

Team 1 - Pier 1 Imports

Major Valuation Project

Value Investing 9403 – Section 8

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Executive Summary

Pier 1 Imports, Inc. is an omni-channel retail business that sells home furnishing and decor. The specialty retail operations of the company consist of retail stores and an e-Commerce website. Pier 1 Imports, Inc. (PIR) stock has been on the radar for value investors due to its key metrics and financials, and ongoing strategic changes from management's side. Key value investing metrics for Pier 1 Imports i.e. Price to Earnings ratio (P/E) is 8.4 (below x13) and its Price to Book Value ratio is 1.0 (below x1.2). These afore mentioned ratios meet the threshold criteria and its market capitalization is 259.2 million, well below the market capitalization ceiling for US companies (1.2- 1.3 billion USD). Although, the recent industry changes and declining financial performance has attracted a lot of analyst coverage, most metrics point towards potential undervaluation of the stock.

An industry analysis using Porter's five forces indicates that the bargaining power of suppliers is low because of the diversity of suppliers available domestically and internationally. However, buyers have higher bargaining power because of intense competition in the industry and lower search and switching costs for buyers. While furniture and home décor are not replaceable merchandise, there is high competition in the industry due to different range of products available and new entrants coming in with specialty products. Therefore, the industry is at 'medium' risk. Financial metrics for Pier 1 Imports such as operating margins and net margins have declined in recent years due to a combination of flat sales and increase in SG&A costs coming from aggressive advertising for customer acquisition and expanded loyalty programs. Although the company has been experiencing declining operating margins, it has established brand equity which may help offset negative industry forces. Hence, the company has been identified to be at 'medium' business risk in line with the industry.

The company is highly leveraged with a debt ratio of ~80% which is well above the optimal capital structure. We find Pier 1 to be at a high financial risk with 'B' credit rating and a cost of debt at 5.5%. Equity Risk Premium based on the company analysis is 5.9%, which resulted in weighted average cost of capital (WACC) of 5.37%

First Pass return on invested capital (1st-ROIC) has been calculated at -0.10% due to expected operating loss in recent fiscal year; based on higher WACC, it can be inferred that 'net asset value'(NAV) is likely to be greater than 'earnings power value' (EPV). Further company valuation substantiates our hypothesis as NAV (\$24.83) is greater than EPV (\$5.36); and second pass ROIC is 2.50%. This difference is being driven largely by management strategies which are not yielding strong operating margins. We have concluded the management to be the catalyst in realizing intrinsic value. The market stock price reflects the operating margin trends and for the stock to realize the intrinsic value the management will need to ensure that the operational efficiencies are achieved. The probability of realizing this catalyst is 50% because although the management has not been able to achieve the optimal level of efficiencies, they have recognized the margins as a problem and stated publicly their intent to address these areas of concern. These enhancements include, but are not limited to, improving supply chain efficiencies and managing capital expenditures. This valuation results in an entry price of \$10.07, much higher than market price (\$3.11); hence Pier 1 Imports (PIR) stock is a 'BUY'.