

## The Michaels Companies, INC.

MIK

**Analyst:** Richard Acheson  
**Sector:** Consumer  
Discretionary

**BUY**

**Price Target: \$48.08**

### Key Statistics as of 4/21/16

Market Price:	\$28.28
Industry:	Specialty Retail
Market Cap:	\$5.9B
52-Week Range:	\$19.46 - \$29.56
Beta:	1.00

### Thesis Points:

- The acquisition of Lamrite West will add value to Michaels.
- Michaels shows that it has enough consistent growth in order to pay off its high amount of debt.

### Company Description:

The Michaels Companies is a specialty retailer that sells arts and crafts to its consumers. It is currently based in North America, having 91% of sales coming from the U.S. and 9% from Canada. Michaels sells good and services that consists of art supplies, baking, knitting, custom made frames, floral decorations, and wedding decorations. Unlike the rest of the retail industry, the transition from brick and mortar stores to online purchasing does not seem to be affecting Michaels. For this sector, consumers need to tangibly see what they are purchasing because they do not necessarily trust what they see online and feel more comfortable with buying a product they can physically see.



## Thesis

In the beginning of February 2016, Michaels acquired Lamrite West. Lamrite West is a wholesaler in the arts and crafts industry. The acquisition was for \$150 million. The market reacted very well to the announcement of the event. Since the acquisition, the stock price increase from \$22.08 all the way to its 52 week high of \$29.56. Investors believe that there is a lot of value to be created from acquiring Lamrite West. Michaels has effectively cut out a link in the supply chain and should be able to show improved margins in the near future.

One aspect of the company that has investors worried is their high amount of debt. They currently have about \$2.7 billion in debt which is fairly large considering that their revenue is \$4.9 billion in comparison. On the positive note, they have shown consistent improvements within the last two years. In 2014, the amount of debt was totaled at \$3.6 billion and in just two years they have been able to shrink their debt by 25%.

## Porter's Five Forces

### Bargaining power of suppliers: **MEDIUM – 38**

With the acquisition, Michaels is now going to be directly dealing with the manufacturers of their products. So this is currently going through a transition. For arts and crafts, Michaels is the biggest retailer in that specific sector. That should give them some bargaining power when it comes to the manufacturers.

### Bargaining power of customers: **MEDIUM – 57**

Consumers that want specific arts and crafts Michaels is the most well-known choice for supplies of that matter. They are the only publically traded arts and crafts specialty retailer, so other options for these products will mainly be small local businesses.

### Threat of substitutes: **LOW – 75**

There is very little threat of substitutes from the high quality products that Michaels offers. If they want

these materials or decorations then there is very little that they can do to find a replacement.

### Existing rivalry: **MEDIUM – 50**

As previously stated, Michaels is the only publically traded arts and crafts specialty retailer. So there is no major group of competitors. However, this is an industry where small businesses can be successful. Small business can sometimes be well known in local areas and be troubling for Michaels.

### Threat of new competition: **HIGH – 29**

This is an industry where small businesses can be successful in local area. It does not require a large amount of capital in order to start an arts and crafts retailer. Once a small business can establish a good relationship with a supplier and can obtain a good location, they can show to be very successful.

## Margins

Michaels' margins are fairly basic for any retailer but most importantly they are consistent. Revenue growth has been constant at 3.7% for the past three years. This isn't a rate that is considered extremely high compared to some others, but it is a rate that can be sustained over a long period of time. Gross margins have remained constant at 40% since 2013. EBITDA and net margins have seen a solid increase within the last year, increasing to 17.1% from 15.7%. Net margins have also increased from 5.7% to 7.5%.

In Millions of USD	FY 2013	FY 2014	FY 2015	FY 2016	Current/LTM	FY 2017 Est	FY 2018 Est
12 Months Ending	02/02/2013	02/01/2014	01/31/2015	01/30/2016	01/30/2016	01/31/2017	01/31/2018
Market Capitalization	-	-	5,209.7	4,556.1	5,896.5	-	-
Cash & Equivalents	56.0	239.0	378.3	499.4	499.4	-	-
+ Preferred & Other	0.0	0.0	0.0	0.0	0.0	-	-
+ Total Debt	3,041.0	3,694.0	3,114.7	2,769.8	2,769.8	-	-
Enterprise Value	-	-	8,046.1	6,916.6	8,259.0	-	-
Revenue, Adj	4,408.0	4,570.0	4,738.1	4,912.8	4,912.8	5,340.6	5,590.1
Growth % YoY	4.7	3.7	3.7	3.7	3.7	8.1	6.7
Gross Profit, Adj	1,765.0	1,822.0	1,901.2	1,968.4	1,968.4	2,131.5	2,243.5
Margin %	40.0	39.9	40.1	40.1	40.1	39.9	40.1
EBITDA, Adj	700.0	728.0	745.7	838.1	838.1	896.3	972.0
Margin %	15.9	15.9	15.7	17.1	17.1	16.8	17.4
Net Income, Adj	228.6	259.9	271.1	370.2	370.2	409.0	460.4
Margin %	5.2	5.7	5.7	7.5	7.5	7.7	8.2
EPS, Adj	-	1.45	1.31	1.75	1.76	1.95	2.20
Growth % YoY	-	-	-10.0	34.0	30.7	11.0	12.8
Cash From Operations	299.0	449.0	442.0	504.0	504.0	-	-
Capital Expenditures	-124.0	-132.0	-137.8	-123.9	-123.9	-131.0	-132.5
Free Cash Flow	175.0	317.0	304.2	380.1	380.1	386.7	488.3

## Lamrite West Acquisition

On February 2<sup>nd</sup>, Michaels announced their acquisition of Lamrite West, a wholesaler within their industry. The acquisition price was for \$150 million. This will help Michaels improve their already consistent margins. It's difficult to put a direct value on it though. Management

has not specifically stated an exact number that operating costs will decrease by. There is no doubt that this should be by a fairly high amount. We are talking about taking a whole link out of the supply chain. All of the margins that used to be part of Lamrite are now a part of Michaels. This vertical acquisition will give Michaels a lot of additional value in the future.

## Debt

As consistent as Michaels has been in the past, investors are clearly still worried about their high level of debt. Their debt is currently more than half of their revenue from last year at \$2.7 billion. It has given them a very high cost of debt as well as a lower credit rating. However, this has improved from previous years. In 2014, their debt totaled at roughly \$3.6 billion. So they have shown the ability to pay this down. There have been improvements shown in their credit ratios as well. For example, their total debt to EBITDA has decreased from 5.16 to 3.32. Also their EBITDA to interest expense has been increasing ever since 2011, going from 2.14 to almost 6. Their debt might make investors hesitant but there are showing the ability to manage it.

In Millions of USD except Per Share	FY 2011	FY 2012	FY 2013	FY 2014	FY 2015	FY 2016
12 Months Ending	01/29/2011	01/28/2012	02/02/2013	02/01/2014	01/31/2015	01/30/2016
Total Debt	--	3,490.0	3,041.0	3,694.0	3,114.7	2,769.8
Short-Term Debt	--	127.0	150.0	16.0	24.9	24.9
Long Term Debt	--	3,363.0	2,891.0	3,678.0	3,089.8	2,744.9
Total Debt/12M EBITDA	--	5.46	4.41	5.16	4.22	3.32
Net Debt/EBITDA	--	4.88	4.33	4.83	3.71	2.83
Total Debt/EBIT	--	6.49	5.14	6.06	4.97	3.84
Net Debt/EBIT	--	5.80	5.04	5.66	4.37	3.28
EBITDA to Interest Expense	2.14	2.52	2.81	3.33	3.72	5.99
EBITDA-CapEx/Interest Expense	1.85	2.09	2.31	2.81	3.02	5.10
EBIT to Interest Expense	1.77	2.12	2.42	2.84	3.16	5.17
EBITDA/Cash Interest Paid	9.23	7.43	6.38	3.91	3.15	6.46
EBITDA-CapEx/Cash Interest Paid	7.97	6.16	5.23	3.30	2.56	5.50
EBIT/Cash Interest Paid	7.63	6.26	5.48	3.33	2.67	5.57
Cash Interest Paid	64.0	86.0	108.0	183.0	234.3	129.3
Interest Expense	276.0	254.0	245.0	215.0	198.4	139.4

Not only that, but Michaels is going to be executing a share repurchase in the near future. During their most recent earnings call, they said they were going to do a share repurchase that would total up to \$200 million. This proves that management believes that their stock is underpriced as well. When the repurchase is executed, it will increase the value of the stock by decreasing the amount of shares available on the open market.

## Valuation

The valuation gave Michaels an intrinsic value of

\$41.97 with a one year target price of \$48.08. The inputs used to get these value were very conservative. The growth rate for the explicit period was 3% which is consistent with their 3.7% growth rate for the past few years. For operating costs, management has not been able to give an exact impact that the Lamrite West acquisition will make on operating margins. Their last reported operating costs were 83.6% of revenue. 82% was used for the continuing period, but it would not be a surprise if it dropped lower than that. Cost of debt for the explicit period is 8%. On the companies' 10k, most of their debt was rated at around that value. It is high but fair considering the amount of debt they carry as well as their credit rating. With these inputs, it shows that Michaels is clearly undervalued and is a great target for a buy.

## Conclusion

There is a great opportunity for a buy here. Michaels is putting themselves in a position to succeed in the future. They have some room for improvement with a decrease in their debt as well as their recent vertical acquisition. The Lamrite West acquisition gives them a huge chance to improve on their margins in 2016. This increase in profits can help them cut down their debt level even faster than they currently are. As previously stated, there is a high amount of debt here but they do have the ability to pay it off. These are the two main reasons that the valuation has calculated an intrinsic value of \$41.97 with a one year target price of \$48.08. With a current stock price of \$28.45 there is a huge chance for a high return here.

**The Michaels Companies, Inc. (mik)**

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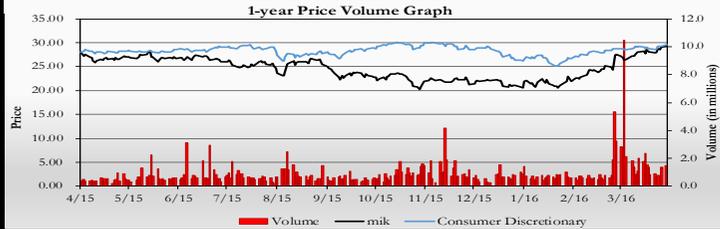
**BULLISH**

Analysis by Richard Acheson  
4/21/2016

Current Price: **\$28.28**  
Divident Yield: **0.0%**

Intrinsic Value: **\$41.90**  
Target Price: **\$48.08**

Target 1 year Return: **70.03%**  
Probability of Price Increase: **100%**



**Description**  
The Michaels Companies, Inc. owns and operates a chain of arts and crafts specialty retail stores under the Michaels and Aaron Brothers names in North America.

**General Information**

Sector	Consumer Discretionary
Industry	Specialty Retail
Last Guidance	November 3, 2015
Next earnings date	May 29, 2016
Estimated Country Risk Premium	7.00%
Effective Tax rate	36%
Effective Operating Tax rate	36%

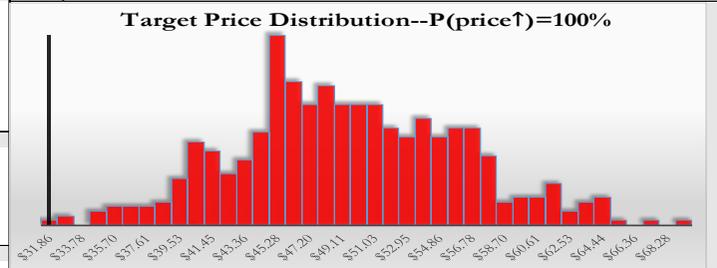
Market Data	
Market Capitalization	\$5,869.48
Daily volume (mil)	0.98
Shares outstanding (mil)	207.55
Diluted shares outstanding (mil)	209.35
% shares held by institutions	117%
% shares held by investments Managers	33%
% shares held by hedge funds	33%
% shares held by insiders	0.32%
Short interest	1.18%
Days to cover short interest	2.00
52 week high	\$29.56
52-week low	\$19.46
Levered Beta	1.00
Volatility	0.00%

**Past Earning Surprises**

Quarter ending	Revenue	EBITDA
1/31/2015	0.00%	-3.78%
5/2/2015	-1.52%	-7.37%
8/1/2015	-0.98%	-3.42%
10/31/2015	-1.71%	-5.47%
1/30/2016	1.06%	-1.08%
Mean	-0.63%	-4.22%
Standard error	0.5%	1.1%

**Peers**

Williams-Sonoma Inc.
Tractor Supply Company
Dick's Sporting Goods Inc.
Cabela's Incorporated
ULTA Salon, Cosmetics & Fragrance, Inc.
Bed Bath & Beyond Inc.
Best Buy Co., Inc.
Party City Holdco Inc.

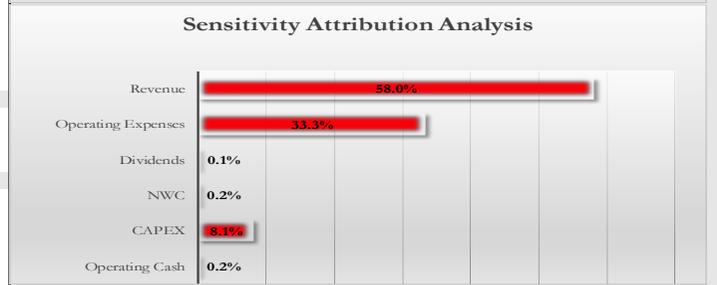


Management	Position	Total compensations growth	Total return to shareholders
Rubin, Carl	Chairman, Chief Executive Of	-47.87% per annum over 2y	N/M
Sonstebj, Charles	Chief Financial Officer and	-10.32% per annum over 5y	N/M
Carloti, Stephen	Executive Vice President of	-44.14% per annum over 1y	N/M
Pappas, Philo	Executive Vice President of	15.51% per annum over 5y	N/M
Mullahy, Dennis	Executive Vice President of	35.42% per annum over 1y	N/M
Sullivan, James	Chief Accounting Officer, Vi	N/M	N/M

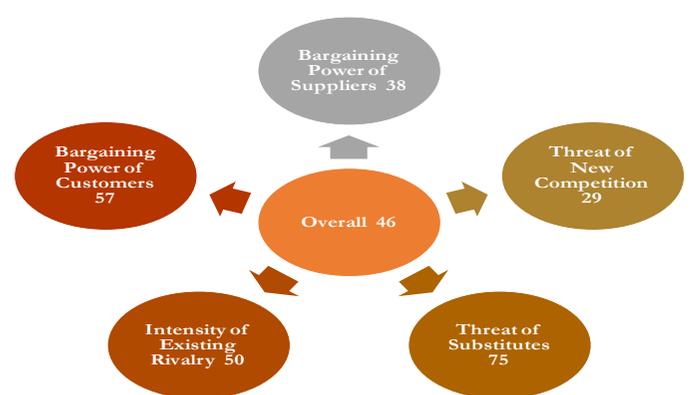
Profitability	mik (LTM)	mik (5 years historical average)	Industry (LTM)
ROIC	17.0%	25.55%	21.09%
NOPAT Margin	14%	13.45%	7.3%
Revenue/Invested Capital	1.25	1.90	2.90
ROE	30.3%	25.25%	24.53%
Adjusted net margin	10%	8.43%	6.9%
Revenue/Adjusted Book Value	2.94	3.00	3.56

Invested Funds	mik (LTM)	mik (5 years historical average)	Industry (LTM)
Total Cash/Total Capital	9.4%	8.0%	19%
Estimated Operating Cash/Total Capital	5.6%	5.4%	N/A
Non-cash working Capital/Total Capital	4.8%	6.3%	18%
Invested Capital/Total Capital	96.2%	97.4%	82%

Capital Structure	mik (LTM)	mik (5 years historical average)	Industry (LTM)
Total Debt/Common Equity (LTM)	1.16	0.26	0.21
Cost of Existing Debt	4.59%	13.94%	7.01%
Estimated Cost of new Borrowing	4.80%	11.35%	7.01%
CGFS Risk Rating	CC	D	A
Unlevered Beta (LTM)	0.60	1.00	0.89
WACC	6.96%	11.14%	9.80%



Porter's 5 forces (scores are out of 100)



Period	Revenue growth	Invested Capital	Net Claims	Price per share
Base Year	3.7%	\$1,501.73	\$5,156.83	\$41.36
1/30/2017	8.2%	\$2,500.92	\$4,366.08	\$47.25
1/30/2018	3.8%	\$3,279.86	\$3,522.28	\$53.41
1/30/2019	3.6%	\$3,725.35	\$2,735.69	\$59.73
1/30/2020	7.9%	\$3,933.55	\$1,765.73	\$66.33
1/30/2021	10.3%	\$4,186.75	\$920.29	\$73.17
1/30/2022	8.9%	\$4,385.99	\$28.44	\$80.31
1/30/2023	7.6%	\$4,561.68	-\$875.38	\$87.70
1/30/2024	6.2%	\$4,826.78	-\$1,930.14	\$95.37
1/30/2025	4.8%	\$5,044.50	-\$3,058.08	\$103.25
1/30/2026	3.5%	\$5,509.62	-\$4,252.24	\$111.32
Continuing Period	2.1%			

Valuation	NOPT margin	ROIC/WACC
Base Year	13.6%	2.44
1/30/2017	13.7%	2.47
1/30/2018	13.8%	2.40
1/30/2019	14.0%	2.41
1/30/2020	15.2%	2.62
1/30/2021	15.4%	2.78
1/30/2022	15.3%	2.70
1/30/2023	15.3%	2.62
1/30/2024	15.0%	2.46
1/30/2025	14.8%	2.33
1/30/2026	14.6%	2.21
Continuing Period	14.4%	2.09