Why Falling for Sears Canada Now May Trap You

Description

Sears Canada (TSX: SCC) shares have been on a tear this month, having gained 31% as of this writing. While the embattled retailer's third-quarter numbers released last week left much to be desired, it was the special cash dividend of $5 per share that fueled the market's optimism.

The latest news is that Sears is overhauling one of its businesses to slash costs and improve profitability. While that sounds good, Sears Canada has too many problems to fix and a lot to do before it can turn a corner. And in my view, none of it justifies the stock's lofty valuation.

Is this growth sustainable?

Sears Canada's third-quarter losses more than doubled to $48.8 million on 6.4% lower revenue year over year. That's uninspiring, but the number that got the market excited was the 1% improvement in same-store sales compared to a nearly 6% drop in Q3 2012. Notably, it was the *first* time in nearly five years that Sears' same-store sales increased. That's big news indeed, but there's more than meets the eye.

One quarter of positive same-store sales doesn't mean that Sears Canada has left the worst behind. Digging deeper, I found that only its apparel and accessories section is doing well while its home and hardlines and appliances divisions continue to struggle. Take a look at the following table, which compares the year-to-date percentage change in same-store sales for Sears' various business categories.

Change in Same-Store Sales

Business category	2013 Year-to-date	2012 Year-to-date
Apparel and Accessories	5.70%	-8.80%
Home and Hardlines	-8.90%	-10.40%
Major Appliances	-2.50%	1.00%

Source: Company Q3 earnings report

Clearly, while Sears' apparel and accessories category has turned around over the past year, sales for the company's other products remain weak. Investors cannot ignore this, because the two struggling businesses together accounted for 47% of Sears' total revenue for the 39 weeks ended Nov. 2.

Moreover, the third quarter included Sears' first-ever Canadian Thanksgiving Black Friday sale, which could have boosted sales. So it becomes even more critical to wait and see whether the growth in Sears' same-store sales is sustainable, especially at a time when competition in the industry is hitting a new peak.

It's a bull fight

Close rival **Hudson's Bay** (TSX: HBC) has lined up big growth plans after acquiring Saks. Hudson's plan is to open seven Saks Fifth Avenue stores and 25 OFF 5TH outlets over the next few years, aside from launching a Canadian saks.com website. That comes close on the heels of **Wal-Mart** Canada's recent launch of its Walmart.ca website. Hudson's moves could well change the landscape of the luxury retail market in Canada.

Competition will further intensify once American upscale retailer **Nordstrom** (NYSE: JWN) enters Canada next year with its first store at Calgary. Ottawa, Vancouver, and Toronto are next on Nordstrom's list. The retailer plans to launch an advertisement campaign for Canadian consumers soon, and promises dazzling stores, unparalleled customer service, and merchandise covering all ranges of price points. If Nordstrom's Rack concept stores, which sell heavily discounted (up to 70%) merchandise, make their way into Canada, Sears' good days could well be over.

Target (NYSE: TGT) looks like the biggest threat of all. The U.S. retail giant is on a massive expansion spree, having opened 124 stores, spread across 10 provinces in Canada, just this year. That's a mind-boggling pace that should make Sears and its investors squirm in their chairs. Through low prices, discounts, price matching policies, and the 5% REDcard reward, Target is set to woo the Canadian consumer. While Target Canada's profits fell last quarter on high inventory mark-downs, it expects sales and margins to improve considerably next year. Since Target counts apparel and home as its high-margin categories, it will likely focus on capturing these markets, which bodes ill for Sears.

Is the dividend just a trap?

Ironically, even as rivals aggressively increase their store count, Sears is downing shutters on many. After announcing plans to sell leases on five store locations last month, Sears will lay off nearly 800 employees from its repair services and parts business over the next six months. Reducing costs is particularly essential for Sears, because as competition in the industry intensifies, the chances of a price war go up. So maintaining healthy margins becomes a bigger challenge.

Sears woes don't end there. The company is free cash flow negative, which means that it is burning cash at an alarming rate. So I don't understand why Sears is paying such a big special dividend when profits are hard to come by and business conditions remain tough. Sears may be trying to woo investors this way, but it may trap them if the company doesn't fix up things quickly.

Foolish takeaway

Sears Canada is at a critical threshold, where it must capture the consumer's attention before rivals from across the border take the game away. Bay Street is betting on a turnaround, but it may be too early to get excited. Sears has too many problems to fix, and it's not going to be a smooth ride. Trading close to its 52-week high, in my view, Sears Canada shares simply look too risky to bet on.

CATEGORY

1. Investing

TICKERS GLOBAL

1. NYSE:TGT (Target Corporation)

Category

1. Investing

Date
2025/07/28
Date Created
2013/11/29
Author
nehams