RH: The Clear Winner from the De-Urbanization of America

$400 Price Target

Making money in this market has been a thinking man's game. While the market was tanking in mid-March, savvy investors were able to put aside the near-term fear and take hold of the new realities and buy what are now known as the "stay at home stocks". The largest beneficiary of this phenomenon was Wayfair whose stock went up over 700% from trough to peak in less than two months as people were scurrying to buy home office and kitchen accessories.

Now that the near-term panic is over, Citron thinks about the new theme that appears to be a secular trend rather than a one quarter phenomenon…

The De-Urbanization of America.

Regardless of the possibility of a vaccine, the trend of moving out of cities to the suburbs for larger living spaces where people can work from home and the home is a sanctuary will be long-lasting.

What one company is already thriving and is about to significantly beat consensus estimates for the coming years on this new way of living?

RH (formerly Restoration Hardware) – a design ecosystem that will boom in de-urbanization.

The De-Urbanization of America

It seems every three hours CNBC is interviewing a realtor about this trend. Instead of Citron editorializing, look at these headlines from NY, SF, Seattle, London, Paris, and every over urban market over the past few weeks:

- "Zillow, Redfin predict a suburban boom in US real estate as remote work becomes more common"

- “Wealthy New Yorkers flee Manhattan for Suburbs and Beyond”
- “New Yorkers Fleeing City Hunt for Million-Dollar Suburban Homes”
- “City Dweller looking to move to suburbs amid pandemic”
- “Young are joining the rich fleeing America’s big cites for the suburbs”
- “Remote work may trigger a suburban boom in real estate”
- “Investors are prioritizing greenery and open space, even if it means leaving the historic city center”

https://realestate.boston.com/buying/2020/05/21/young-joining-rich-fleeing-cities-for-suburbs/

https://www.nytimes.com/2020/05/08/realestate/coronavirus-escape-city-to-suburbs.html

https://nj1015.com/new-yorkers-moving-to-the-new-jersey-suburbs-in-droves/

https://denver.cbslocal.com/video/4552437-real-estate-trend-more-moving-to-the-suburbs/

https://www.bloomberg.com/news/articles/2020-05-20/bidding-wars-are-back-even-in-housing-market-stung-by-pandemic

https://www.bloomberg.com/news/articles/2020-05-20/young-join-the-rich-fleeing-america-s-big-cities-for-suburbs

https://www.bloomberg.com/news/articles/2020-05-21/new-yorkers-fleeing-city-hunt-for-million-dollar-suburban-homes

https://www.cnbc.com/2020/04/30/wealthy-new-yorkers-flee-manhattan-for-suburbs-and-beyond.html

https://www.seattlepi.com/coronavirus/article/zillow-predicts-suburban-boom-in-real-estate-covid-15281310.php

https://www.mansionglobal.com/articles/the-pandemic-could-shift-centuries-old-behavior-patterns-in-paris-214951

https://www.telegraph.co.uk/luxury/property-and-architecture/large-private-gardens-have-become-non-negotiable-luxury-property/

Why RH? CEO Gary Friedman explains how the ecosystem that RH has created will flourish in de-urbanization:

"We have revolutionized the customer experience by showcasing products in a sophisticated lifestyle setting that we believe is on par with world-class interior designers, consistent with the imagery and product presentation featured on our websites and in our catalogs. Products in our Galleries are presented in fully appointed rooms, emphasizing collections over individual pieces. ***This***

presentation encourages a higher average order value as our customers are inspired to consider purchasing a full collection of products to replicate the design aesthetic experienced in our Galleries."

To put the business model in perspective:

The most popular item at RH is the cloud couch with the $10K configuration. The average order size at Wayfair is $235. People buy home accessories at Wayfair whereas people design homes with furniture at RH.

The same upwardly mobile and style conscious consumer who is moving to the suburbs is RH's target market.

https://www.forbes.com/sites/amandalauren/2019/01/25/is-restoration-hardware-the-retail-experience-that-will-change-the-way-millennials-buy-furniture/#4dd8c5bf3ba9

https://www.barrons.com/articles/restoration-hardware-shows-how-amazon-isnt-the-only-retail-winner-51560446237

This massive de-urbanization will put into hyper speed the projections of CEO Friedman with his long-term revenue guidance of $20 billion vs. approximately $2-3 billion today with just the existing ecosystem.

Even if we assume that he is only 50% right on this claim and RH achieves $10 billion in revenue, the stock is going to over $1,000… Buffett believes it.

What about this Quarter?

While we believe the big boom to RH's business is yet to come, the trend of the home as a sanctuary is already showing its benefits.

Based on proprietary credit card data that has an 80-90% correlation with RH same store sales, we are seeing not only a beat with the upcoming earnings but **QTD trends that are tracking at +4-5% vs. consensus at -22%**. Citron cannot remember the last time we've seen such a large divergence between reality and expectations.

Consider this, despite all RH galleries being closed, the company should still post YoY revenue growth in Q2. Unheard of.

The recent strength we are witnessing at RH has been corroborated by additional positive industry data points. Online furniture sales volumes continued to accelerate in May based on data from online furniture retailer platforms Blueport Commerce and ImagineRetailer.

Blueport Commerce has reported online furniture sales growth of:

- First two weeks of April: Up 200% YoY
- First two weeks of May: Up 450% YoY

ImagineRetailer has reported online furniture sales growth of:

- First two weeks of April: Up 302% YoY
- First two weeks of May: Up 538% YoY

With consumers staying at home this summer, RH will also see a benefit to profitability from a mix shift towards outdoor furniture, which is one of RH's most profitable businesses.

https://www.cnbc.com/2020/05/17/outdoor-furniture-sales-grow-as-customers-prepare-for-a-summer-at-home.html

As CEO Friedman previously stated:

"The good thing about the outdoor business that I love, it always fits in the room when we deliver it to a home. It's like all the other businesses have high risk of they don't fit in the room. We also never scratch any walls or paint or dent anything when we deliver something and put it in the backyard. ***So, we like the outdoor business, lowest return rates, highest margins, et cetera et cetera****."*

Despite all of this, RH has been a notable laggard YTD vs. other companies seeing tailwinds to their business from COVID-19 such as Wayfair, Peloton and Zoom.

Why RH goes to $400 in the next 12 months

The work at home and move to larger spaces trend is just beginning. But more importantly, the people who will be working at home are younger and have more disposable income. Consider these points:

- "Mark Zuckerberg plans to shift Facebook toward a substantially remote workforce over the next decade, permanently reconfiguring the tech giant's operations around the dispersed structure that the coronavirus pandemic forced on it"
- Twitter and Square CEO Jack Dorsey informed employees that they could work from home indefinitely even after the COVID-19 lockdowns end
- Shopify CEO Tobi Lutke announced that employees will permanently work remotely until 2021 and said the era of "office centricity is over"
- "The New York Times reported this week that major firms like Barclays, JPMorgan Chase and Morgan Stanley are all debating whether they really need to maintain the more than 10 million square feet of New York office space. The three firms have more than 20,000 employees in the city, but it seems remote workers are doing just fine from home"

https://www.wsj.com/articles/facebook-to-shift-permanently-toward-more-remote-work-after-coronavirus-11590081300

https://www.businessinsider.com/twitter-tells-employees-they-can-work-from-home-permanently-2020-5

https://www.reuters.com/article/us-health-coronavirus-shopify/canadas-shopify-ceo-says-era-of-office-centricity-is-over-most-staff-to-permanently-work-from-home-idUSKBN22X21M

https://www.pymnts.com/news/retail/2020/pandemic-might-launch-flight-to-suburbs/

Tasteful and stylized home furniture is in its early innings. Consider how much money can be spent on beautifying the home.

Last year, US consumers spent approximately $2 trillion on experiences (e.g., travel, movies, concerts, amusement parks, etc.) vs. only approximately $200 billion on furniture & home furnishings. Even if a fraction of this $2 trillion experience spend is re-allocated, this will be a massive tailwind for the category (e.g., if only 10% of experience spend is re-allocated to furniture & home furnishings, the category will see 100% YoY growth).

Exhibit 1: ~$2 trillion of experience spend up for grabs

Category	Spend
Experiences Impacted by Social Distancing	$1,876.6
Air transportation	$105.6
Membership clubs and participant sports centers	$235.2
Casino gambling	$115.3
Hotels and motels	$118.1
Child care	$46.2
Purchased meals and beverages	$863.8
Package tours	$14.2
Personal care services	$168.0
Foreign travel by U.S. residents	$210.3
Used Autos	$167.1
Auto Parts	$79.8
Furniture & Home Furnishings	$220.6
Home Improvement	$114.9
Consumer Electronics	$329.5
Total Hardlines	**$911.8**

Note: Dollars in billions
Source: Bureau of Economic Analysis and Wells Fargo Securities, LLC

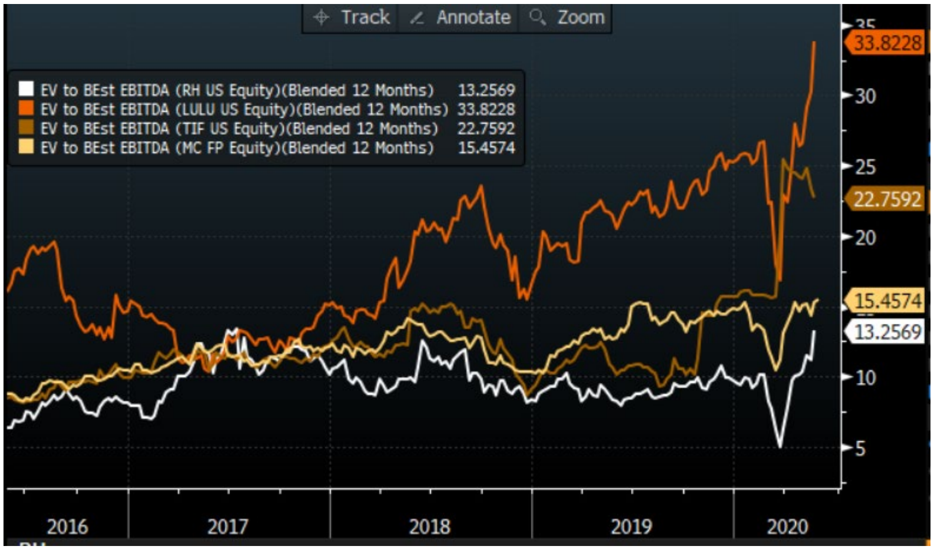
With the high-end consumer spending more time at home, where are they going to spend their money? They are not spending it on luxury apparel.

https://www.wsj.com/articles/gucci-and-louis-vuitton-reopen-but-their-best-customers-are-stuck-at-home-11589634001

Despite owning the most beautiful galleries in the top areas in the country and being on the cusp of explosive international growth, Wall St analysts still have not assigned a luxury brand valuation to RH.

Luxury peers are trading at a 100% premium valuation vs. RH

The valuation discount between RH and luxury/growth peers such as LVMH, Tiffany & Co, and Lululemon has never been clearer.



One day analysts will wake up and see what the Oracle of Omaha saw, and the stock will quickly re-rate to the average multiple of its luxury peers at 25x on 2021 EBITDA and trade at over $400. If we assume that RH should trade in-line with growth retailer peer Lululemon at 35x, the stock would trade at over $600.

RH 2021 EBITDA	$500	$500	$500
EV/EBITDA Multiple	25x	30x	35x
Enterprise Value	$12,500	$15,000	$17,500
Debt	$902	$902	$902
Cash	$48	$48	$48
Market Cap	$11,646	$14,146	$16,646
Shares Outstanding	27	27	27
RH Price Target	**$431**	**$524**	**$617**

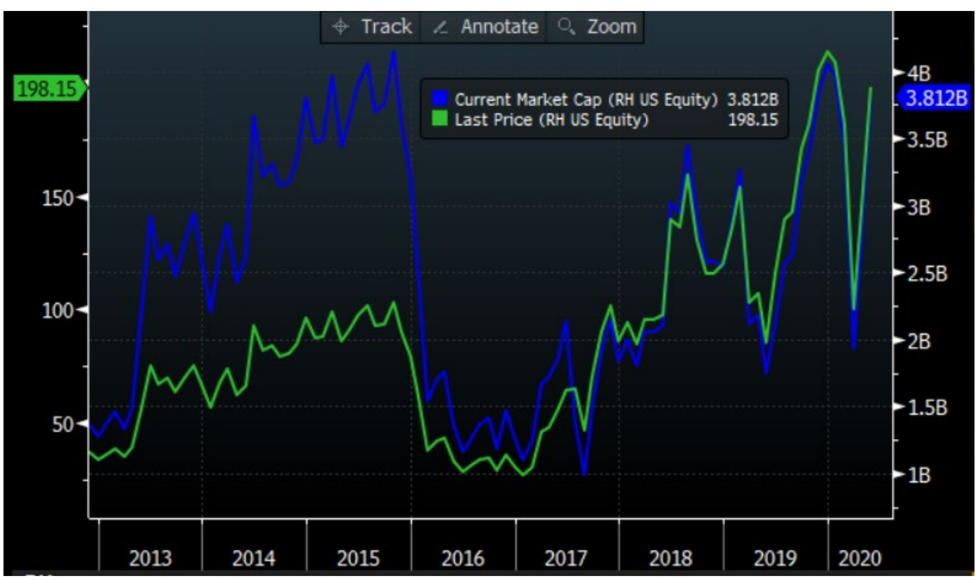
More Valuation Craziness

The valuation gap with Wayfair has never been wider. Today, Wayfair has 4-5x the market cap of RH. This is despite Wayfair still losing money vs. RH generating industry leading margins.

Don't Let the Stock Price Fool You

For investors that are new to the RH story, they should be aware that the company has done a fantastic job of creating shareholder value. Since 2017, RH has bought back approximately 50% of shares outstanding.

In other words, buying the stock today at $200 is the same as buying the stock at under $100 in 2015 (i.e., the market cap today vs. 2015 is the same despite during that same time EBITDA grew 100%).



Conclusion

We have always been a fan of the product and the stock and now the new way of living will propel this business model into hyper speed.

CEO Friedman remains the company's largest shareholder owning almost 30% of the company and he believes the stock is going much higher. Investors should recognize that Gary has not sold a single share since 2013 and his sale in December represents an immaterial percentage of his overall holdings as well over 90% of his net worth remains in RH's stock price – a clear vote of confidence.

Once Wall St understands the ecosystem of design that has been created by RH and how far ahead of the competition they are with the introduction of international, don't be surprised to see RH at $800.

Cautious Investing to All

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