

Ticker:	SIG	Current Price:	\$111.86
Action:	Short	Market Cap (M)	\$8,896
Expected Timeframe:	1-2 years	Enterprise Value(M):	\$10,157
Target Allocation	2%	Target Price:	\$31.00
Asset Class:	Common Equity	Investment Type	Short: Valuation

Investment Overview/Background

On the surface Signet is a growing retailer that maintains a dominant position within the jewelry industry. GAAP earnings are growing quickly, management is buying back stock, and a transformational acquisition just took place. With same-store-sales growing at 5-6% and 2015 adjusted EPS of \$5.63, the name is priced at a reasonable 18x P/E ratio.

Unfortunately, this is a facade. Signet is not a jeweler so much as it is a credit card company for subprime borrowers. Over the past four years, management has decided to focus on borrowers and less on making money upfront. As one sell-side report put it "SIG runs its finco in support of the operating company." Too bad neither division generates any real free cash flow. In fact, since 2011 Signet has generated just under \$11/share in cumulative free cash flow. Not per year - cumulative. As the company expands their credit book they must take on worse and worse credits. Eventually this will catch up to them.

I believe that Signet should not be valued as a premier retail company and instead should be valued for what it is – a financing company. Depending on the valuation method, a fair value of Signet is between \$20-\$40/share, implying more than 60% downside from the recent share price.

Background

Signet is a jewelry store owner that operates Kay, Jared, Zale's (acquired in 2014), a few regional brands, stores in Canada, and stores in the United Kingdom. The Signet brands were able to capitalize on a rapidly consolidating/shrinking jewelry market during the recession. The financial crisis saw the exit of jewelers like Whitehall, Friedman's, Christian Bernard, Fortunoff and a number of smaller players.

With an industry in disarray and an unknown future, Signet capitalized by taking market share and by maximizing free cash flow the good old fashioned way – by throttling back capital expenditures. For a number of reasons, Signet is in catch up mode. This can be seen in the table below.

Table 1. Signet CapEx Spend, Depreciation, and associated metrics. Source: Company Filings

In Millions	2010	2011	2012	2013	2014	2015	Average
CapEx	\$43.5	\$57.5	\$97.8	\$134.2	\$152.7	\$220.2	\$117.65
Depreciation	\$101.0	\$89.7	\$92.4	\$99.4	\$110.2	\$149.7	\$107.07
Ratio of Capital Additions to D&A US	39.7%	61.4%	109.6%	146.1%	151.1%	164.7%	112.1%
Ratio of Capital Additions to D&A Signet	40.0%	58.8%	105.8%	135.0%	138.6%	147.1%	104.2%

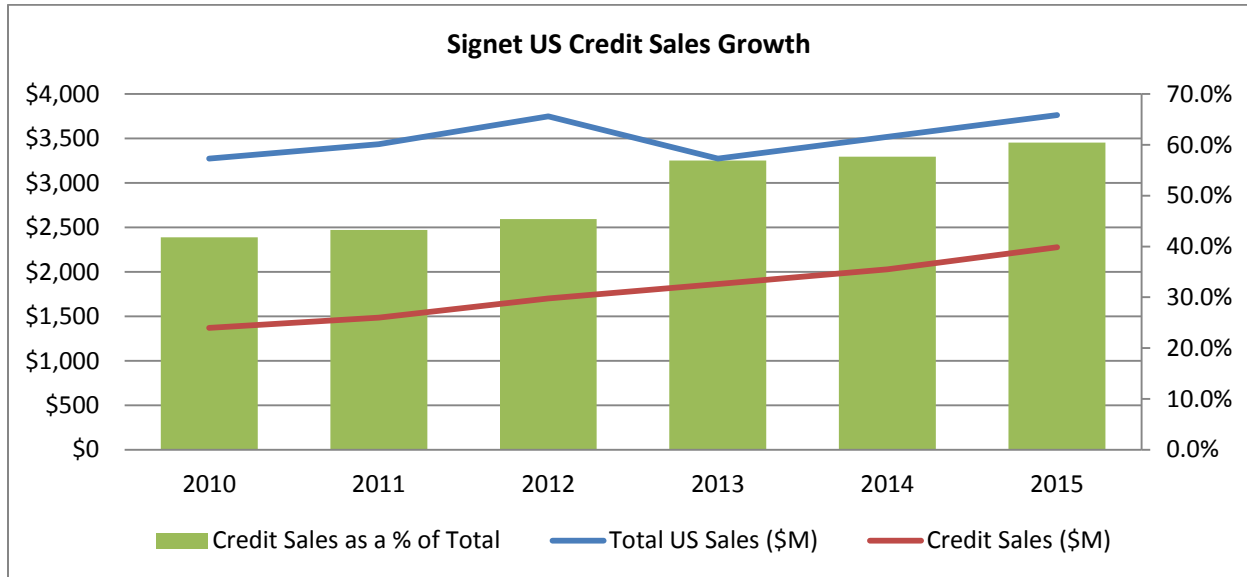
The company, by all accounts, was performing well and growing. Signet acquired Zale’s in 2014 and the bulk of the bull argument rests on expanding margins and compounding EPS from Zale’s. The bull argument is that the acquisition will not result in cannibalization and the two can coexist together (often only a few yards apart). I do not know conclusively, but if I was shopping for jewelry in a Kay and saw a Zale’s across the street, I might check it out. This bull argument seems eerily similar to the Jos. A. Bank and Men’s Warehouse bull argument, but any sort of extrapolation would simply be speculation.

Ignoring that speculation, the bull thesis also centers on margin expansion. Zale’s had relatively poor margins compared to Kay. Some of this margin expansion is pinned on better sourcing; some is based on better management. The bulk of the improvement seems to rest on extending more credit to more customers. Credit sales within Signet’s Sterling division (the unit that houses Kay and Jared) account for more than 60% of all sales, whereas Zale’s credit approval rate was in the 30’s. Why the discrepancy? Well Signet uses an in-house system, whereas Zale’s outsourced their credit approval to Alliance Data Systems.

The Rise of the Receivables

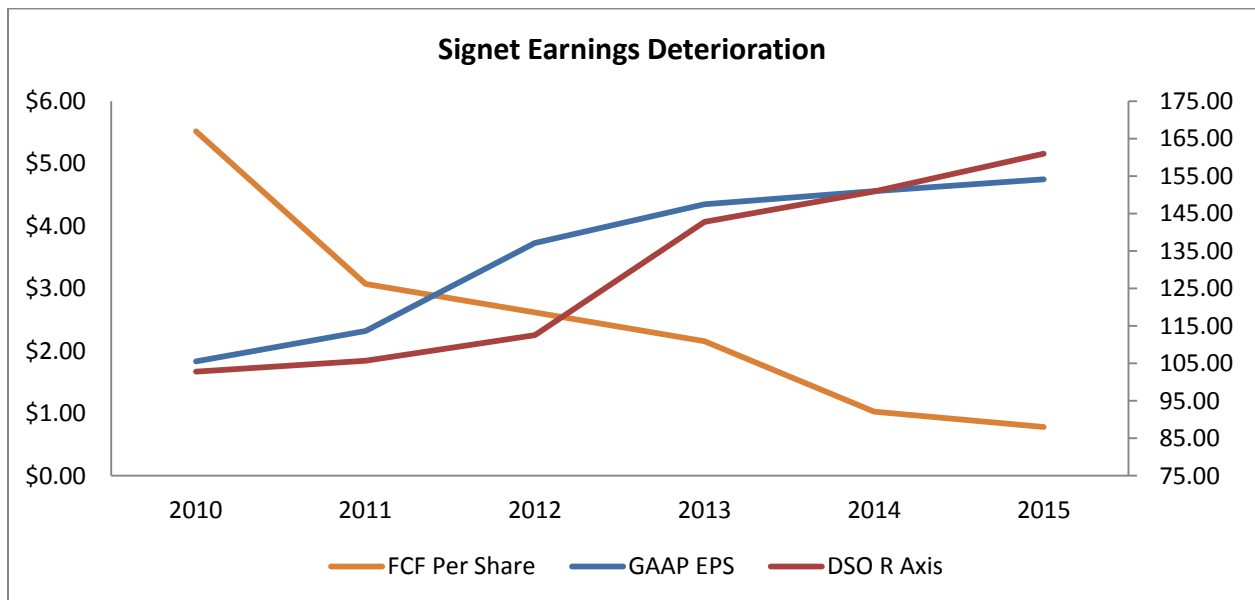
Signet has long used in-house credit to finance a portion of their sales. The use of this began to climb dramatically in 2012 and 2013. This financing is completely in-house, a fact that sales representatives will brag about in stores. Like a number of new direct lenders (Lending Club being a prime example), Signet believes they can quantify the credit risk better than traditional banks. The push to build credit within the Sterling division (Kay and Jared stores) can be seen in the chart below.

Chart 1. Signet Credit Sales Source: Company Financials, Author's calculations



At a high level, things look fine. Bad debt, as a percentage of credit sales, has oscillated between 6.8%-7% since 2011 and charge-offs have come in at ~9.3% of average receivables in the past three years. These facts ignore some large fundamental issues with the credit business. Since 2011 free cash flow (defined as cash flow from operations less capital expenditures) has basically evaporated. This decline in free cash flow contrasts with the increase in Days Sales Outstanding (DSO) and GAAP earnings per share, all of which can be seen on the chart below.

Chart 2. Signet Earnings Deterioration Source: Company Filings, author's calculations



Some of the deterioration in free cash flow can be attributed to increased capital expenditures for new store remodels. Signet woefully underinvested in their stores after the recession and seems to be playing catch-up now. Even using a “normalized” version of CapEx (5-year average applied to each year), investors are left with 2015 FCF per share of \$2.06, down from \$4.65 in 2010. Even this calculation likely underestimates true capital expenditures as it is less than depreciation. Regardless of the calculation method, the trend is not Signet’s friend.

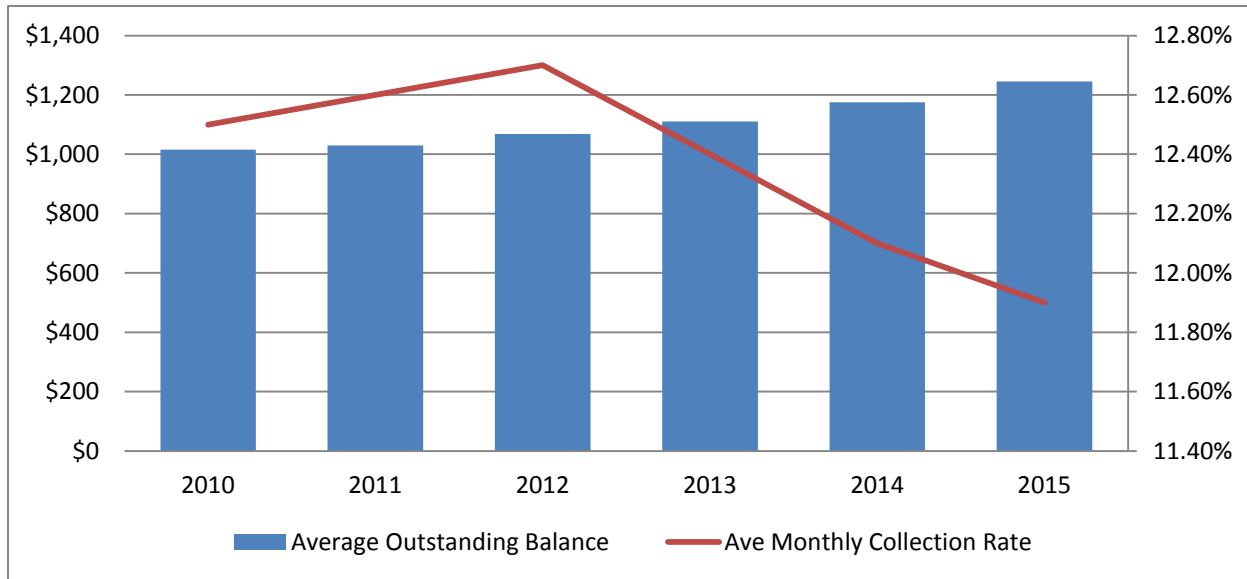
Signet is in a league of its own when it comes to this type of earnings dislocation. When compared to numerous other retailers, the only company with a DSO even remotely close to Signet’s is Conn’s. Tiffany’s DSO was less than 17 days during 2015. Signet is almost 10x longer than Tiffany’s, despite what two similar businesses on the surface. In reality, Signet is not a pure-play jewelry store and is more akin to a consumer finance company. This is similar to Conn’s, a retailer who markets to subprime consumers. While Conn’s looks to sell electronics, furniture, and appliances to subprime customers, Signet looks to do the same for jewelry. This report will compare Conn’s and Signet later in the valuation segment.

Subprime borrowers (defined as those with sub-640 FICO scores) have [default](#) rates of ~15%, with dramatically higher default rates for those with sub-600 scores. Subprime credit is very difficult to make money in. As the CFPB states in a [2015 paper](#): “the total cost of credit on cards issued by subprime specialist credit card companies is significantly higher than on cards offered by their mass market competitors, even after controlling for consumers’ credit risk.”

Signet keeps their credit portfolio a closely guarded secret. There is zero mention of FICO scores or anything that indicates overall portfolio risk in the 10-K’s outside of loss provisions and bad debt expense. Almost any primary due diligence will show that Signet’s in-house credit program will give credit to just about anyone. My discussions with several store employees and managers indicates that A. Signet approves credit via a soft pull, B. for many people this is their first and/or only credit card, C. management compensation is based on credit applications, and D. there is no need to verify income or employment. Conference calls back up the “give anyone credit” as management has consistently said that approval rates are around 50%. Meanwhile, the average [approval](#) rate in the United States is around 39%.

If there are no cracks in the credit portfolio, why should investors care? First, the time to care is when everything is alright and things cannot get much better. Second, Signet is expanding into riskier pools of credit. For several years, the primary credit terms were 0% interest for 12-month payment terms. Pay on time and pay within 12 months, and no worries. Still not good for free cash flow, but not terrible either. However, average monthly collection rate has been creeping down over time and average balance has been creeping up. This can be seen in the graph below.

Chart 3. Signet Average Credit Balance and Monthly Collection Rate Source: Company Financials and Author Calculations



Based on conference call transcripts and discussions with store employees, I expect these trends to continue. At a very basic level, Kay has shifted from a jewelry retailer to a consumer finance company that just happens to have some stores that sell jewelry. This will never turn into a cash cow like bulls expect, at least not without a lot of leverage.

One way to assess the longer-term profitability of Signet's newer strategy is to examine Lending Club and Prosper wedding loans. I consider these somewhat similar except for one fact: both P2P sites are lending to better borrowers than Signet on a FICO score basis (average FICO score range of 660-740, >80% of loan applicants rejected using similar credit scoring criteria). Using the public loan file data, I calculated returns on investment for engagement ring/wedding loans to borrowers with incomes under \$100,000/year. Across both sites the return on investment was less than 7% for loans originated since 2011. This was with an average interest rate of more than 15%, a rate that is higher than Signet's current rate. When I isolated loans exclusively for engagement rings (Prosper only) average interest rate went up to 18%, and return on investment dropped to 4%. The calculations are summarized in the table below.

Table 2. Returns for Wedding and Engagement Ring Loans via P2P Platforms Source: nsrplatform.com

Platform	Loan Count	Interest Rate	ROI
Prosper	309	18.4%	4.0%
Lending Club	1,975	14.5%	7.7%
Combined	2,284	15.3%	6.9%

This is not a good sign for Signet who, unlike other P2P platforms, has higher overhead thanks to a retail base, and utilizes their own balance sheet to fund the loans.

It can be argued that Lending Club and Prosper are unsecured loans, and therefore riskier, whereas Signet holds a secured claim against the jewelry. Unfortunately for Signet bulls, this is not entirely true. There are hundreds of court cases for personal bankruptcies where Signet is listed as a creditor and low and behold, only a fraction of the claim is secured with jewelry. Signet will often reach out to debtors to extend payment terms, reduce principal, or cancel payments outright in exchange for the return of jewelry. When push comes to shove, Signet is usually just another unsecured creditor.

In a nutshell, Signet's credit division is not causing credit problems today, but that will change as new customers are granted longer and larger loans. This will continue to have a detrimental effect on Signet's cash flows, and eventually, earnings.

Valuation

As always, fair value is an art. I believe that there are several points to consider.

- Signet is more akin to a consumer finance company. They utilize their own balance sheet to finance their customer's sales.
- This is a subprime finance company. Whether or not this blows up is not the question – the question is *when?* Getting paid someday in the future is more risky than getting paid today.
- Free cash flow is king and eventually EPS will converge with FCF.

Method 1: Free Cash Flow Multiple

Free cash flow has been declining for years now at Signet. I am not quite sure how/if this reverses. To be conservative, this valuation will assume that Signet's free cash flow is just as robust and sustainable as Tiffany's. Tiffany's [expects](#) to generate more than \$500 million in free cash flow during 2015, which prices shares at 18.8x 2015's free cash flow (no surprise, FCF and EPS closely track each other). In FY 2015 Signet generated \$0.78 in free cash flow (operating cash flow less CapEx), and \$2.06 of normalized

free cash flow (free cash flow adjusted for average CapEx spend). Applying a 20x multiple to both free cash flow figures results in a fair value of \$15.60-\$41.20 per share.

Method 2: Book Value Multiple

Signet finances a majority of their customer's purchases using their own balance sheet. Therefore the company should trade at some multiple to book value, just like a bank or insurance company. Relative to their tangible book value, Signet's free cash flow was equal to a 6.4% return. I would argue that such a return would normally be worth about 1x book value. Given the brand value, I will conservatively assume that Signet is worth 2x tangible book value, or \$47.20 per share.

Method 3: Calling a spade to a spade

At the end of the day, this is a business that resembles Conn's more than any other. Conn's is subject to routine reassessments of their credit portfolio and I expect Signet to be subject to the same in the future. On a basic valuation front, shares of CONN trade right around tangible book value and sport a 0.4x price-to-sales ratio. Notably, Conn's DSO is very close to Signet's. While Signet may have better brand recognition and loyalty than Conn's, the valuation discrepancy between the two is astonishing. If Signet traded down to TBV and/or price-to-sales ratios similar to Conn's, Signet would be valued at \$32 per share.

Valuation Range: \$15.60 to \$47.20.

Midpoint of \$31.40.

Relative to a price of \$111, this implies downside of more than 70%.

Why Short Now?

While these types of shorts inevitably take longer than anyone expects, Signet is hitting the upper limit of credit expansion. Currently, credit sales make up more than 61% of all sales. During the IR day in 2012, management guided that they believe "Bridal customer's credit penetration can reach 70%." In the Q4 2013 conference call management iterated that credit penetration is unlikely to get much higher than "60-ish" percent of total sales.

Could Signet push credit penetration rates even higher? Sure, and this is one of many risks to the thesis. Irrational things stay irrational for long periods of time and this thesis may prove to be very early. I accept that this could be a long wait. Bulls have made the argument that the credit portfolio is not a problem, and thus far, they are right. Management has been able to adjust the payment structure and push out the day of reckoning.

Finally, while seemingly minor, there are a few accounting changes that have helped the company meet, or exceed, targets over the past year. As the integration of Zale's laps a full year these tricks are typically a little more difficult to keep going.

Conclusion

Signet is simply a consumer finance company that generates sub-par returns. There is little reason for the company to trade at current levels given the deterioration of cash flows, risky nature of their finance receivables, and accounting games. Bulls will point to increasing same-store-sales, but I believe Signet has simply extended credit to individuals who should not be given credit. I believe that shares of Signet have more than 70% downside and the company faces a number of headwinds.

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