Why Is Hudson's Bay Co. Interested in Macy's Inc.?

Description

Hudson Bay Co. (TSX:HBC) shares are rallying during Friday morning's trading, increasing more than 4% on news the retailer has approached **Macy's Inc.** (NYSE:M) about a possible takeover.

The first thing many investors notice about this deal is the size difference. Hudson's Bay has a market cap of $1.9 billion. Macy's has a market cap of more than US$10.5 billion. How can a company afford to take over such a larger rival? And why would it?

Once we drill down a little bit, this deal doesn't look quite so odd. Here's the thought process behind it.

It's not about retail

One of the things that bugs me about investors who analyze Hudson's Bay stock is the focus on the retail operations.

Retail results have been lacklustre of late. Sales have faltered, which has led the high-end chain to resort to more discounting to get rid of slower-moving merchandise. No retailer wants to be in that position.

Analysts are also concerned about the company's ambitious expansion plans, which include opening more Saks stores in Canada as well as exporting both the HBC and Saks brand to Europe. If existing store sales are tepid, then perhaps expansion isn't the best course of action.

While those are legitimate concerns, many Hudson's Bay shareholders — including me — don't really care about the retail operations. As long as the stores do well enough to stay open, that's good enough for me.

Why? Because Hudson's Bay isn't a retail play. It's a real estate play.

According to a presentation made by management at the last annual meeting, the company's real estate alone is worth $36 per share, while the retail operations are worth about $8 per share.

The real estate isn't a dead asset on the balance sheet either. Hudson's Bay is actively working towards spinning off the assets, working with **RioCan** and **Simon Property Group** to create two joint ventures. The partnership with RioCan will consist of Canadian properties, and the partnership with Simon Property Group will cover the U.S. properties.

There's no timetable as to when both joint ventures will trade publicly, but I suspect it will be relatively soon. The proceeds gained from both would then be used to help pay for a Macy's acquisition.

Macy's real estate

Once an investor realizes what Hudson's Bay is all about, a potential Macy's acquisition makes far more sense.

Macy's shares currently trade hands at just under $33 each with a market cap of US$10.5 billion. Various investors have been pressuring the company to spin-out its real estate holdings for years now because, like Hudson's Bay, the real estate is worth more than the company as a whole.

Estimates vary, but the consensus is Macy's real estate is worth $20 or $21 billion, or about $65 per share. That's the prize here.

In fact, some analysts are speculating that Hudson's Bay is only interested in the real estate and Macy's would then rent the locations back. Macy's is profitable enough to do such a thing. It earned $2.19 per share in the last 12 months. And if the company got enough from a sale to eliminate its US$7.5 billion debt, it would save millions in interest.

The bottom line

Richard Baker, who is the chairman of Hudson's Bay, has done this before. He monetized Zellers' leases in 2011. Then the company acquired Saks in 2013, paying less for the chain than the iconic Saks building was worth in New York City. Macy's would be yet another play using the same successful formula.

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