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Siena Market Line
4th week of October 2016

Williams-Sonoma Inc.

NYSE:WSM

Analyst: Maxime Lattanzio
Sector: Consumer Disc.

BUY

Price Target: $53.94

Key Statistics as of 10/27/2016

Market Price:	$46.33
Industry:	Specialty Retail
Market Cap:	$4.102B
52-Week Range:	$45.96-$75.90
Beta:	0.83

Catalysts:

- Short-term: Q3-Q4 2017 Earnings Report
- Mid-term: Increased efficiency through broad supply chain reorganization
- Mid/long-term: Acquisition of Restoration Hardware and success of West Elm Hotels

Company Description:

Williams-Sonoma, Inc., is a retailer of home furnishing. It was founded in 1957 in Sonoma, California, and is nowadays headquartered in San Francisco. Even though the company's original goal was mainly oriented towards cooking hardware, it has diversified to general home furniture by acquiring companies such as Pottery Barn (itself divided into Pottery Barn, PB Teens, and PB Kids) and West Elm, and has acquired the lighting and hardware company Rejuvenation in 2011. West Elm just announced it will open a hospitality branch named "West Elm Hotels". Overall, the company operates mainly in the United States (95% of its revenue), but has operations in Canada, Puerto Rico, Mexico, Australia, UK, and has franchising agreements in the Middle East. The stock is currently trading at $46.33, close to its 52 week low of $45.96.

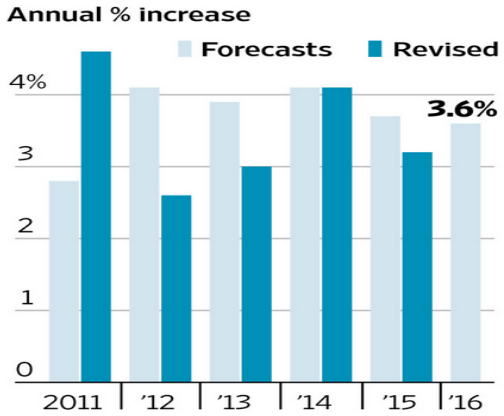
Thesis

- The stock price has suffered from a weak retail environment since early 2016, but the outlook for the industry is positive for both brick-and-mortar retail as well as for the e-commerce.
- In spite of the outlook, Williams-Sonoma managed to show positive revenue growth and above-average operating profits, and is currently consenting to financial discipline and supply chain restructuration that will positively impact profit margins in the future, in addition to stronger revenue growth.
- The company wanting to sustain strong revenue growth is acting aggressively (expansion and diversification of services), and would benefit from opportunities such as Restoration hardware.

Industry Outlook

The retail industry can be divided into two main segments: brick-and-mortar retail through physical stores, and online retail.

After several years of strong growth, the first half of 2016 has been challenging for the old-school segment of the industry. The main driver of this softening environment has been the net decline in mall traffic that has been observed in the whole country. However, solid job market and increased household spending, that likely improved consumer confidence, are expected to help sustain strong holiday sales. The most recent forecast from the National Retail Federation suggests that the annual increase is going to be around 3.6%, above the 2009 post-recession average of 3.4%, and well above last year's growth rate of 3.2%.



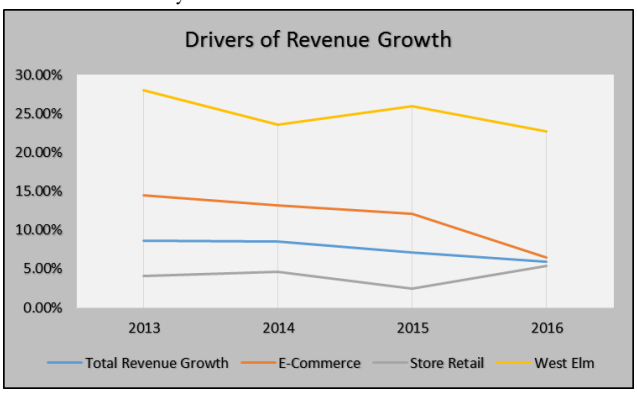
Source: National Retail Federation

Regarding the growing online retail segment of the industry, forecasts are optimistic on both short and medium term. The Online Retail Market in the United States is expected to grow at a compounded annual rate of more than 15% from 2016 to 2020.

Furthermore, the strong labor market and the only slow increase in interest rates from the Fed are expected to lead to another bullish year for the housing market. The Home Furnishing Retail Sub-Industry, heavily depending on the housing market and new home sales, is therefore going to benefit from this.

Driving Revenue Growth

The drop in Williams-Sonoma's stock price can be explained by the general concern of the market regarding the company's ability to generate strong revenue growth. As a matter of fact, the company's sales growth has been decreasing over time to fall below 6.0% for fiscal year 2016.



Store Retail sales have been growing at a slow 5% average rate for the past 5 years, and fell as low as 0.4% year-over-year for Q2 2017. E-commerce revenue, which had been growing at a solid double digit rate over the past years, has slowed down and recently dropped at a level equivalent to store retail's growth, around 6%. This means the company did not benefit from the fast-growing online retail market.

Management has understand these issues, and is planning to reallocate resources, especially marketing and advertising budgets directed towards digital, to boost online retail revenue growth. Strong focus is being put especially on sustaining strong growth, as the brand is aggressively directed towards e-commerce, and is already growing at a faster pace. 3 years ago, it only represented 10.6% of Williams Sonoma's revenue, and it weighed as much as 16.5% of the company's total sales at the end of fiscal year 2016, thanks to its CAGR of 25.0% over the last 4 years. The company believes West Elm has potential to become a "$2 billion brand", and past growth rate in addition to the aggressive e-

commerce strategy wanted by management are likely to lead the brand to maintain this fast growth rate for the coming years. Overall, Williams-Sonoma knows that future success depends on online retail, and the revenue trends confirm that e-commerce has become as important as physical stores, and is soon to become the main source of revenue for the company. E-commerce represented barely 41.5% of the total revenue in 2011, and increased to represent 50.7% of total revenue in 2016. Management statements during earning calls make me believe that the trend will continue, and could even accelerate in the future, which will have a positive impact on the company's overall profitability, as explained in the next section.

Profit Margins

When it comes to profitability, Williams-Sonoma has been performing better than its peers overall. In the last 12 months, the company generated Gross Margin 70bps lower than its peers, but generated higher EBIT, EBITDA, and Net Income Margins than the average, outperforming almost all its competitors on EBITDA and Net Income. Moreover, when it comes to ROIC, Williams-Sonoma is by far the best in class with 25.58%, outperforming the second best (BBBY) by more than 6% on this matter.

Name (BI Peers)	Gross Margin	EBIT Margin (TTM %)	EBITDA Margin (TTM %)	Net Income Margin (TTM %)	Return on Invested Capital
Average	37.38%	6.03%	8.54%	3.18%	2.47%
WILLIAMS-SONOMA INC	36.68%	9.80%	13.10%	6.18%	25.58%
BED BATH & BEYOND INC	37.83%	10.51%	12.89%	6.15%	19.28%
RESTORATION HARDWARE...	33.82%	7.08%	9.38%	3.08%	6.08%
PIER 1 IMPORTS INC	36.40%	2.24%	5.43%	1.06%	5.58%
ETHAN ALLEN INTERIORS...	55.68%	10.95%	13.39%	6.85%	12.49%
WAYFAIR INC- CLASS A	23.87%	-4.37%	-2.93%	-4.27%	-54.19%

Regarding the low gross margins compared to the industry, the underperformance is largely due to a recent management decision to offer large discount in retail stores to reduce the total merchandise inventories and promote supply chain efficiency, which will be discussed in the very next section. Management has accepted temporary hit on margins to promote future efficiency, and has already reduced its inventory by 6.6% as of Q2 2017, which is likely to drive profitability up in the coming quarters and years.

Finally, the outlook for the industry, compared to revenue trends and management objectives make me believe that the company's general operating margins are going to increase drastically in the future. As written earlier, revenue from e-commerce is consistently outpacing brick-and-mortar retail revenue. As of FY2016, e-commerce accounted for 50.7% of total revenue and for as much as 70.1% of operating income. Indeed, most recent data indicates that e-commerce produces operating margins as high as 22.10%, almost 4 times more than retail's 5.90% margin in the last quarter. As the market for e-commerce is expecting to grow rapidly and constantly over the last 5 years, and management is targeting its marketing and operations to promote e-commerce growth over retail stores, I expect the general profitability of the corporation to tend towards higher values than its history and the industry average, that are around 14.0%. This will increase the cash flows to the company, and therefore the value of the enterprise.

Supply Chain Management

One of the struggles of the company has been the management of its supply chain. Customer reviews about deliveries regularly point out delayed deliveries. On the company side, the poor management of deliveries and inventory had induced higher freight costs, contributing to destroy profitability.

In addition to the inventory clearance, recent delivery improvements have increased on-time deliveries and reduced deliveries per order. However, the biggest improvement of the supply chain might not have happened yet. The company has recently opened a single distribution center in Georgia for the whole Southeastern part of the country. The center, working at only 50% of its maximal capacity as of Q2 2017, already handles 40% of the Southeastern volume, and made the average delivery time to customers in the region decrease by 3 to 5 days. Once the center works at full capacity, distribution will be even more efficient in the region, contributing to lower shipping costs and increased customer satisfaction, helping improving customer retention and profit margins even more. As a consequence, I expect top management to expand the use of this distribution model to other regions of the United States until it covers the whole country, which will make the whole company able to generate increased revenue and profits.

Store Efficiency

12 Months Ending	02/03/2013	02/02/2014	02/01/2015	01/31/2016
Same Store Sales %				
Home Goods Stores	2.30	8.80	7.10	3.70
West Elm	17.40	17.40	18.20	14.80
Pottery Barn Kids	5.60	7.80	5.90	2.20
Pottery Barn	8.50	10.40	5.80	1.90
Williams-Sonoma	-1.10	1.50	3.80	1.10
PBteen	1.70	14.10	5.70	-2.70
Outlets	–	–	–	–

Since 2011, the company has constantly been posting positive organic growth. However, supplementary breakdown between different brands shows that most of the growth is attributable to West Elm. From year to year, same store sales growth is volatile. The company

is opening stores (33 openings company-wide in FY2016 and 9 closings in Williams-Sonoma stores in the same year), but is not generating constant organic growth, thus not adding much value to the company. To remediate this, management is conducting audit of markets and stores to reposition those that are less efficient. The ultimate goal would be to drive more sustainable same store sales growth.

Expansion and Acquisitions

West Elm Hotels

To diversify its business, West Elm announced on September 26th it will open, jointly with DDK Hospitality Management, a hospitality branch focused on boutique hotels. While the company will manage the design and furnishing of the hotels, DDK will operate them. Upon announcement, the market was worried that it could be a diversion from the core business (Short Interest increased to tend towards 11%). However, DDK will bring the necessary knowledge to manage the hotels efficiently through its experienced executives. Moreover, West Elm already operates a hospitality branch, and Peter Fowler, head of the branch, stated that hotels will cost 40% less to construct and furnish compared to the average, thanks to existing vendor base.

Acquisition of Restoration Hardware

Restoration Hardware Holdings Inc. is a high-end furnishing company. After growing at a tremendous rate (over 20% in the last 7 years), has been having troubles capitalizing on its growth, and past year has been rough for the company (-35.6% EPS growth, Revenue growth of only 9.1%), as the company is having troubles upgrading its supply chain to its growing market shares, and has had several unsuccessful promotional campaigns over the last 2 years, leading to a -62.45% stock price change YTD. Many observers think RH could benefit from a merger with WSM as it would be able to use its supply chain and gain the efficiency it has been lacking in the last quarters. For Williams-Sonoma, the advantage would be penetrating the high-end furniture market.

On June 22nd, the sole rumor that the deal was bound to happen made WSM stock jump by 2.7% (and RH stock by 7%). The main obstacle for now is management reluctance to sell its company, but the increasing pressures on sales and profits might be likely to force Restoration Hardware to accept a deal in the coming years.

Financials and Multiples

Historically, Williams-Sonoma has had extremely low debt levels (both Long Term and Short Term) tending towards 0, well below its competitors. As of July 31st, it had only $125M of short-term debt, but still is more financially flexible than its competitors.

Capitalization (Debt/Equity)			Kd		
	History	*LFY*		*History*	*LFY*
WSM	0.00	0.03	WSM	3.0%	3.0%
Competitors	0.14	0.15	Competitors	13.4%	4.4%

Consequently, if the company ever had the opportunity to expand or acquire another company, it could take on debt at an affordable interest rate.

WACC			ROIC /WACC		
	History	*LFY*		*History*	*LFY*
WSM	12.5%	9.5%	WSM	1.82	2.65
Competitors	18.7%	9.8%	Competitors	0.91	2.32

Historically, has had lower WACC than the industry and its competitors. However, in the last year, competitors have lowered their Cost of Capital and are now close to WSM. However, given Williams-Sonoma low cost of debt, it has room to improve its capital structure to converge towards its optimal WACC.

Thanks to this low WACC and a higher ROIC than its competitors (discussed before), the company has been creating value historically, even when its competitors had been destroying value (added-value ratio<1). Now that all of the industry is performing on a value creation basis, WSM is creating even more value than competitors, being best in class. With the rapid growth of the profitable e-commerce segment, value creation is likely to keep on going the right path.

12 Months Ending	02/02/2014	02/01/2015	01/31/2016	10/24/2016
P/E	19.20	24.45	15.19	13.66
Average	21.12	23.76	23.41	
High	23.77	28.50	27.71	
Low	17.04	18.61	15.19	
EV/EBITDA	7.98	10.49	6.75	6.47
Average	8.91	9.95	9.96	
High	10.19	11.84	11.88	
Low	7.16	7.74	6.29	

Finally, when it comes to multiples, the company, like the industry, is trading at low multiples compared to its historical average: EV/EBITDA of 6.47 near its 3-year low, P/E of 13.66 near its 7-year low. All stocks in the industry have taken a hit since beginning of the year, but current value creation, profit margin and initiatives, growth potential of West Elm brand, and the macro-outlook for the coming years make me believe that Williams-Sonoma is going to bounce back from its current price 52-low.

Future Dates and Catalysts

In the near future, the price of the stock is likely to be moved significantly by earnings announcements for Q3 and Q4 2017. Even though the company has recently beaten estimates on Revenue and EPS (beat 5 and 7 out of 8 last estimates), the stock has suffered in Q2 2016 from weak retail traffic that has negatively impacted same store sales growth. However, the outlook is positive for the near future, and, as expectations for the back half of the year have been lowered, negative surprise is less likely. The main move will be in Q4, as this period is usually the company's more lucrative (+50% revenue than other quarters).

In the next year, significant effects of initiatives in supply chain management and e-commerce revenue growth on the company's results will be expected and will move the price.

Finally, in a longer range, first results of West Elm Hotels, which will have a strong impact on the brand's revenue growth, as well as the potential buyout of Restoration Hardware, will lead to significant changes in the stock price.

Summary

In conclusion, Williams-Sonoma is a strong opportunity for several reasons. It is currently trading at a really low price (on both historical and multiple grounds), and recent and current initiatives, segments growth, and profitability are indicators that the company is likely to perform better than its competitors in the future, driving the price of the stock closer to what it was a few years ago.

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4th week of October 2016

Williams-Sonoma Inc. (WSM)

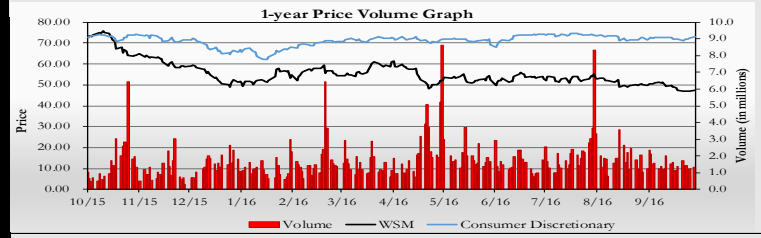
CENTER FOR GLOBAL FINANCIAL STUDIES

NEUTRAL

Analysis by Maxime Lattanzio
10/27/2016

Current Price:	$46.32	Intrinsic Value	$59.14
Divident Yield:	3.2%	Target Price	$53.94

Target 1 year Return: 19.65%
Probability of Price Increase: 89.4%



Description

Williams-Sonoma, Inc. operates as a multi-channel specialty retailer of various products for home.

General Information

Sector	Consumer Discretionary
Industry	Specialty Retail
Last Guidance	November 3, 2015
Next earnings date	November 19, 2016
Estimated Country Risk Premium	6.50%
Effective Tax rate	39%
Effective Operating Tax rate	38%

Market Data

Market Capitalization	$4,129.84
Daily volume (mil)	0.74
Shares outstanding (mil)	88.53
Diluted shares outstanding (mil)	90.67
% shares held by institutions	96%
% shares held by investments Managers	83%
% shares held by hedge funds	13%
% shares held by insiders	8.30%
Short interest	20.24%
Days to cover short interest	9.63
52 week high	$75.90
52-week low	$45.96
Levered Beta	0.99
Volatility	25.33%

Past Earning Surprises

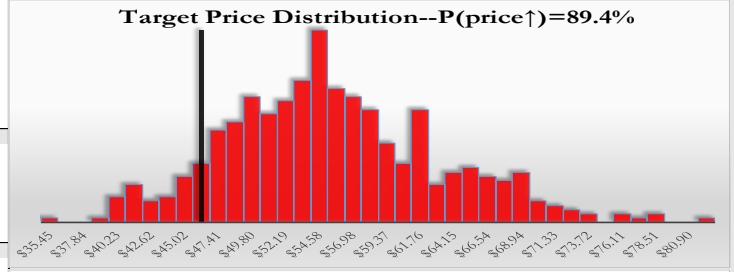
Quarter ending	Revenue	EBITDA
8/2/2015	-1.36%	-8.69%
11/1/2015	0.22%	-8.11%
1/31/2016	-5.01%	-9.37%
5/1/2016	0.44%	-1.27%
7/31/2016	-2.20%	-7.52%
Mean	-1.58%	-6.99%
Standard error	1.0%	1.5%

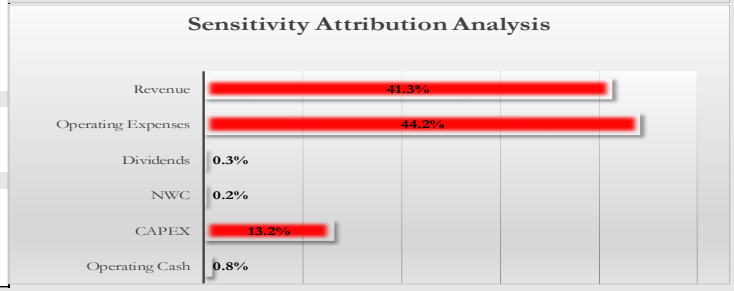
Peers

Bed Bath & Beyond Inc.
Tractor Supply Company
Pier 1 Imports, Inc.
Restoration Hardware Holdings, Inc.
Wayfair Inc.
Lowe's Companies, Inc.
The Home Depot, Inc.
Best Buy Co., Inc.

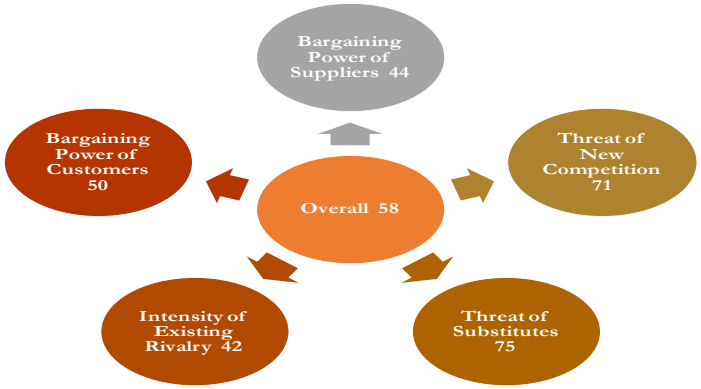
Management	Position	Total compensations growth	Total return to shareholders
Alber, Laura	Chief Executive Officer, Pre	-100% per annum over 4y	8.8% per annum over 4y
Whalen, Julie	Chief Financial Officer and	-100% per annum over 3y	7.21% per annum over 3y
Stangl, Sandra	President of Pottery Barn, P	-100% per annum over 4y	8.8% per annum over 4y
Hayes, Janet	President of the Williams-So	-100% per annum over 2y	-0.52% per annum over 2y
Brett, James	President of West ELM Brand	N/M	0% per annum over 0y
Miller, Dean	Chief Operating Officer and	N/M	N/M

Profitability	WSM (LTM)	WSM (5 years historical average)	Industry (LTM)
ROIC	17.3%	11.74%	20.68%
NOPAT Margin	9%	9.13%	7.1%
Revenue/Invested Capital	1.98	1.29	2.91
ROE	24.7%	15.74%	24.64%
Adjusted net margin	8%	8.06%	6.4%
Revenue/Adjusted Book Value	3.07	1.95	3.84
Invested Funds	**WSM (LTM)**	**WSM (5 years historical average)**	**Industry (LTM)**
Total Cash/Total Capital	3.4%	8.6%	19%
Estimated Operating Cash/Total Capital	3.4%	7.8%	N/A
Non-cash working Capital/Total Capital	10.3%	8.3%	19%
Invested Capital/Total Capital	99.5%	98.6%	82%
Capital Structure	**WSM (LTM)**	**WSM (5 years historical average)**	**Industry (LTM)**
Total Debt/Common Equity (LTM)	0.32	0.22	0.24
Cost of Existing Debt	4.82%	8.48%	7.32%
Estimated Cost of new Borrowing	6.08%	7.70%	7.32%
CGFS Risk Rating	D	D	D
Unlevered Beta (LTM)	0.89	1.25	0.94
WACC	9.28%	11.81%	9.80%





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



Valuation

Period	Revenue growth	NOPAT margin	ROIC/WACC
Base Year	4.8%	8.7%	1.86
7/31/2017	3.0%	8.5%	1.53
7/31/2018	3.2%	8.7%	1.45
7/31/2019	3.3%	9.0%	1.48
7/31/2020	3.1%	9.4%	1.53
7/31/2021	3.2%	9.6%	1.54
7/31/2022	3.3%	9.7%	1.57
7/31/2023	3.5%	9.9%	1.61
7/31/2024	3.6%	10.1%	1.64
7/31/2025	3.8%	10.3%	1.68
7/31/2026	3.9%	10.5%	1.72
Continuing Period	4.1%	10.7%	1.76

Period	Invested Capital	Net Claims	Price per share
Base Year	$2,645.97	$1,578.56	$64.73
7/31/2017	$2,858.53	$1,569.01	$71.26
7/31/2018	$2,990.85	$1,335.29	$78.78
7/31/2019	$3,081.99	$995.10	$86.80
7/31/2020	$2,564.19	$687.94	$95.04
7/31/2021	$3,230.69	$308.22	$103.65
7/31/2022	$3,586.15	-$88.66	$112.59
7/31/2023	$3,779.17	-$504.07	$121.89
7/31/2024	$3,905.27	-$939.51	$131.54
7/31/2025	$4,086.50	-$1,396.61	$141.56
7/31/2026	$4,215.22	-$1,877.16	$151.94
Continuing Period			