Floor & Decor Holdings, Inc. (FND)
Strong 1Q Results, QTD Comp Better-than-Feared

Maintain Outperform rating. 1Q results were solid, and QTD comps are tracking better than feared (-50% despite stores being closed). Looking ahead, the shape of the demand curve remains uncertain; however, sample sales have surged in April (pent-up demand?), and comps in two stores recently opened went from "really negative" to positive. Big picture, while 2Q will be a tough quarter, FND has ample liquidity to weather this storm and is poised for significant share gains once this crisis passes. As such, we are maintaining our Outperform rating; new $46 price target.

- 1Q beat. Sales eclipsed lowered expectations (comps +2.4% vs. our/Street's 0%/1.1%), GM was solid (+32bps), and G&A benefited from lower incentive comp accruals. All told, adjusted EPS grew ~20% y/y to $0.34 (above our/Street's $0.27E/$0.26E).

- Strong comps prior to stores closing; QTD trend better-than-feared. 1Q comps were running +6.1% (in line with our initial 6%E) prior to FND's self-imposed decision to close stores and pivot to a curbside-only model on March 21. The final six days of 1Q comped down 46%. While QTD comps are running slightly below late-March levels at -50%, this is better than most feared, and the trajectory of business has been slightly improving of late. In short, FND's digital capabilities and superior customer service have allowed the company to retain a significant amount of sales (and grow mind share with Pros and DIY-ers) while operating a predominantly curbside-only model.

- What will the shape of the go-forward demand curve look like as stores reopen? This is the key near-term debate on the stock. On one hand, the economic fallout from COVID-19 will likely pressure big-ticket spending. That said, sample sales have surged in April (an indication of pent-up demand), and comps in two stores recently opened in Utah went from "really negative" to positive. While FND plans to have ~70% of its stores opened by the end of May, the company is currently rolling out an in-store Pro appointment model. Bottom line, we continue to model 2Q/3Q comps down 30%/10% but are cautiously optimistic this could prove conservative.

- Protecting cash flow and boosting liquidity. In order to protect cash flow, FND has reduced its 2020 cash expenditures by ~$400M (~$100M opex, ~$110M capex, ~$190M inventory/supply chain). While the demand recovery trajectory is unknown, FND has ample liquidity (~$376M "unrestricted" at 1Q-end) to withstand a prolonged downturn and expects to be in a position to repay its ABL in 4Q.

- Estimates. Raising FY20E EPS to $0.80 from $0.75; FY21E remains $1.15.

FND is a leading specialty retailer of hard surface flooring and related decorative and installation accessories, operating 123 warehouse-format stores across 30 states.
Details

1Q beat. Sales eclipsed lowered expectations (comps +2.4% vs. our/Street's 0%/1.1%), gross margin was solid (+32bps; higher product margins), and G&A benefited from lower incentive comp accruals. All told, adjusted EPS grew ~20% y/y to $0.34 – well above our $0.27E and the Street's $0.26E.

Strong comps prior to stores closing. 1Q comps were running +6.1% (in line with our initial 6%E) prior to FND's self-imposed decision to close stores and pivot to a curbside-only model on March 21. This included a healthy balance between traffic (transactions +3.4%) and average ticket (+2.7%). That said, the final six days of 1Q comped down 46%, dragging the overall 1Q comp down to 2.4%.

1Q Comps Solid Considering Steep Drop-Off During the Final Week Once Stores Closed

QTD trend better than feared. While QTD comps are running slightly below late-March levels at down 50%, this is better than most feared, and the trajectory of business has been slightly improving of late. In short, FND's digital capabilities and superior customer service have allowed the company to retain a significant amount of sales (and grow mind share with Pros and DIY-ers) while operating a curbside-only model. In order to make the curbside model seamless, FND has moved certain merchandise outside (bulk installation materials, best-selling SKUs), added designated "runners" to grab samples from the store, and implemented mobile POS.

What will the shape of the go-forward demand curve look like as stores re-open? This is the key near-term debate on the stock. On one hand, the economic fallout from COVID-19 will likely pressure big-ticket spending. That said, sample sales have surged in April (an indication of pent-up demand), and comps in two stores recently opened in Utah went from "really negative" to positive. While FND plans to have ~70% of its stores opened by the end of May, the company is currently rolling out an in-store Pro appointment model. Bottom line, we continue to model 2Q/3Q comps down 30%/10% but are cautiously optimistic this could prove conservative.

Protecting cash flow and boosting liquidity. In order to protect cash flow, FND has reduced its 2020 cash expenditures by ~$400M (~$100M opex, ~$110M capex, ~$190M inventory/supply chain). While the demand recovery trajectory is unknown, FND has ample liquidity (~$376M "unrestricted" at 1Q-end plus accordion features as part of the company's term loan and ABL facilities) to withstand a prolonged downturn and expects to be in a position to repay its ABL in 4Q.
Estimates. Raising FY20E EPS to $0.80 from $0.75 (assumes comps down ~10%) as we flow-through 1Q’s upside. Our FY21E EPS remains $1.15, which assumes sales of $2.517B (comps up 12.7%) and EBIT margins of 6.6% (below FY19’s 8.0%).

Investment Thesis

- **Early-stage category killer.** FND operates a differentiated store model, with the broadest assortment, lowest prices, and highest in-stock position. Comps have averaged ~14% since 2011, nearly double industry growth. With brand awareness still low, we believe FND is well-positioned to build upon recent share gains (still <10% market share today) and become the dominant specialty player in what is still a fragmented industry.

- **Significant whitespace opportunity.** With ~20% annual unit growth and the potential to quadruple its footprint to ~400 stores, FND represents one of the longer duration whitespace stories in retail. Importantly, unit-level economics continue to surpass prior vintages (cash payback now <2 years), underscoring improved execution across recent store classes (site selection, grand opening process, assortment localization).

- **Still room to improve sales productivity.** While comps have moderated from prior years’ double-digit pace, we see several initiatives across merchandising (design services, adjacent categories), marketing/CRM, omni-channel (room visualizer recently added online), and Pro (app, loyalty program, private label credit) to drive sales productivity. When combined with the lift from store maturation (>300bps comp tailwind), we think M-HSD% comps are sustainable in a “normalized” environment.

- **Long-term EBIT margin expansion potential is compelling.** While the demand shock following COVID-19 will certainly pressure operating margins this year, the longer term margin expansion opportunity for FND remains compelling, in our view. Specifically, we see potential for low double-digit operating margins (vs. FY19’s 8.0%) as the business scales and growth investments plateau.

- **Price target rationale.** Our $46 price target assumes ~40x FY21E EPS estimate, a multiple in line with the stock’s three-year average of ~40x as we balance likely pressure on big ticket spending with prospects for significant market share gains.

Risks & Caveats

- **Prolonged contraction in housing.** A sustained downturn in housing turnover and/or declining home prices could negatively impact demand for hard surface flooring and pressure FND’s fundamentals.

- **Product innovation wanes.** Product innovation, particularly around fashion and durability, has been a key driver of hard surface flooring industry growth over the past decade. A slowdown in the pace of innovation and/or FND’s inability to identify and respond to new/emerging trends could result in decelerating comps.

- **Execution risk associated with new store growth.** New store growth could cannibalize existing store sales and damage FND’s overall operating results. Additionally, FND’s entry into new markets with lower brand awareness could result in lower new store productivity, exacerbating the deleveraging impact from new stores.

- **Rising input costs (including tariffs) and mix shift could pressure gross margin.** Rising input costs (raw materials, labor) used in the production of hard surface flooring, as well as tariffs, could have a significant impact on FND’s profitability. Additionally, the mix shift to LVP/LVT could hurt gross margin as these products typically require less higher margin installation accessories.
Vendor/supply chain risk. While FND has a diversified supplier base (>200 vendors across 20 countries) and has been transitioning away from China (~50% of COGS in FY18; 30%-35% in FY19), any disruption to FND's global supply chain could lead to lost sales, incremental costs, and/or margin rate pressure.

Concentration of ownership. FND's private equity sponsors (Ares and Freeman Spogli) still hold ~20% of the shares outstanding. FND shares could come under pressure as the sponsors look to monetize their investment through follow-on offerings.

Increased competition from big-box home centers. Any decision by the big-box home centers to increase space allocation to the category and/or sharpen pricing could pressure FND's fundamentals.

Geographic concentration of store base. Over 40% of FND's store base is located in 3 states (Florida, Texas, and California), so FND is more susceptible to macroeconomic conditions in those markets.

Compliance/regulatory. The hard surface flooring industry is highly regulated. If FND does not maintain compliance with appropriate regulatory bodies, the company could face heightened litigation costs.

Company Description

Founded in 2000, Floor and Décor (FND) is a leading specialty retailer of hard surface flooring and related decorative and installation accessories. The company offers the industry’s broadest in-stock assortment at everyday low prices through its 123 warehouse-format stores across 30 states. With FY19 sales of ~$2.0B, we believe FND is now the second largest retailer of hard surface flooring products in the U.S. (behind only Home Depot). That said, we estimate FND’s market share is only ~10% today as the brand is still being “discovered” by consumers (just ~13% unaided awareness).
1 Robert W. Baird & Co. Incorporated makes a market in the securities of FND.

**Appendix – Important Disclosures and Analyst Certification**

Robert W. Baird & Co. Incorporated (“Baird”) and/or its affiliates expect to receive or intend to seek investment-banking related compensation from the company or companies mentioned in this report within the next three months. Baird may not be licensed to execute transactions in all foreign listed securities directly. Transactions in foreign listed securities may be prohibited for residents of the United States. Please contact a Baird representative for more information.

**Investment Ratings: Outperform (O)** - Expected to outperform on a total return, risk-adjusted basis the broader U.S. equity market over the next 12 months.

**Neutral (N)** - Expected to perform in line with the broader U.S. equity market over the next 12 months.

**Underperform (U)** - Expected to underperform on a total return, risk-adjusted basis the broader U.S. equity market over the next 12 months.

**Risk Ratings:**
- **L - Lower Risk** – Higher-quality companies for investors seeking capital appreciation or income with an emphasis on safety. Company characteristics may include: stable earnings, conservative balance sheets, and an established history of revenue and earnings.
- **A - Average Risk** – Growth situations for investors seeking capital appreciation with an emphasis on safety. Company characteristics may include: moderate volatility, modest balance-sheet leverage, and stable patterns of revenue and earnings.
- **H - Higher Risk** – Higher-growth situations appropriate for investors seeking capital appreciation with the acceptance of risk. Company characteristics may include: higher balance-sheet leverage, dynamic business environments, and higher levels of earnings and price volatility.
- **S - Speculative Risk** – High growth situations appropriate only for investors willing to accept a high degree of volatility and risk. Company characteristics may include: unpredictable earnings, small capitalization, aggressive growth strategies, rapidly changing market dynamics, high leverage, extreme price volatility and unknown competitive challenges.

**Valuation, Ratings and Risks.** The recommendation and price target contained within this report are based on a time horizon of 12 months but there is no guarantee the objective will be achieved within the specified time horizon. Price targets are determined by a subjective review of fundamental and/or quantitative factors of the issuer, its industry, and the security type. A variety of methods may be used to determine the value of a security including, but not limited to, discounted cash flow, earnings multiples, peer group comparisons, and sum of the parts. Overall market risk, interest rate risk, and general economic risks impact all securities. Specific information regarding the price target and recommendation is provided in the text of our most recent research report.

**Distribution of Investment Ratings.** As of April 30, 2020, Baird U.S. Equity Research covered 724 companies, with 59% rated Outperform/Buy, 40% rated Neutral/ Hold and 1% rated Underperform/Sell. Within these rating categories, 12% of Outperform/Buy-rated and 4% of Neutral/ Hold-rated companies have compensated Baird for investment banking services in the past 12 months and/or Baird managed or co-managed a public offering of securities for these companies in the past 12 months.

**Analyst Compensation.** Research analyst compensation is based on: (1) the correlation between the research analyst's recommendations and stock price performance; (2) ratings and direct feedback from our investing clients, our institutional and retail sales force (as applicable) and from independent rating services; (3) the research analyst's productivity, including the quality of such analyst's research and such analyst's contribution to the growth and development of our overall research effort; and (4) compliance with all of Baird’s internal policies and procedures. This compensation criteria and actual compensation is reviewed and approved on an annual basis by Baird's Research Oversight Committee. Research analyst compensation is derived from all revenue sources of the firm, including revenues from investment banking. Baird does not compensate research analysts based on specific investment banking transactions.
A complete listing of all companies covered by Baird U.S. Equity Research and applicable research disclosures can be accessed at http://www.rwbaird.com/research-insights/research/coverage/third-party-research-disclosures.aspx. You can also call 800-792-2473 or write: Robert W. Baird & Co., Equity Research, 777 E. Wisconsin Avenue, Milwaukee, WI 53202.

**Analyst Certification**

The senior research analyst(s) certifies that the views expressed in this research report and/or financial model accurately reflect such senior analyst's personal views about the subject securities or issuers and that no part of his or her compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.

**Disclaimers**

Baird prohibits analysts from owning stock in companies they cover. This is not a complete analysis of every material fact regarding any company, industry or security. The opinions expressed here reflect our judgment at this date and are subject to change. The information has been obtained from sources we consider to be reliable, but we cannot guarantee the accuracy.

**ADDITIONAL INFORMATION ON COMPANIES MENTIONED HEREIN IS AVAILABLE UPON REQUEST**

The Dow Jones Industrial Average, S&P 500, S&P 400 and Russell 2000 are unmanaged common stock indices used to measure and report performance of various sectors of the stock market; direct investment in indices is not available. Baird is exempt from the requirement to hold an Australian financial services license. Baird is regulated by the United States Securities and Exchange Commission, FINRA, and various other self-regulatory organizations and those laws and regulations may differ from Australian laws. This report has been prepared in accordance with the laws and regulations governing United States broker-dealers and not Australian laws.

**Other Disclosures**

The information and rating included in this report represent the research analyst's views based on a time horizon of 12 months, as described above, unless otherwise stated. In our standard company-specific research reports, the subject company may be designated as a “Fresh Pick”, representing that the research analyst believes the company to be a high-conviction investment idea based on a subjective review of one or more fundamental or quantitative factors until an expiration date specified by the analyst but not to exceed nine months. The Fresh Pick designation and specified expiration date will be displayed in standard company-specific research reports on the company until the occurrence of the expiration date or such time as the analyst removes the Fresh Pick designation from the company in a subsequent, standard company-specific research report. The research analyst(s) named in this report may, at times and at the request of clients or their Baird representatives, provide particular investment perspectives or trading strategies based primarily on the analyst’s understanding of the individual client’s objectives. These perspectives or trading strategies generally are responsive to client inquiries and based on criteria the research analyst considers relevant to the client. As such, these perspectives and strategies may differ from the research analyst’s views contained in this report.

Baird and/or its affiliates may provide to certain clients additional or research supplemental products or services, such as outlooks, commentaries and other detailed analyses, which focus on covered stocks, companies, industries or sectors. Not all clients who receive our standard company-specific research reports are eligible to receive these additional or supplemental products or services. Baird determines in its sole discretion the clients who will receive additional or supplemental products or services, in light of various factors including the size and scope of the client relationships. These additional or supplemental products or services may feature different analytical or research techniques and information than are contained in Baird’s standard research reports. Any ratings and recommendations contained in such additional or research supplemental products are consistent with the research analyst’s ratings and recommendations contained in more broadly disseminated standard research reports. Baird disseminates its research reports to all clients simultaneously by posting such reports to Baird’s password-protected client portal, https://bol.rwbaird.com/Login("BairdOnline"). All clients may access BairdOnline and at any time. All clients are advised to check BairdOnline for Baird’s most recent research reports. After research reports are posted to BairdOnline, such reports may be emailed to clients, based on, among other things, client interest, coverage, stock ownership and indicated email preferences, and electronically distributed to certain third-party research aggregators, who may make such reports available to entitled clients on password-protected, third-party websites. Not all research reports posted to BairdOnline will be emailed to clients or electronically distributed to such research aggregators. To request access to Baird Online, please visit https://bol.rwbaird.com/Login/RequestInstLogin or contact your Baird representative.

**Dividend Yield.** As used in this report, the term “dividend yield” refers, on a percentage basis, to the historical distributions made by the issuer relative to its current market price. Such distributions are not guaranteed, may be modified at the issuer’s discretion, may exceed operating cash flow, subsidized by borrowed funds or include a return of investment principal.

**United Kingdom (“UK”) disclosure requirements for the purpose of distributing this research into the UK and other countries for which Robert W. Baird Limited holds a MiFID passport.**

The contents of this report may contain an “investment recommendation”, as defined by the Market Abuse Regulation EU No 596/2014 (“MAR”). This report does not contain a “personal recommendation” or “investment advice”, as defined by the Market in Financial Instruments Directive 2014/65/EU (“MiFID”). Please therefore be aware of the important disclosures outlined below. Unless otherwise stated, this report was completed and first disseminated at the date and time provided on the timestamp of the report. If you would like further information on dissemination times, please contact us. The views contained in this report: (i) do not necessarily correspond to, and may differ from, the views of Robert W. Baird Limited or any other entity within the Baird Group, in particular Robert W. Baird & Co. Incorporated; and (ii) may differ from the views of another individual of Robert W. Baird Limited.

This material is distributed in the UK and the European Economic Area (“EEA”) by Robert W. Baird Limited, which has an office at Finsbury Circus House, 15 Finsbury Circus, London EC2M 7EB and is authorized and regulated by the Financial Conduct Authority (“FCA”) in the UK.
For the purposes of the FCA requirements, this investment research report is classified as investment research and is objective. This material is only directed at and is only made available to persons in the EEA who would satisfy the criteria of being "Professional" investors under MiFID and to persons in the UK falling within Articles 19, 38, 47, and 49 of the Financial Services and Markets Act of 2000 (Financial Promotion) Order 2005 (all such persons being referred to as “relevant persons”). Accordingly, this document is intended only for persons regarded as investment professionals (or equivalent) and is not to be distributed to or passed onto any other person (such as persons who would be classified as Retail clients under MiFID).

All substantially material sources of the information contained in this report are disclosed. All sources of information in this report are reliable, but where there is any doubt as to reliability of a particular source, this is clearly indicated. There is no intention to update this report in future. Where, for any reason, an update is made, this will be made clear in writing on the research report. Such instances will be occasional only.

Please note that this report may provide views which differ from previous recommendations made by the same individual in respect of the same financial instrument or issuer in the last 12 months. Information and details regarding previous recommendations in relation to the financial instruments or issuer referred to in this report are available at https://baird.bluematrix.com/sellside/MAR.action.

Robert W. Baird Limited or one of its affiliates may at any time have a long or short position in the company or companies mentioned in this report. Where Robert W. Baird Limited or one of its affiliates holds a long or short position exceeding 0.5% of the total issued share capital of the issuer, this will be disclosed separately by your Robert W. Baird Limited representative upon request.

Investment involves risk. The price of securities may fluctuate and past performance is not indicative of future results. Any recommendation contained in the research report does not have regard to the specific investment objectives, financial situation and the particular needs of any individuals. You are advised to exercise caution in relation to the research report. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice.

Robert W. Baird Limited and Robert W. Baird & Co. Incorporated have in place organisational and administrative arrangements for the prevention, avoidance, and disclosure of conflicts of interest with respect to research recommendations. Robert W. Baird Limited’s Conflicts of Interest Policy, available here, outlines the approach Robert W. Baird Limited takes in relation to conflicts of interest and includes detail as to its procedures in place to identify, manage and control conflicts of interest. Robert W. Baird Limited and or one of its affiliates may be party to an agreement with the issuer that is the subject of this report relating to the provision of services of investment firms. Robert W. Baird & Co. Incorporated’s policies and procedures are designed to identify and effectively manage conflicts of interest related to the preparation and content of research reports and to promote objective and reliable research that reflects the truly held opinions of research analysts. Robert W. Baird & Co. Incorporated’s research analysts certify on a quarterly basis that such research reports accurately reflect their personal views.

This material is strictly confidential to the recipient and not intended for persons in jurisdictions where the distribution or publication of this research report is not permitted under the applicable laws or regulations of such jurisdiction.

Robert W. Baird Limited is exempt from the requirement to hold an Australian financial services license and is regulated by the FCA under UK laws, which may differ from Australian laws. As such, this document has not been prepared in accordance with Australian laws.

Copyright 2020 Robert W. Baird & Co. Incorporated

This information is prepared for the use of Baird clients and may not be redistributed, retransmitted or disclosed, in whole or in part, or in any form or manner, without the express written consent of Baird. Any unauthorized use or disclosure is prohibited. Receipt and review of this information constitutes your agreement not to redistribute, retransmit, or disclose to others the contents, opinions, conclusion, or information contained in this information (including any investment ratings, estimates or price targets) without first obtaining expressed permission from an authorized officer of Baird.