



Levered Beauty
Sally Beauty Holdings
NYSE: SBH - \$7.00
6/9/2008

	<u>Current</u>
Price	\$7.00
Shares Outstanding	181
Market Cap	\$1.3 B
Long-Term Debt	\$1.8 B
Dividend	None
Dividend Yield	NA
Location	Denton, TX

Sally Beauty, operating in the stable, low growth beauty supply industry, is holding its own during these rocky economic times. Although investors are shying away from consumer exposed names, and Sally's leveraged capital structure makes it an easy target for elimination from any portfolio, the company still managed to beat expectations in the March quarter. The stock jumped 15%. Although it is down 26% YTD, operational improvements, steady store expansion and continued paydown of debt could bring this stock easily within reach of its 52-week high of almost \$11, a potential gain of 50%.

Background and Recent Corporate History

Sally Beauty is a beauty supplies retailer. It has two divisions: Sally Beauty stores and the Beauty Systems Group. The Sally Beauty division operates 2,700 retail stores selling higher-end beauty products, such as premium shampoo and hairstyling tools, that are not available through mass merchants. The stores tend to be located in second-tier strip malls. The customer base is 30% professional hairdressers and 70% independent consumers. The Beauty Systems Group is a division with 900 stores and about 1,000 independent sales consultants selling exclusively to professional hairdressers and salons.

Sally was spun-off from Alberto-Culver in a sponsored-spin transaction with Clayton, Dubilier & Rice (CDR) in November, 2006. As part of the spin, CDR purchased a 50% stake in Sally while it was still a subsidiary of Alberto-Culver. Then, Sally borrowed \$1.8 billion from the capital markets, and used the proceeds from the CDR purchase and the debt offering to pay a one-time dividend to Alberto-Culver. The remaining 50% of Sally was spun-off to Alberto-Culver's shareholders.

Importance of the Sponsored-Spin

It is important to understand the sponsored spin-off from Alberto-Culver to fully appreciate the attractiveness of Sally Beauty stock. A sponsored spin-off is an interesting transaction: public shareholders in the company get a levered investment plus the added benefit of having a sophisticated shareholder, in the form of a private equity firm, driving value. Joel Greenblatt talks about sponsored spin-offs in Chapter 6 of his book, [You Can Be a Stock Market Genius](#).

A few years ago, CDR made an unsuccessful bid to buy Sally Beauty from Alberto Culver. Instead, Alberto agreed to merge with Regis. When that transaction fell apart, CDR approached Alberto-Culver again to arrange a deal for Sally. The terms of this deal were that CDR would take a stake in Sally, Sally would borrow more money to pay a tax-free dividend to Alberto, and the remaining piece of Sally would be spun-off to shareholders.

Currently, there are two CDR representatives on the Sally's Board. They are there to drive value for CDR. Since CDR only owns 50% of Sally and the public owns the rest, CDR's efforts directly benefit the public stockholders. As a 50% owner, CDR can give Sally's management team the boot if they do anything stupid. Even better, they can potentially stop the management team from doing anything stupid. This structure solves the problem of management having too much control.

Investment Thesis and Gator's Investment Criteria

Sally is essentially a publicly-traded LBO. It is a stable business that came public in a sponsored spin-off with a private equity firm. At the time of the spin-off, the company took on a significant debt load. Sally's management team has cut costs and made some additional investments. As the business grows, the debt provides leverage for the stockholders and magnifies the potential return.

Does Sally meet Gator's investment criteria of a high-quality growth business? Consider the following:

Franchise	
Strong brand	Yes
Dominant market share	No
Pricing power	No
Recurring revenue stream	Yes
Free cash flow	Yes
High ROIC	Yes
Strong balance sheet	No
Long-term prospects	
Predictable growth	Yes
Sustainable growth	Yes
Long product life cycle	Yes
Enduring competitive advantage	Yes
Favorable demographic trends	Yes
Excellent management	
Rational capital allocation	Yes
Consistent operating history	Yes

Incentives aligned with shareholders Yes

Clearly, Sally meets some but not all of the criteria of a high-quality growth business. While Sally's brand is not iconic, it is strong in its target market of the local hairdresser. And in terms of growth prospects, it is a slow growing business but is steady. Finally, although the balance sheet is not strong, it is improving with each passing quarter.

Recent Stock Performance

Sally stock closed just under \$8 on its first day of trading in November, 2006 and quickly traded up above \$10 over the next month. Then, L'Oreal unexpectedly pulled a product exclusive to Sally's Beauty Systems Group. This caused a hole in Sally's revenue stream amounting to about \$120 million. Management quickly recovered and replaced the lost revenue with new agreements with some of L'Oreal's competitors, including P&G's Wella line. During 2007, the stock inched back up above \$10 as the company posted solid results. It looked like the stock was going to break-out at the end of 2007, but it quickly turned around and closed the year at \$9.



So far this year, Sally has suffered due to its consumer exposure and its heavy debt load. The stock has declined from \$9 to below \$6 just prior to the March earnings report. The main reason for the stock decline was a hint of customer weakness in the December earnings report. Management called out weakness in their customer base, especially in California and Florida.

Latest Earnings

Sally's reported earnings on May 8th of this year surprised the Street. Sally reported March quarter earnings of 10 cents. This beat the analysts' estimates of 7 cents. Importantly, Sally's same-store sales growth rebounded from the slight deceleration seen in the December quarter. Plus, the company was able to publish an adjusted operating earnings number, which filtered out the noise from marking-to-market a couple of interest rate swaps. The stock jumped 15% on the earnings but was still down 26% year-to-date.

Industry Analysis

The beauty supply industry has some attractive characteristics. Due to the non-discretionary purchase of beauty products, growth in the industry has been stable since 1990, ranging from 3% to 6.5% and averaging 5% annually. The industry's customer base is fragmented, with most customers being small retail shops without much buying power. About 75% of the industry's volume is conducted through distributors like SBH.

Near Term Business Initiatives

Sally has several near-term business initiatives that could help boost earnings and drive further gains.

First, Sally is consolidating warehouses in the Beauty Systems Group division. The extra warehouse will be closed at the end of this September, saving \$10 million in duplicative expenses and an unquantified amount in inventory savings. The inventory savings is important because the reduction in inventory will go to pay down debt.

Store openings are robust in both divisions. Management plans to open about 200 new stores in spite of the heavy debt load. The bet here is to grow out of the high debt load. So far, this strategy is working. Debt has basically remained unchanged since the spin, but the EBITDA has grown 11%.

Sally also has a new product about to launch, Paris Hilton Hair Extensions, that it hopes will attract younger customers to the Sally stores for the first time. This celebrity endorsement didn't cost much: Paris will receive a commission on each unit that sells. Hair extensions are very fashionable at the moment, so this new product should increase traffic at the stores.

Sally is still rolling out its e-commerce website. The company didn't start selling online until October 2007, and currently only has about 300 products on its website. By the end of 2008, Sally's entire inventory will be available online, along with some products not available in the stores. These incremental sales come at a very favorable ROIC.

The company has been testing a CRM system in about 100 stores. The system tracks customer purchases and then sends targeted emails to the customers with coupons and/or promotions based on their purchasing history. The CRM system will be rolled out to the rest of the Sally chain this year.

Lastly, Sally is expanding into international markets, beginning with an acquisition in the UK in early 2007. With the latest earnings release, Sally announced the additional acquisition of a chain in Belgium, which gives them a foothold into France and Spain. Lastly, they expect to make a small acquisition in South America in the next 18 months. These acquisitions become platforms for further organic growth.

Balance Sheet

At 5.5 turns, there is no question that Sally is levered. One could argue there is even more leverage if taking the store leases into account. However, Sally's debt ratios are improving steadily. In November, 2006, when it was spun from Alberto Culver, debt stood at 6.1x trailing EBITDA. As EBITDA has grown, the debt-to-EBITDA has declined to 5.5 times. With the forecasted improvement in EBITDA over the next 12 months, the ratio should stand below 5

times a year from now.

S&P has taken notice of this improvement and put SBH on a positive ratings watch at the end of March. The company's current credit rating is "B."

Valuation

Sally trades at reasonable valuation levels, 8.5x our 2008 EV/EBITDA and 7.5x our 2009 number. On an earnings basis, it trades at 17x our 2008 EPS and 12x our 2009 number. The growth in the earnings in 2009 shows the amount of financial leverage Sally has, and the positive effect this leverage can have on the numbers.

	<u>2007</u>	<u>2008</u>	<u>2009</u>
Est EPS	0.32	0.40	0.60
Growth Rate		25%	50%
P/E	21.9x	17.5x	11.7x
Adj EBITDA	309.5	342.5	410.3
Growth Rate	5.3%	10.6%	19.8%
EV/EBITDA	9.9x	8.9x	7.5x

Risks

There are several risks with Sally. The obvious risk is the rollover of the consumer. So far, the business hasn't show signs of weakness. The other near-term risk is the lack of a permanent CFO. The CFO left in March for reasons that are unclear. A CFO departure, whether voluntary or involuntary, is always unsettling.

Longer term, Sally may face some other challenges. There is the possibility of increased competition with L'Oreal. Or, another supplier might decide to follow L'Oreal into distribution, increasing competition. Also, Sally would be under pressure if its suppliers began distributing their premium product lines through mass market channels. Lastly, there is always the threat of the salon industry consolidating, though this seems unlikely for now: if anything, it seems the industry continues to fragment.

Conclusion

Sally Beauty Holdings is an attractive investment. A sponsored spin-off with a well known private equity firm owning 50% of the stock and sitting on the Board, SBH shows stable growth in spite of the current economic environment. The heavy debt load is being well-managed and can benefit common stock holders by providing leveraged returns. Lastly, the company is planning and implementing several business enhancements that will help earnings grow in spite of the economic environment. The upside is close to 50%.