanted his identity to be kept under wraps. He felt the biggest risk was not the stock's borrow, as the rate is low even though 28% of the float is short, but rather the timing of the short. The risk for a short-seller is that Friedman keeps executing. So when RH reported last month that comparable brand revenues increased 22% year-over-year, the stock jumped as many shorts covered. Yes, the company is currently doing well, he allowed, but the building boom presents an opportunity (as a bear would define opportunity). New stores tend to cannibalize existing stores—in other words, not all the expected business would be incremental. Furthermore, massive stores only work if a large portion of the neighborhood is shopping in them."

Speaking for himself, our anonymous short-seller continues: "In general, this is a tough business. One of the reasons furniture companies have never really grown to more than say $2 billion in sales is that it's just not a great economic return. It's harder to grow a business that doesn't have a great economic return versus something like Facebook. That's why there is nobody dramatically bigger than they are. So the financial aspects of this square footage growth, I think, are questionable. Another issue is the size of the stores. So their stores, on average, have been smaller, but they're talking about opening these 50,000 or 60,000 square-foot meccas—like in Atlanta or West Hollywood. In my experience, the only large store formats that work are ones that have mass-market appeal. So Wal-Mart, Target, even Best Buy. Best Buy did well at 25,000 to 30,000 square feet. Best Buy did not do well at 45,000 square feet. So the idea that you're going to appeal to a high-end customer—and I'll give them credit for doing a good job merchandising-wise, and building the brand in a way that appeals to the upper-end customer—it's hard to fill a huge store with upper-end customers because, frankly, there is not as many of them. The other related fact is that people in those neighborhoods don't want to all have the same furniture."

The furniture wouldn't have to be the same, to judge by the bulge in RH inventories. The company seems to carry everything and anything (as long as it's color is tastefully muted). Third-quarter results showed a 36.2% jump in stocks on hand from the year-earlier period. The number of days required to sell those goods—i.e., "days of inventory outstanding"—rose to 173 for the third quarter from 163 in the second quarter and from 152 in the third quarter one year earlier. Friedman registered no concern on the Dec. 10 conference call. "If you're growing the business horizontally," he told dialers-in, "there's no way your inventory growth is going to keep up with your sales growth or you are going to underoptimize the business. You have to—from an inventory point of view, you really have to be looking ahead. You can't just be looking at today."

Shopper shortage?



source: The Bloomberg

We conjecture that ZIRP is responsible for a general breakdown in managerial discipline. Late last year, Restoration amended and expanded its senior secured revolving credit facility. Instead of $600 million, it can now borrow $800 million. Instead of paying Libor plus 1.75% to Libor plus 2.25%, it can now pay Libor plus 1.25% to Libor plus 1.75%. In June, the company issued $350 million of convertible notes in a private offering. The interest rate attached to the coupon on those securities was zero, and with the proceeds of the financing, RH paid down its bank debt. As money is free, ambition can be boundless. By "stimulating" aggregate demand via ultra-low interest rates, the Fed is also necessarily stimulating aggregate supply. More aggregate supply is a force for lower prices (absent a corresponding uptake in demand), which is another word for "deflation," which is a trigger for additional monetary easing. More easing, other things being the same, means lower cap rates and higher stock prices. Higher stock prices mean more high-end consumption. More high-end consumption means higher multiples for the equity of high-end retailers. For RH, these are the good old days.

"I feel like he is running this business with the assumption that we'll never have another recession," our short-seller remarks. "They have so much inventory, it could get real ugly, real fast. And this inventory doesn't get better with age." Whatever the timing of the next recession, the past week has brought downbeat news on U.S. retail sales and disappointing guidance by Tiffany, Richemont, Best Buy and KB Home. Houston was the site of Restoration's first built-from-scratch design gallery. When it opened in November 2011, a barrel of WTI crude oil fetched $100; now the price is $46. We suspect that the prototypical RH shopper, in or out of Houston, is less sensitive to gasoline prices than to stock and bond and real estate prices.

The bulls may not yet be selling RH, but the insiders are. Thus, on Dec. 17, the afore-quoted Karen Boone—she appeared in the film clip—exercised and sold 8,000 shares of RH at a price of $95.28; she directly holds zero shares. Carlos Alberini, an RH director and Friedman's former co-CEO and soulmate (see the *Businessweek* story), sold 40,000 shares on Jan. 6 and 7 at prices ranging from $90.61 to $93.87 through a 10b(5)-1 plan. He continues to hold 532,855 shares, of which he owns 333,441 directly. Alberini, who left tens of millions of dollars on the table in unvested options to become chairman of the board and CEO of Lucky Brand one year ago (as RH common was extending its climb), was quoted as saying in a December 2013 Restoration Hardware press release that he plans "to remain a significant shareholder." Then there's Tommy Mottola, another RH director who, in his day job at Sony Music helped to develop the careers of Hall & Oates and Celine Dion; Mottola sold 163,733 shares on Dec. 12 at prices ranging from $93.31 to $98.21. Restoration's chief operating officer, Kenneth Dunaj, sold 20,280 shares on Dec. 11 through a 10b(5)-1 plan at a price of $93.54. His remaining directly held holdings are zero.

"Using RH as a way to be long U.S. consumption and housing for the past two years, the bulls absolutely nailed this one," Peligal winds up. "But things change—markets, styles, expectations, business conditions. Perhaps 2015 will be kinder to the bears."

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Read the footnotes

Vanguard Group Inc., which beats the mutual fund industry by not trying to beat the stock market, attracted more money in the first 10 months of 2014 than it did in any calendar year of its storied 39-year history. Reciprocally, reports Monday's *Financial Times*, "fewer fund managers are beating the market this year than at any time in over a decade, piling further misery on a profession that faces increasing investor skepticism."

Costs, returns and fads are the topics under discussion. In preview, we judge that passive equity investing is a good idea. It is such a very good idea, in fact, that it has become a fad. We are accordingly bearish on it—bearish in a cyclical way. We are bearish on passive bond investing, too—bearish in a more than cyclical way. And we are bullish on security analysis—bullish in an unconditional way.

You can't really argue with the Vanguard value proposition. Markets are reasonably efficient, and information is yours for the asking. Active managers, en masse, are not very good at their jobs. Costs are therefore a critical determinant—*the* critical determinant, Vanguard calls them—in achieving investment success. A half-decade's worth of rising asset prices is the evidentiary icing on the cake. "Active management has never been in worse repute," a man from Morningstar testifies. "This is the darkest of days."

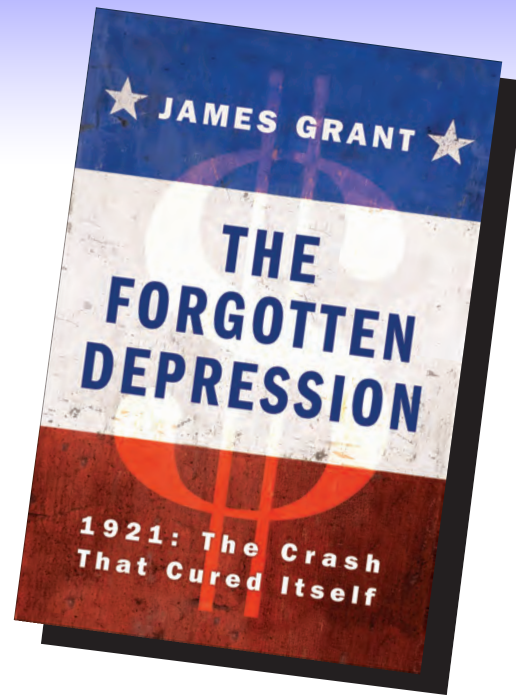
Many have helped to dim the lights. We think of Fred Schwed Jr., progenitor of the efficient markets concept in his wise and hilarious 1940 book, "Where Are the Customers' Yachts?"; Burton G. Malkiel, author of the influential 1973 book, "A Random Walk Down Wall Street"; Jack Bogle, who launched the good ship Vanguard in 1975; William F. Sharpe, author of the 1991 monograph, "The Arithmetic of Active Management"; and most recently, Charles D. Ellis whose "The Rise and Fall of Performance Investing" in the July/August issue of the *Financial Analysts Journal* initiated one of Wall Street's rare bursts of soul searching (nothing's turned up yet).

"As we all know," Ellis writes—"but without always understanding the ominous long-term consequences—over the past 50 years, increasing numbers of highly talented young investment professionals have entered the competition for a faster and more accurate discovery of pricing errors, the key to achieving the Holy Grail of superior performance. They have more advanced training than their predecessors, better analytical tools and faster access to more information. Thus, the skill and effectiveness of active managers as a group have risen continuously for more than half a century, producing an increasingly expert and successful (or 'efficient') price discovery market mechanism. Because all have ready access to almost all the same information, the probabilities continue to rise that any mispricing—particularly for the 300 large-capitalization stocks that necessarily dominate major managers' portfolios—will be quickly discovered and arbitraged away to insignificance. The unsurprising result of the global commoditization of insight and information and of all the competition: The increasing efficiency of modern stock markets makes it harder to match them and much harder to beat them—particularly after covering fees and costs."

The hedge fund business makes an ironic star witness for Ellis's case. In the decade ended in 2000, average annual returns topped 20%, according to Hedge Fund Research via a recent article in *Institutional Investor* magazine. In the five years to 2013, those annual returns had dwindled to an average of just 7.78%, as tallied by the HFR Fund Weighted Composite Index. Individuals who tritely apportioned 60% of their money to stocks and 40% to bonds in a low-fee index fund achieved an annual return of 13.17% over the same interval.

The retired hedge-fund eminence Michael Steinhardt came to the phone the other day to discuss the reasons hedge funds have fallen so short of the high mark he helped to set. The fund that became Steinhardt Partners (it was originally Steinhardt, Fine, Berkowitz & Co.) debuted in 1967. Over the next 28 years, it produced compound annual returns of 24.5% net of fees and profit reallocation, i.e., the standard 1% and 20% hedge-fund remuneration schedule. At the start, Steinhardt observed, there were perhaps 10 funds. Today,

"Hi, I'm rich. What's your name?"



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