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INTRINSIC VALUE ASSESSMENT OF

WILLIAMS-SONOMA INC. (WSM)

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This article was written with David J. Flood from The Investor's Podcast

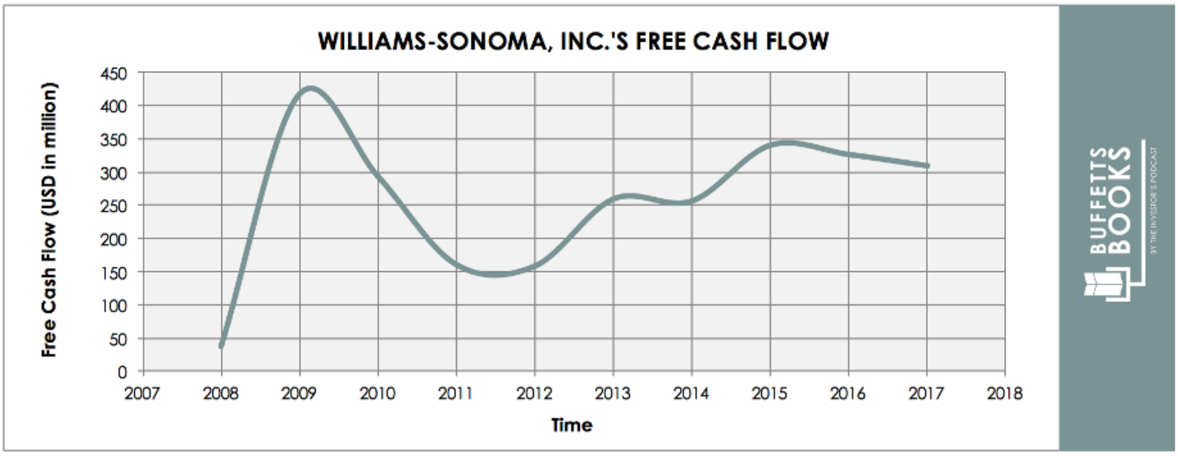
Introduction

Williams-Sonoma Inc. is an American based multi-channel consumer retail company whose business involves the sale of kitchenware and home furnishings. The company, which was founded in 1956, has grown to become one of the largest e-commerce retailers in the United States and one of the largest multi-channel specialty retailers in the world. Williams-Sonoma Inc. also sells its products through retail stores and franchises across North America, Europe, and the Middle East. The firm's market cap currently stands at around $4 Billion and its revenues and free cash flows for the previous financial year were around $5.3 Billion and $0.3 Billion respectively. The company's common stock has fluctuated between a high of $56 and a low of $43 over the past 52 weeks and currently stands at $48. Is Williams-Sonoma Inc. undervalued at the current price?

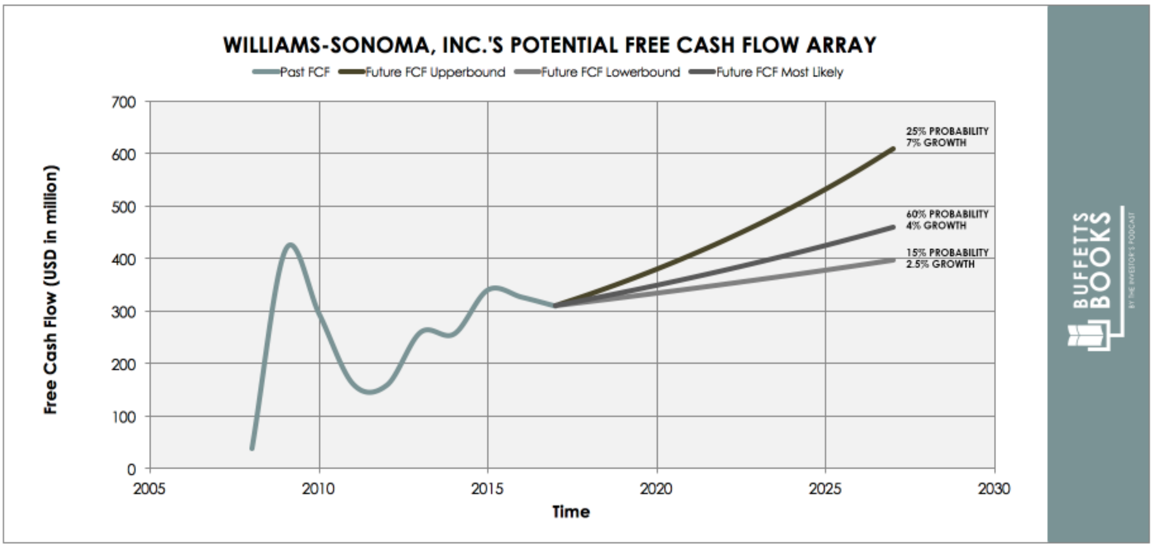
WILLIAMS-SONOMA

The Intrinsic Value of Williams-Sonoma, Inc.

To determine the intrinsic value of Williams-Sonoma Inc., we'll begin by looking at the company's history of free cash flow. A company's free cash flow is the true earnings which management can either reinvest for growth or distribute back to shareholders in the form of dividends and share buybacks. Below is a chart of Williams-Sonoma Inc.'s free cash flow for the past ten years.



As one can see the company's free cash flow has been lumpy over the past decade which is a common feature for retail companies. In order to determine Williams-Sonoma's intrinsic value, an estimate must be made of its potential future free cash flows. To build this estimate, there is an array of potential outcomes for future free cash flows in the graph below.



When examining the array of lines moving into the future, each one represents a certain probability of occurrence. The upper-bound line represents a 7% growth rate which is based on the company's earnings growth rate from 2005 to 2018. The author has opted to use this period in lieu of the more common 10-year period to smooth out cyclical fluctuations. This growth rate has been assigned a 25% probability of occurrence to account for the threat of competitive pressure from its peers and the increasing likelihood of a recessionary environment emerging in the next ten years.

The middle growth line represents a 4% growth rate which is based on the firm's historical revenue growth. Revenue tends to be far more stable over time and is a suitable proxy for a conservative estimate of future free cash flow growth, as such it has been assigned a 60% probability of occurrence.

The lower bound line represents a 2.5% rate in free cash flow growth, which is the estimated mean average GPD growth rate in the United States between 2018-2025. Since Williams-Sonoma possesses competitive advantages which allow it to outperform its peers, and the wider economy this scenario has been assigned a 15% probability of occurrence. Assuming these potential outcomes and corresponding cash flows are accurately represented, Williams-Sonoma Inc. might be priced at a 9.2% annual return if the company can be purchased at today's price. We'll now look at another valuation metric to see if it corresponds to this estimate.

Based on Williams-Sonoma Inc.'s current Earnings yield, which is the inverse of its EV/EBIT ratio, the company is currently yielding 10.98%. This is above the firm's 10-year historical median of 9.20%. The Global industry median of 5.21% suggests that the company may be undervalued relative to the historical and industry comparisons. Finally, we'll look at Williams-Sonoma Inc.'s Price-to-Median P/S ratio, a metric based on the firm's current P/S ratio relative to its historical median average, to see if it supports the assertion that Williams-Sonoma Inc. is undervalued. At present, the company trades at a Price-to-Median P/S ratio of 0.83 which is below the company's 10-year historical median of 1.04 and the industry median of 1.04. This suggests that the firm may indeed be undervalued. Taking all these points into consideration, it seems reasonable to assume that Williams-Sonoma Inc. may be undervalued relative to its peers and the market's historical valuation for the company. Furthermore, the company may return around 9% at the current price if the estimated free cash flows are achieved. Now, let's discuss how and why these estimated free cash flows could be achieved.

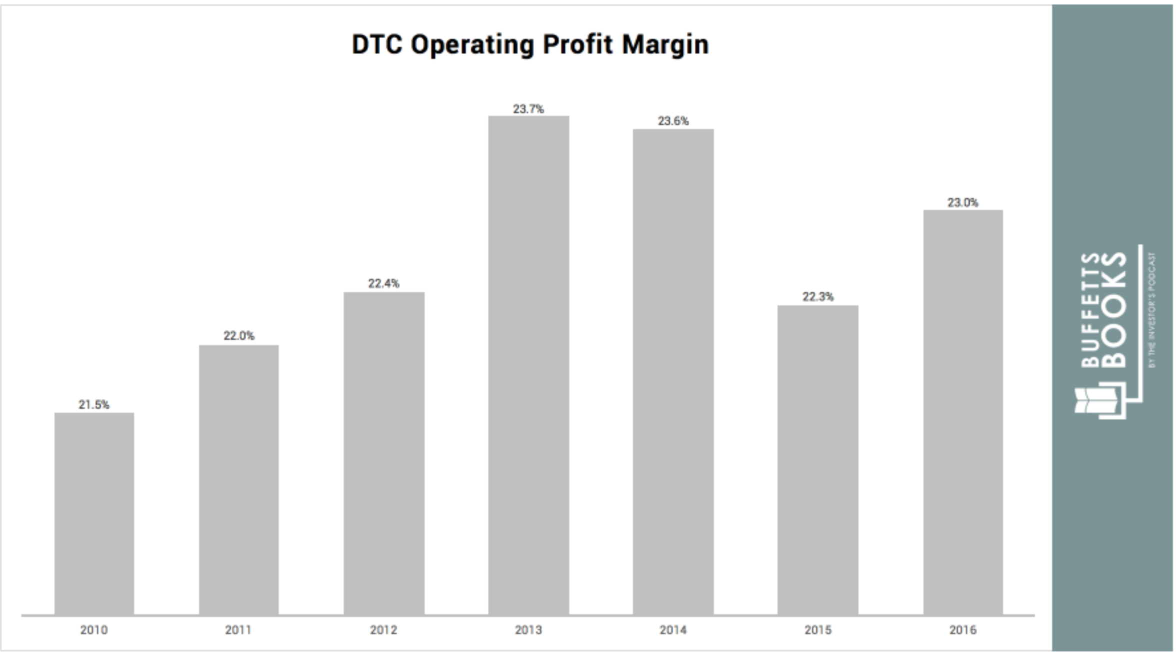
The Competitive Advantage of Williams-Sonoma, Inc.

Williams-Sonoma Inc. has various competitive advantages outlined below.

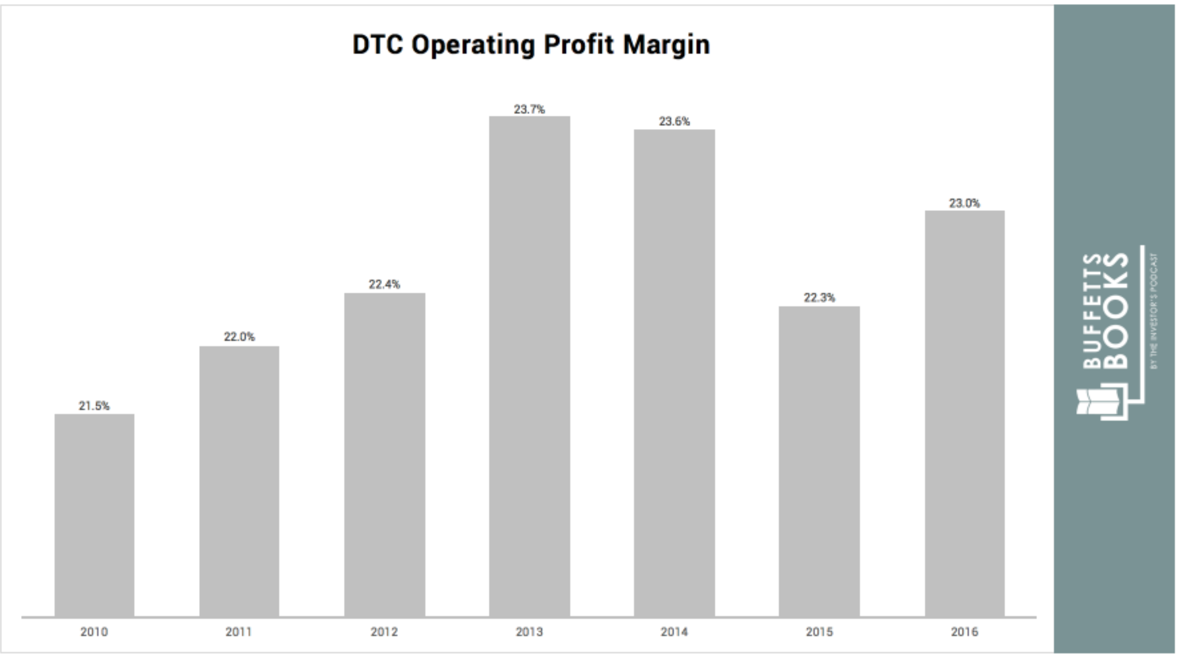
- **Brand Portfolio.** Williams-Sonoma Inc. possesses a powerful brand portfolio protected by around 126 trademarks and service mark patents in the United States and 94 additional jurisdictions. These brands, which include Williams-Sonoma, West Elm, and Pottery Barn, allow the company to significantly outperform the industry on several key metrics outlined in the table below.

	Williams-Sonoma Inc.	Global Specialty Retail Industry Med. Average
ROA (ttm)	10.21%	3.03%
ROE (ttm)	21.55%	6.78%
Operating Margin % (ttm)	8.57%	3.67%
Net Profit Margin % (ttm)	4.90%	2.36%

- **E-commerce Platform**. Williams-Sonoma has developed a highly successful E-commerce platform and leverages this intangible asset to deepen its penetration of the market and outperform its competitors in the retail sector. The charts below demonstrate the value of this E-commerce platform which now makes up 52.5% of the firm's revenue.



2016 Internet Retailer Top 500		
Top 23	Williams-Sonoma Inc.	$2,630



- **Vertical Integration.** Williams-Sonoma Inc. has vertically integrated its operations to effectively control every aspect of its supply chain from product development and manufacture through to distribution and sale. This drives down costs and improves efficiencies and margins.

Source: Williams-Sonoma Inc. 2017 Investor Presentation

Williams-Sonoma Inc.'s Risks

Now that Williams-Sonoma Inc.'s competitive advantages have been considered, let's look at some of the risk factors that could impair my assumptions of investment return.

- While Williams-Sonoma possesses several competitive advantages, its business is cyclical since its revenues and earnings are driven by consumer spending. In the event of a recession, Williams-Sonoma Inc.'s earnings would likely be impacted since consumers tend to forego discretionary purchases or opt for cheaper alternatives when times are tough. In 2007, the company's adjusted EPS stood at $1.76. In 2008, they fell by 84% to $0.28. In 2009, they rose by 157% to $0.72. And in 2010, they rose a further 154% to $1.83.

- Williams-Sonoma is likely to face increasing competitive pressure from its peers as competition in the retail industry becomes fiercer. For the firm to maintain its competitive position, it must continue to innovate and develop new products and to ensure that it focuses its efforts on expanding into new markets to drive growth.
- The specialty retail industry is subject to changing consumer habits and fashion trends. If Williams-Sonoma fails to implement effective market research and adapt its product offerings to changing consumer trends, it may see its brand value weaken and suffer a decline in economic performance. At present, the company targets its products at the high end of the specialty retail market which allows it to achieve superior margins. This could potentially be a problem as the firm has seen its margins fall over the last few years as consumer spending tightens, and the firm's pricing power has somewhat weakened.

Opportunity Costs

Whenever an investment is considered, one must compare it to any alternatives to weigh up the opportunity cost. At present, 10-year treasuries are yielding 2.83%. If we take inflation into account, the real return is likely to be closer to 1%. The S&P 500 Index is currently trading at a Shiller P/E of 31.9 which is 89.9% higher than the historical mean of 16.8. Assuming reversion to the mean occurs, the implied future annual return is likely to be -2.7%. Williams-Sonoma, therefore, appears to offer a much better return for investors at present, but other individual stocks may be found which offer a similar return relative to the risk profile.

Macro Factors

Investors must consider macroeconomic factors that may impact economic and market performance as this could influence investment returns. At present, the S&P is priced at a Shiller P/E of x31.9. This is 89.9% higher than the historical average of 16.8 suggesting markets are at elevated levels. U.S. unemployment figures are at a 30-year low suggesting that the current business cycle is nearing its peak. U.S. private debt/GDP currently stands at 199.6% and is at its highest point since 2009, when the last financial crisis prompted private sector deleveraging.

Summary

Williams-Sonoma Inc., like a great many other retailers, is currently the subject of pronounced pessimism from the market for a variety of factors including weak consumer spending growth, increasing competitive pressure, and changing consumer habits. The current bull market is fast approaching the record as the longest in history, and fears are growing that a bear market and recessionary environment are drawing nearer. Considering how Williams-Sonoma Inc. has performed in previous recessionary environments, investors should be under no illusion that the firm will not be adversely affected. The company is, however, in a reasonably strong financial position with a debt/equity ratio of 0.25 and an Altman Z-Score of 4.62 suggesting that the company is highly unlikely to be at risk of bankruptcy in the coming years.

Regarding management's capability and shareholder friendliness, Williams-Sonoma Inc. has a decent track record. Over the past ten years, the firm has achieved an average return on invested capital of 17.79% and an FCF/Sales of 6.18%. Management is also adept at brand building having grown their West Elm brand at a compound annualized rate of 30% between 2002-2016. In terms of Global growth, the firm has doubled international revenues from 3% of total revenues in 2010 to 6% in 2016. The company has also increased its dividends by 100% since 2010 returning over $2 Billion to shareholders. The company has also extended its share buyback program with the option to purchase $0.5 Billion worth of shares in the next few years.

In summary, Williams-Sonoma Inc. is a strong retail business whose long-term economic future appears more robust than many other firms in the industry. While the emergence of a recessionary environment will likely impact the company's economic performance, it appears well equipped to handle this. Given the elevated price of the market at present, Williams-Sonoma Inc. is likely to provide a higher rate of return over the coming decade, but investors should be aware that earnings are likely to be lumpy. Based on the conservative assumptions used in the free cash flow analysis, Williams-Sonoma Inc. may return around 9% at the current market price.

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