Hudson's Bay Co: A Classic Case of Misunderstanding Risk

Description

The following title says it all:

"**Amazon** worth more than **Sears**, **Macy's** and **Target** combined."

CNN Money Digital correspondent Paul LaMonica's January 6th story said that the headline didn't include seven other retailers, four of which are department stores.

That's right, Amazon is worth more in terms of market cap than 10 well-known U.S. retailers combined.

Now, to be fair to the retailers, Amazon has a cloud business (Amazon Web Services) that is responsible for 35% of that market cap — a business that has everything to do with technology and very little to do with retail.

That said, I think we all get Mr. LaMonica's point.

Brick-and-mortar retail independent of online retail is a thing of the past. Department stores, such as **Hudson's Bay Co** (TSX:HBC) and the ones mentioned above, have been woefully slow to respond to the challenges posed by Amazon in the fight for online supremacy.

Unfortunately for department stores, it's not just a lack of online panache that's put most North American firms on the endangered list. A poor understanding of what clients are looking for in the way of apparel purchases has them two steps behind the H&Ms and Zaras of the world, resulting in heavy discounting, which in turn creates a customer who only wants cheap.

That's a recipe for disaster.

I am a fan of Richard Baker, the majority owner of Hudson's Bay.

A combination of timely asset sales (Zellers) mixed in with some smart real estate partnerships with **RioCan** and **Simon Property Group,** and the hiring of some of the best retail talent anywhere has created a buzz around the company that hadn't been present for many years.

But, as they say about the markets, you can't fight the trend. Right now, department stores, and most retail, for that matter, are the rotten apples of the services sector; their low stock prices are the proof that this is true.

In early December, I called Hudson's Bay the best deep-value play on the TSX. Since then, HBC stock has declined by almost 13% and sits perilously close to dropping below $12 — significantly less than the $30-per-share analyst estimate for its real estate holdings.

In other words, in the eyes of the market, it's worth more dead than alive. Both Sears and **Yahoo** fit into this category. When a public company reaches this stage of its life cycle, the risk to investors is ratcheted up tenfold.

So let me be very clear.

If you go to The Motley Fool Canada website and do a search for Hudson's Bay, the first three stories you will find are all positive about the company's future, and while you can definitely add me to that camp, you must understand that this is not an investment for the faint of heart.

Consider for a moment the $30-per-share valuation by analysts for HBC's real estate holdings. Management pegs that number even higher at $36 per share. As we've seen with the Sears debacle in the U.S., value is in the eyes of the buyer, not the seller.

Sears announced January 6 that it had reached an agreement to sell its Craftsman brand to **Stanley Black & Decker** for US$900 million. Last May, when Sears announced it would put its Craftsman, Kenmore, and DieHard brands up for sale, *Bloomberg* pegged Craftsman's value at US$2 billion.

Either Stanley Black & Decker got a great deal, or the brand was never anywhere near that value. I think we know the answer to that one.

So, the risk to HBC investors is that future buyers of its real estate don't hold the same opinion of its true intrinsic value. After all, to buy and repurpose the real estate costs money; plus, you need to have a workable idea to fill the space. Given that retail in North America is generally considered overdone in terms of square footage, it's not a slam dunk for any buyer.

HBC stock might be cheap, but before buying, do yourself a favour and really think hard about the risk and if you can stomach it because it could get a lot worse before it ever gets better.

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