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New Rec: hhgregg, Inc. (HGG: $22.57) July 5, 2010

Position: Sell **Target: $16**

$000	FQ1 11e	FQ2 11e	FQ3 11e	FQ4 11e	FY 11e	FY 12e
Revs	394,441	487,512	702,432	564,372	2,179,400	2,556,252
EPS $*	0.06	0.12	0.67	0.33	1.19	1.32
Y/Y Gr	42%	-4%	18%	29%	15%	11%
PE	n/a	n/a	n/a	n/a	18.5	16.7
PSR	n/a	n/a	n/a	1.2	0.41	0.35
Consens	0.02	0.15	0.79	0.44	1.40	1.74

Shares Out: 40M **Market Cap: $903M** **FYE: March**

Concept:

1. Old store comps are stagnant or in decline. This calls into question the long-term success of the business model. Because old stores sales are in decline, the company's bullish comments about new store productivity are unimpressive.

2. The company uses commission only salespeople, who help negotiate prices. It compares itself to Circuit City. Analysts think it has solved Circuit City's problems, but has it?
3. Stores appear to be in many inferior locations.
4. Bulls assume that ASP pressures in TVs will abate due to innovations such as LEDs. Bulls also think that appliance sales will continue to comp positive. Our store checks suggest that TV pricing pressure continues and that appliance sales could be disappointing. TVs and appliances account for three-quarters of the company's sales.

Summary: Based in Indianapolis, hhgregg (HGG) store chain sells video electronics (primarily TVs and DVD players), appliances and other items such as computers, cameras, camcorders, GPS devices and mattresses. In FY 10, which ended on March 31, 2010, video, appliance and other segment sales accounted for 47%, 35% and 18%, respectively, of total sales. HGG currently has 163 stores in 15 states in the Midwest, Southeast and mid-Atlantic regions of the US. HGG stores average 30,000 square feet, and are spare, with linoleum floors and painted ceilings. HGG stores do not carry video games, CDs or DVDs. HGG competes with Best Buy (BBY) and Wal-Mart in electronics and computers, and with Lowe's (LOW), Home Depot (HD) and BBY in appliances.

After expanding at a 15%-20% clip in the last few years, HGG decided to use the demise of Circuit City Stores in late 2008 to expand into Florida and the Baltimore, DC and Philadelphia metro areas in FY 10 and FY 11. The company plans to open 45 stores in FY 11 (ends March), which would represent a 35% Y/Y growth in store count. On its FQ4 10 call on May 27, 2010, HGG forecast FY 11 EPS of $1.35 to $1.45, above the consensus expectation then of $1.32 and well above the $1 EPS level of the last three fiscal years. On the call, HGG made positive comments regarding new store productivity, and stated that innovative technology such as LED TVs and up selling by HGG's commissioned salespeople could mitigate pricing pressures in TVs, which could lead to better video category comps in FY 11. Finally, HGG projected a better environment for appliance sales. Based on these comments, the "street" concluded that HGG is a growth story deserving a forward multiple on estimated FY 12 EPS as high as 20X and price targets as high as $35. By contrast, BBY has a forward multiple on FY 12 consensus of 9X.

There may be problems with the bullish arguments. First, our analysis of HGG's revenues and comps yielded the conclusion that new store productivity numbers seem good not because new stores are going exceptionally well, but rather because comp store sales are stagnant. Comp growth figures in the last five fiscal years were -6.6% (FY 10), -8.3% (FY 09), 4.8% (FY 08), 5.5% (FY 07), and 1.7% (FY 06). The company had only 58 stores at the beginning of FY 06. By age, we estimate that of the 106 comp stores at the end of FQ4 10, 18 were less than two years old, 32 were between two and five years old and 56 were more than five years old. The stagnant to declining historical comp growth suggests that old stores stop ramping, and even comp negatively. After all, the newest stores in the comps ought to be ramping up, so the only way to explain the weak comps is that the older stores are not comparing well or are going negative. HGG management claims to run a growth company and, but the growth has to be generated by opening new stores. We doubt that this business model is built for long-term success.

Second, our store checks in Tennessee and Florida indicated that, in every instance, HGG was located in noticeably inferior locations relative to BBY and LOW. The stores seem to be destination stores, not really conducive to up selling. During our store visits, we did not observe any instance of successful up selling, since few customers lingered in the stores. They appeared to come in, select their items, and leave. We also noted that traffic at the nearby BBY stores was 5X-10X that of the HGG stores we visited.

Third, while the company claims to up sell customers on premium products, HGG salespeople appeared actually to be focused mainly on price and on “closing the deal” by negotiating as necessary. HGG offers a 110% price protection guarantee, whereby if a customer finds an identical product for sale at a lower price at a competing store, HGG will sell the product to the customer at the lower price and also give the customer 10% of the price difference between HGG’s price and the competitor’s price. During our store checks, when we expressed concern about pricing, the salesperson would lead us to his or her desk, where he/she would pull up competitor prices on a computer to demonstrate to us that HGG had the lowest price. It appears to us that the combination of commissioned salespeople and price aggression is a potentially difficult one, although we understand why the company needs a salesman when it is constantly negotiating price, but this could generate gross margin pressures. Ironically, HGG has been telling the “street” that it is a growth story like Circuit City circa 1989. Recall that in 2007, Circuit City was compelled to replace its experienced salespeople with inexperienced, but less expensive, salespeople as a result of intense competition and pricing pressure, which marked the beginning of the company’s demise.

Fourth, it appears that special factors benefited HGG sales in FY 10. HGG benefited from the disappearance not only of Circuit City, but also of regional retailers such as Rex Electronics in Florida. We note that, in addition to its aggressive pricing, HGG offers discounts if a customer makes multiple simultaneous purchases (e.g., TV, appliances and mattresses). As a result, We think that the company’s sales in FY10 and in FQ 11 benefited from the housing tax credit and stimulus funded appliance rebates. Now that these have expired, sales growth should be harder to generate. Salespeople at the Florida stores we visited told us that sales of full kitchen suites (refrigerator, stove, dishwasher) had halved from two suites per month until April to just one a month in May and June.

Fully half of the Florida HGG salespeople and three quarters of the store managers with whom we spoke said that while revenues were up Y/Y in FQ1 11, sales were noticeably down Q/Q.

Fifth, LED TVs are being significantly discounted right out of the box. For instance, at the Clearwater HGG store, a 60" Sharp AQUOS LED TV set is now selling for $2,699 versus the $3,499 MSRP price when it was introduced just a month ago. This suggests to us that price is the selling factor, rather than innovation, and therefore HGG is unlikely to see any stabilization in downward ASP pressure from a higher proportion of LED TVs in its portfolio.

Because of these factors, we think that the comp growth and gross margin expansion that some bulls are counting on in the next couple of years is unlikely to materialize, which should result in EPS misses. We estimate EPS of $1.19 and $1.32, respectively, in FY 11 and FY 12 versus "street" expectations of $1.40 and $1.74. Puzzlingly, D&A expenses for HGG have not kept pace with capex growth, as we discuss later, and if this discrepancy corrects, there may be further downside to EPS.

Our price target for the shares is $16, based on a 12X multiple of out FY 12 EPS estimate of $1.32. Our assumed multiple is higher than current FY 12 forward multiples for BBY and LOW. Note that at our target price, HGG's price to sales ratio (using our FY 12 revenue estimate in the denominator) would be 0.26. This is also the current P/S ratio for BBY, using the estimated FY 12 revenue figure for BBY in the denominator.

Note that the company has used its growth status to sell shares, which allows it to open stores and grow some more, sort of a self-fulfilling prophecy. While the company raises money, insiders sell. HGG sold $83M from share sales in FY 10 and raised $49M in its IPO offering in FY 08. We discuss insider selling in more detail in a later section.

Background:

In 1955, Henry Harold Gregg and his wife Fansy opened an appliance store on the north side of Indianapolis. Since then, hhgregg (HGG) has expanded both its merchandise and geographical presence to become a chain of retail stores that sells electronics and home appliances in the Midwest, southeast and mid-Atlantic regions of the US. Currently, the company has about 160 stores in 15 states. Table 1 shows the distribution of stores by state.

Table 1: Distribution of HGG stores by state

State	Number of stores
Alabama	5
Delaware	3
Florida	20
Georgia	15
Indiana	17
Kentucky	5
Maryland	12
Mississippi	1
North Carolina	17
New Jersey	3
Ohio	23
Pennsylvania	12
South Carolina	6
Tennessee	11
Virginia	13
Total	163

Source: Company web site

HGG's stores average 25,000 to 35,000 square feet, and carry audio-visual equipment, appliances, computers and mattresses. Unlike Best Buy stores, HGG stores do not carry CDs, DVDs and video games. Table 2 shows the distribution of sales by merchandise category in recent years. Video includes TVs and DVD players. Appliances include refrigerators, cooking ranges, dishwashers, freezers, washers and dryers. The other category includes audio products, notebook computers, cameras, personal navigation, gaming bundles, telephones, advanced cables and mattresses.

Table 2: Distribution of HGG sales by category

	FY 06	FY 07	FY 08	FY 09	FY 10
Video	44%	47%	46%	50%	47%
Appliances	41%	40%	39%	35%	35%
Other	15%	13%	15%	15%	18%

Source: Company reports

HGG salespeople work fully on commission. Besides selling, salespeople are also responsible for price tagging and store cleanliness. The company claims that its salespeople are able to persuade customers to purchase higher-end feature-rich products. On recent calls, management has stated that its TV products are over weighted towards larger screen sizes and LED backlighting.

HGG positions itself as a growth company and has been expanding its square footage at a 15%-20% rate in recent years. However, the company plans to expand square footage and stores by over 30% in FY 11, supposedly to capitalize on the demise of Circuit City. In its latest 10-K, HGG noted that its new stores required average net capital expenditures of $700K and average initial net-owned inventory investments of $900K. Table 3 shows store and square footage data for HGG in recent years.

Table 3: HGG store and square footage growth

	FY 05	FY 06	FY 07	FY 08	FY 09	FY 10
Stores, beginning of period	54	58	67	77	91	110
Stores, end of period	58	67	77	91	110	131
Total square footage (000), BOP	1,862	2,009	2,333	2,651	3,127	3,698
Total square footage (000), EOP	2,009	2,333	2,651	3,127	3,698	4,403
Y/Y square footage growth	11%	12%	15%	16%	18%	19%
Average store square footage (000)	32	30	30	29	28	28

Source: Company reports

Because it sells appliances, HGG's results are less seasonal than those of peers. For instance, in the last couple of fiscal years, calendar Q4 has accounted for about 30% of sales versus 33% for Best Buy. HGG's primary competitors include Best Buy, Sears, Lowe's, Home Depot and Wal-Mart. HGG also competes with regional retailers such as Fry's (in IN and GA) and BrandsMart (in GA and FL), and with independent specialty retail stores. HGG has about 5,000 employees, of whom 90% are full-time.

Discussion:

1. Despite their recent pullback, HGG shares are up 8% YTD versus losses of 6% and 13%, respectively, for the S&P 500 index and for BBY. Two thirds of the 20 "street" analysts that follow the company have "buy" ratings on the shares. After three years of flat EPS (excluding a non-recurring charge in FY 08), bulls think that Y/Y EPS should grow 37% and 23%, respectively, in FY 11 and FY 12, largely because of square footage increases. Bulls also assume that the ASP pressure in TVs will abate as a result of customer shift to LED and 3D TVs. Finally, bulls argue that the company's new store productivity (new store sales/comp store sales) has been above 100% in recent quarters, which bodes well for the new stores the company has opened or will open in FY 11. Our research suggests that these bullish assumptions are likely too optimistic. We think that the company is likely to miss earnings estimates in the latter half of FY 11, which should drive shares lower.

2. New store productivity for HGG's recent openings has been impressive only because comp store sales have been anemic. Table 4 shows our estimates of comp store and new store sales for recent quarters. Note that HGG classifies a store as a comp store once it has completed fourteen full months of operation.

To calculate the average revenue per new store in a given period, we first compute the comp store revenues in that period, and subtract this figure from the total revenues for the period. For instance, HGG's revenues in FQ4 10 were $417.3M. The comp base consists of stores that were operating in FQ3 09. There were 103 stores open in the beginning of FQ3 09 and 108 stores at the end of FQ3 09, for an average of 106 stores in the comp base. In FQ4 09, revenues were $364.9M and an average of 109 stores were open in that quarter (108 at the beginning of the quarter and 110 at the end). Sales per store in FQ4 09 were $3,347K. Applying FQ4 10 comp of -4.8% to the FQ4 09 sales per store figure and multiplying the result by the FQ4 10 comp base of 106 stores yields comp store revenues of $336.2M in FQ4 10, and $3.187K/comp store.

Therefore, we estimate that new store revenues in FQ4 10 were $417.3M - $336.2M, or $81.1M. We calculate the revenue per new store per dividing this new store revenue result by the number of new stores (i.e., stores not in the comp base), which is 23 (129-106). This gives us the average revenue per new store figure of $3.451K in FQ4 10. Thus, new store productivity was $3.451K/$3.187K, or 108%.

Table 4: Comp store and new store sales analysis for HGG: FQ1 09 – FQ4 10

	FQ1 09	FQ2 09	FQ3 09	FQ4 09	FQ1 10	FQ2 10	FQ3 10	FQ4 10
Comp growth	-2.6%	-8.8%	-13.2%	-6.5%	-14.7%	-9.4%	-0.2%	-4.8%
Average comp stores in period	76	78	80	83	88	94	100	106
Comp store revenues ($000)	239,617	257,608	326,558	284,176	235,905	272,782	393,624	336,189
Average revenue per comp store ($000)	3,174	3,303	4,108	3,445	2,681	2,902	3,936	3,187
New store revenues ($000)	55,798	62,694	89,548	80,679	48,485	59,396	106,768	81,104
Average stores open in period	94	100	106	109	111	115	123	129
Average revenue per new store ($000)	3,016	2,850	3,444	3,044	2,155	2,897	4,745	3,451
Y/Y change	n/a	-14%	-28%	-5%	-29%	2%	38%	13%
New store productivity	95%	86%	84%	88%	80%	100%	121%	108%

Source: Company filings, OWS estimates

It is worth noting an approximation we have made. We use the sales per store figure from FQ4 09 to calculate comp sales in FQ4 10. The FQ4 09 sales per store figures include sales from new stores opened in FQ4 09, in addition to the comp base. Thus, our average sales per comp store figure in FQ4 09, which forms the basis of our FQ4 10 comp sales derivation, is likely overstated. However, given that just 3-6 stores per quarter were opened in recent quarters, the error induced by of a couple of stores in the sales per comp store calculation is probably small.

Table 5a shows the same information as Table 4, but for recent fiscal years. The new store revenue information in Table 5a is slightly less accurate than the information in Table 4 because the comp store age is closer to twelve months than the 14-month actual age that can be better approximated with quarterly figures. Note, however, that comp store sales, which are reported by the company, have been sluggish or negative for the past several years just as we saw in Table 4.

Table 5a: Comp store and new store sales analysis for HGG: recent fiscal years

	FY 05	FY 06	FY 07	FY 08	FY 09	FY 10
Comp growth	0.4%	1.7%	5.5%	4.8%	-8.3%	-6.6%
Comp stores in period	51	56	63	72	84	101
Comp store revenues ($000)	756,169	816,853	949,947	1,110,281	1,152,363	1,304,497
Average revenue per comp store ($000)	14,827	14,587	15,199	15,421	13,719	12,980
New store revenues ($000)	47,030	83,571	109,481	146,385	244,315	229,756
Average revenue per new store ($000)	9,406	12,857	11,524	12,199	14,807	11,488
Y/Y change	n/a	37%	-10%	6%	21%	-22%
New store productivity	63%	88%	76%	79%	108%	89%

Source: Company filings, OWS estimates

We estimate that there were 97 comp stores in FY 10. Table 5b shows our estimate of the breakdown of this comp base by age. From this table, we see that 42% of the comp base is less than 5 years old and 13% is less than two years old. One would expect newer stores in the comp base to be ramping sales and sales at older stores to be slowing down. Thus, even in a tough year such as FY 10, one might have expected the stores less than two years old in the comp base to comp at 5%, the stores between two and five years old to be flat, and the stores older than five years to comp at -5%. With these assumptions, the overall comp would be 13%*(5%)+29%*(0%)+58%*(-5%), or -2%. The actual comp was much lower, at -6.6%.

HGG management portrays itself as running a growth company. It does grow the store base, but existing stores appear to stop growing, and even go negative. Given HGG's low or negative historical comps, the only available path to pursue growth is to open new stores. Therefore, our opinion is that the bulls' focus on new store openings and new store productivity just diverts attention from the company's core problem, which is that store sales in new stores appear to stagnate quickly.

Table 5b: HGG's FY 10 comp base by age

Comp base age	Number of stores	Percent of comp base by age
< 2 years old	13	13%
2-5 years old	28	29%
> 5 years old	56	58%

Source: Company reports, OWS estimates

3. Our store checks do not support bulls' view that HGG is superior to its competitors because it offers more service and carries superior products.

HGG claims that it differentiates itself by the superior nature of the customer service offered by its commissioned sales employees, and by its wide selection of TVs and appliances. The company has stated that its sales force is able to persuade fully informed customers to purchase higher-end, feature-rich products because customers are able to gain an appreciation of the performance of those products.

Our store visits appear to belie these claims. First, without exception, we found that HGG stores were located in B-/C+ class strip centers next to stores like Big Lots, Family Dollar and Super K-Mart. By contrast, most BBY stores are located in B+/A class malls or shopping centers. There were 5X to 10X as many customers at the nearby BBY as there were at the HGG stores when we visited. The customers or potential customers we encountered on our store visits did not seem to us to be candidates for up selling, but, rather, went to HHG as a destination mainly knowing what they want.

A second factor that stood out during our store visits was the emphasis on price. HGG has a Suggested Retail Price tagged on each product, and an Everyday Low Price, as well as a published monthly zero interest payment amount. The salespeople work down from the Every Day Low price, and it appears that the Suggested Retail Price is posted to make the customer feel as if he/she is getting a deal right from the get-go. HGG offers a 110% price protection guarantee versus competitor store prices, which means that if a customer finds a lower price for the same item at a Best Buy, Home Depot or Wal-Mart store within 30 days of a purchase, the customer gets the lower price and an additional 10% of the difference in prices between the HGG price and the lower store price of the competitor. In other words, if the HGG price for a TV set is $2,199 and BBY is selling the same set for $2,099, HGG will sell the set to the customer for $2,099, less 10% of the $100 difference, or for $2,089. Additionally, there is a 30-day price protection guarantee for price reductions that HGG itself might make.

In addition to pricing aggressively on each item, the company's strategy, conveyed through its salespeople, appears to be "the more you buy, the more we will discount your total invoice." Such a philosophy incentivizes the customer to buy other items he or she really didn't initially intend to buy when entering the store. Perhaps this is why there are a few odd high margin categories of products (mattresses, vacuum cleaners, and luggage) within this mostly Audio Visual/Appliance store. Thus, HGG may be an attractive option when one is shopping for TVs, appliances and mattresses, for instance, after moving into a home.

On the other hand, what HGG salespeople call the "we will do what it takes to earn your business" strategy of selling more units at increasing discounts does not appear to be conducive to maintaining gross margins. At every store, when we showed any inclination of being price sensitive, our salesperson led us to his/her desk, where we were shown an instant price comparison of all other stores locally selling the selected product(s)/model(s). We find the emphasis on beating competitors on pricing to be inconsistent with a commissioned sales force supposedly focused on an up selling model. We also noted during our store visits that most customers did not linger in the store. They came in, picked up or selected what they wanted and left. Salespeople have a better chance to up sell if customers linger in the store. We did not see even one instance of a successful up sell in our visits to twenty stores.

4. Our store checks did not suggest any lessening of TV pricing pressure as a result of increased LED TV penetration. Rather, we found that despite noticeably superior quality in some instances, these TVs are marked down significantly right out of the box. For example, the 60" Sharp AQUOS LED TV, which has been out for only a month, had been marked down at HGG's Clearwater (FL) store to $2,699 from its MSRP of $3,499. LED TVs of this size, which were noticeably inferior in quality relative to the new Sharp AQUOS that we saw, were selling last Christmas at $2,800 to $4,800 post Black Friday markdowns. From such observations, it is difficult to see TV ASP pressure stabilizing in FY 11 as HGG bulls like to think. Rather, we think that the out-of-the-box price slashing on more expensive LED TVs is an ominous sign for prices.

5. Given its strategy to sell as many items to its customers as possible, we think that HGG's sales benefited from home sales as a result of people taking advantage of the housing tax credit in the past 15 months. This credit has now expired and recent home sales data point to a slowdown. Consequently, we think HGG comps and sales should be adversely affected. Our store checks support this notion.

More than half of the salespeople and nearly two-thirds of HGG store managers with whom we spoke in Tennessee and Florida told us that while FQ1 11 sales were higher compared to a year ago, sales were down noticeably Q/Q in their stores. The other half of the salespeople with whom we spoke thought that sales in FQ1 10 were flat Y/Y.

In particular, sales of full kitchen suites (refrigerator, stove, dishwasher) appear to have slowed down. Salespeople at more than half of the stores in Tampa, Clearwater, Sarasota and Orlando told us that sales of full kitchen suites had declined from two a month in April to one a month in May and June. We also note that the stimulus-funded appliance rebate programs in many states expired in the June quarter. We suspect that appliance comps, which had been positive in the last two fiscal quarters, are likely to weaken after FQ1 10.

6. In FY 11, HGG is expanding by opening 40-45 new stores in Virginia (southern suburbs of DC), Maryland (Baltimore), Pennsylvania (Philadelphia) and Delaware. In FY 10, HGG opened stores in Tampa, Richmond (VA), and Memphis. We visited seven recently opened stores in Newark, (DE), Tampa and Memphis. More than three quarters of these stores had Best Buy, Home Depot and Lowe's stores in the vicinity. As noted earlier, HGG stores are located in locations inferior to the locations of these competitors. We think that the competitive environment, along with a slowdown in the housing market, will pressure comps and gross margins.

7. Recent results.

On May 27, HGG reported FQ4 10 results. Revenue of $417M was better than "street" expectations of $408M, but reported EPS of 25 cents missed consensus by a couple of pennies. The "street" focused on the company's FY 11 EPS guidance of $1.35 to $1.45 versus consensus before the call of $1.32 and EPS of $1.03 in FY 10, and concluded that management projections of new store productivity would enable achievement of guidance. Comp guidance of flat to 2% for FY 11 was below some bullish estimates of 2.3%.

Days of inventory were up 12 days Y/Y at the end of FQ4 10. Bulls ascribe the increase in inventory to the company's opening of 26 new stores in FQ1 10. Table 6 shows the inventory data by category for recent quarters. The company's book (and tangible book) value was $6.34 per share at the end of FQ4 10.

Table 6: HGG inventory data and distribution by category

(Amounts in $000)	FQ4 08	FQ4 09	FQ1 10	FQ2 10	FQ3 10	FQ4 10
Appliance inventory	45,518	48,037	48,261	46,709	53,338	55,244
Video inventory	59,898	58,111	75,233	85,196	116,400	93,520
Other inventory	27,952	35,462	36,962	41,033	47,638	52,739
Total inventory	133,368	141,610	160,456	172,938	217,376	201,503
Appliance inventory per store	517	441	437	408	435	428
Video inventory per store	681	533	681	744	950	725
Other inventory per store	318	325	334	358	389	409
Total inventory per store	1,516	1,299	1,452	1,510	1,774	1,562
Appliance % of total inventory	34%	34%	30%	27%	25%	27%
Video % of total inventory	45%	41%	47%	49%	54%	46%
Other % of total inventory	21%	25%	23%	24%	22%	26%

Source: Company reports

Table 7 shows HGG's cash flow generation in the past few years. We define sustainable cash flow (SCF) as net income plus D&A plus one-time charges – net capex. Note that SCF per share has generally underperformed reported EPS. Also note that D&A expenses have been well below capex in recent years. We could not find any comments in the company's filings that explain this discrepancy. If D&A expenses had increased in proportion to the capex increases in recent years, as one would have expected, we estimate that EPS would have been 15%-20% lower in each of the past three years.

Table 7: HGG cash flow information and comparison with net income

(Amounts in $000,except per share amounts)	FY 05	FY 06	FY 07	FY 08	FY 09	FY 10
Net income	29,248	22,125	21,358	21,406	36,497	39,198
D&A	8,635	10,459	11,663	12,605	15,984	17,160
Loss on early extinguishment of debt	-	(39)	1,403	21,930	-	146
Other items	448	(33,069)	16,234	11,698	(11,031)	51,376
Cash flow from operations	38,331	(524)	50,658	67,639	41,450	107,880
Capex	(15,212)	(19,046)	(19,492)	(42,175)	(33,715)	(62,161)
Proceeds from sale leasebacks	-	-	6,433	4,402	14,413	4,694
Free cash flow	23,119	(19,570)	37,599	29,866	22,148	50,413
Sustainable cash flow	22,671	13,499	21,365	18,168	33,179	(963)
FCF per share	0.40	(0.69)	1.28	0.94	0.67	1.33
SCF per share	0.39	0.48	0.73	0.57	1.00	(0.03)
Reported EPS	0.51	0.78	0.73	0.67	1.10	1.03

Source: Company reports

Some bulls were excited about HGG's FCF generation in FY 10. We note that the primary reason for the seemingly robust FCF in FY 10 was a $71M increase in payables. As reflected by the SCF figure in Table 7, the company's free cash flow, excluding working capital items, in FY 10 was about breakeven.

8. Financial assumptions.

a. Revenues.

Tables 8a and 8b show comps by category in recent quarters and recent fiscal years, respectively. The recent negative comps in the video category have been due to declining ASPs. Units have actually grown through the downturn. The negative comps in the appliance category in the last couple of years have been due to the downturn in housing. With the expiration of the appliance rebates and the housing tax credit, we anticipate that the appliance growth experienced in the last two fiscal quarters will slow. We also anticipate continued pricing pressure in TVs, as discussed earlier. We also assume that pricing pressure in computers with offset unit growth. As a result, we assume flat comps Y/Y in both FY 10 and FY 11. Management guidance for comp growth in FY 11 is flat to +2%. Bulls assume comp growth of 2% each in FY 11 and FY 12.

Table 8a: Recent HGG quarterly comps by category

	FQ1 09	FQ2 09	FQ3 09	FQ4 09	FQ1 10	FQ2 10	FQ3 10	FQ4 10
Video	5.5%	-0.6%	-6.9%	1.5%	-17.0%	-15.9%	-7.5%	-12.0%
Appliances	-9.7%	-15.2%	-21.9%	-19.7%	-17.5%	-7.5%	7.5%	3.7%
Other	-0.5%	-11.9%	-14.6%	0.6%	1.4%	5.9%	9.6%	4.3%
Total	-2.6%	-8.8%	-13.2%	-6.5%	-14.7%	-9.4%	-0.2%	-4.8%

Source: Company reports

Table 8b: Historical HGG annual comps by category

	FY 06	FY 07	FY 08	FY 09	FY 10
Video	-0.1%	9.3%	4.7%	-1.1%	-12.3%
Appliances	3.9%	3.5%	1.6%	-16.5%	-3.9%
Other	1.0%	-0.6%	15.9%	-8.0%	5.9%
Total	1.7%	5.5%	4.8%	-8.3%	-6.6%

Source: Company reports

We assume that new store productivity will approximate 110% in both FY 11 and FY 12, primarily because of weak comp growth. We assume that the company will open 45 new stores in FY 11 (at the upper end of company guidance of 40-45 new stores) and 25 new stores in FY 12. Management indicated to a "street" analyst recently that it plans to grow at a 15%-20% rate beyond FY 11.

b. Gross margin.

According to the "street," appliances, TVs and computers carry gross margins of 40%, 20% and 15%, respectively. Because we expect continued pricing pressure in TVs and computers and weak appliance sales, we anticipate that gross margins will decline from the FY 10 level of 30.4% to 30.1% in FY 11 and 29.7% in FY 12. Bulls assume flat or rising Y/Y gross margins in FY 11 and FY 12.

c. Other operating expenses.

We estimate that SG&A expenses as a percentage of sales will increase slightly Y/Y to 21.2% in FY 11 (versus 21.1% in FY 10) due to the substantial increase in store count in FY 11. In FY 12, we assume that SG&A expenses will decline slightly to 21.0% of sales as the company expands at a more normal rate. We expect net advertising expenses and D&A expenses as a percentage of sales to be flat Y/Y in both FY 11 and FY 12. Some on the "street" expect D&A expense as a percentage of sales to decline slightly in FY 11 and FY 12. As we noted earlier, we are puzzled that HGG's D&A expense increase has not kept up with increases in capex in the past three years. Thus, it appears to us that some "street" analysts might be underestimating HGG's D&A expenses.

d. Other items.

We assume net interest expense of $4M in both FY 11 and FY 12, in line with "street" expectations. Our tax rate assumption of 39% in both FY 11 and FY 12 is at the lower end of management guidance of 39.0% to 39.5%. Our assumed share count is 40.3M in FY 11 and 41M in FY 12.

9. Valuation & risks.

Our revenue and EPS expectations, based on the foregoing assumptions, are shown in Table 9, along with "street" expectations. The primary reasons for the differences are our lower comp growth and gross margin assumptions. The revenue difference between our estimate and the "street" is not as great in FY 11 because of the substantial increase in new stores.

Table 9: Comparison of OWS and "street" estimates

	OWS estimates	"Street" estimates
FY 11 Revenues ($000)	2,149	2,183
FY 11 EPS ($)	1.19	1.40
FY 12 Revenues ($000)	2,502	2,733
FY 12 EPS ($)	1.32	1.74

Source: OWS estimates, "Street" reports

To obtain a price target for the shares, we look at comparables Best Buy and Lowe's. BBY and LOW trade at 8.9X and 11.6X FY 12 consensus estimates. Their

FY 12 EPS is expected to grow 11% and 20%, respectively. Since we expect EPS for HGG to grow 11% Y/Y in FY 12, we apply a 12X multiple, which represents a premium to LOW's forward multiple, to our FY 12 EPS estimate of $1.32. This yields a price target of $16. Note that at our target price, HGG's price to sales ratio (using our FY 12 revenue estimate in the denominator) would be 0.26. This is also the current P/S ratio for BBY, using the estimated FY 12 revenue figure for BBY in the denominator.

The risks associated with our recommendation are a rebound in housing, which could lead to appliance sales level greater than our expectations, and strong demand for LED TVs, which could increase sales without pressuring ASPs. Our extensive store checks suggest that the probability of these risks occurring is low.

10. Insider selling.

Insiders have been actively selling since the company reported FQ4 10 results. The current CEO and former CEO (who serves as Executive Chairman of the Board) sold about a quarter each of their stakes. The COO, who is the son of the Executive Chairman, sold 14% of his stake.

11. Financial projections.

a. Quarterly projections.

	FQ1 10	FQ2 10	FQ3 10	FQ4 10	FQ1 11e	FQ2 11e	FQ3 11e	FQ4 11e
Net sales	284,390	332,178	500,392	417,293	394,441	487,512	702,432	564,372
COGS	199,715	229,858	347,888	289,851	276,109	339,796	491,702	395,060
Gross profit	84,675	102,320	152,504	127,442	118,332	147,716	210,730	169,312
SG&A expense	65,140	75,471	92,715	89,856	91,905	112,128	133,462	118,518
Net ad expense	11,803	13,485	17,189	15,331	16,567	20,476	24,585	21,446
D&A expense	3,968	4,011	4,345	4,836	4,733	5,850	7,024	6,772
Operating income	3,764	9,353	38,255	17,419	5,128	9,263	45,658	22,575
Interest expense	1,318	1,337	1,317	1,182	1,100	1,025	975	950
Interest income	(6)	(8)	(4)	(31)	(10)	(10)	(10)	(10)
Loss early debt	-	-	-	146	-	-	-	-
Pretax income	2,452	8,024	36,942	16,122	4,038	8,248	44,693	21,635
Income taxes	983	3,077	14,207	6,075	1,575	3,217	17,430	8,438
Net income	1,469	4,947	22,735	10,047	2,463	5,031	27,263	13,197
Diluted shares	34,062	38,148	39,737	39,947	40,100	40,350	40,500	40,600
Diluted EPS	0.04	0.13	0.57	0.25	0.06	0.12	0.67	0.33

Y/Y change

	FQ1 10	FQ2 10	FQ3 10	FQ4 10	FQ1 11e	FQ2 11e	FQ3 11e	FQ4 11e
Net sales	-4%	4%	20%	14%	39%	47%	40%	35%
COGS	-3%	4%	22%	16%	38%	48%	41%	36%
Gross profit	-6%	4%	17%	10%	40%	44%	38%	33%
SG&A expense	-2%	8%	19%	24%	41%	49%	44%	32%
Net ad expense	-19%	-21%	-4%	21%	40%	52%	43%	40%
D&A expense	2%	-5%	10%	23%	19%	46%	62%	40%
Operating income	-29%	22%	25%	-33%	36%	-1%	19%	30%
Interest expense	-27%	-33%	-32%	-14%	-17%	-23%	-26%	-20%
Interest income	50%	167%	100%	417%	67%	25%	150%	-68%
Loss early debt	n/a	n/a	n/a	n/a	n/a	n/a	n/a	-100%
Pretax income	-30%	41%	29%	-35%	65%	3%	21%	34%
Income taxes	-31%	34%	23%	-44%	60%	5%	23%	39%
Net income	-30%	46%	33%	-28%	68%	2%	20%	31%
Diluted shares	2%	15%	22%	20%	18%	6%	2%	2%
Diluted EPS	-32%	26%	9%	-40%	42%	-4%	18%	29%

As % of sales

	FQ1 10	FQ2 10	FQ3 10	FQ4 10	FQ1 11e	FQ2 11e	FQ3 11e	FQ4 11e
Net sales	100%	100%	100%	100%	100%	100%	100%	100%
COGS	70%	69%	70%	69%	70%	70%	70%	70%
Gross profit	30%	31%	30%	31%	30%	30%	30%	30%
SG&A expense	23%	23%	19%	22%	23%	23%	19%	21%
Net ad expense	4%	4%	3%	4%	4%	4%	4%	4%
D&A expense	1%	1%	1%	1%	1%	1%	1%	1%
Operating income	1%	3%	8%	4%	1%	2%	7%	4%
Interest expense	0%	0%	0%	0%	0%	0%	0%	0%
Interest income	0%	0%	0%	0%	0%	0%	0%	0%
Loss early debt	0%	0%	0%	0%	0%	0%	0%	0%
Pretax income	1%	2%	7%	4%	1%	2%	6%	4%
Income taxes	0%	1%	3%	1%	0%	1%	2%	1%
Net income	1%	1%	5%	2%	1%	1%	4%	2%

b. Annual projections

	FY 07	FY 08	FY 09	FY 10	FY 11e	FY 12e
Net sales	1,059,428	1,256,666	1,396,678	1,534,253	2,148,757	2,502,061
COGS	730,696	867,733	961,570	1,067,312	1,502,667	1,758,949
Gross profit	328,732	388,933	435,108	466,941	646,090	743,112
SG&A expense	217,257	254,486	286,655	323,182	456,013	525,433
Net ad expense	43,996	53,525	62,224	57,808	83,073	97,580
D&A expense	11,663	12,605	15,984	17,160	24,380	27,523
Asset impairment charge	1,997	-	602	-	-	-
Operating income	53,819	68,317	69,643	68,791	82,623	92,576
Interest expense	17,464	10,706	7,103	5,154	4,050	4,000
Interest income	(243)	(88)	(15)	(49)	(40)	(50)
Loss from early ext. of debt	1,403	21,930	-	146	-	-
Income before taxes	35,195	35,769	62,555	63,540	78,613	88,626
Income taxes	13,837	14,363	26,058	24,342	30,659	34,564
Net income	21,358	21,406	36,497	39,198	47,954	54,062
Diluted shares	29,400	31,891	33,054	37,974	40,388	41,000
Diluted EPS	0.73	0.67	1.10	1.03	1.19	1.32

Y/Y change

	FY 07	FY 08	FY 09	FY 10	FY 11e	FY 12e
Net sales	18%	19%	11%	10%	40%	16%
COGS	19%	19%	11%	11%	41%	17%
Gross profit	16%	18%	12%	7%	38%	15%
SG&A expense	9%	17%	13%	13%	41%	15%
Net ad expense	6%	22%	16%	-7%	44%	17%
D&A expense	12%	8%	27%	7%	42%	13%
Asset impairment charge	-107%	-100%	n/a	-100%	n/a	n/a
Operating income	-10%	27%	2%	-1%	20%	12%
Interest expense	-8%	-39%	-34%	-27%	-21%	-1%
Interest income	5%	-64%	-83%	227%	-18%	25%
Loss from early ext. of debt	-3697%	1463%	-100%	n/a	-100%	n/a
Income before taxes	-14%	2%	75%	2%	24%	13%
Income taxes	-26%	4%	81%	-7%	26%	13%
Net income	-4%	0%	70%	7%	22%	13%
Diluted shares	4%	8%	4%	15%	6%	2%
Diluted EPS	-7%	-8%	64%	-7%	15%	11%

As % of sales

	FY 07	FY 08	FY 09	FY 10	FY 11e	FY 12e
Net sales	100%	100%	100%	100%	100%	100%
COGS	69%	69%	69%	70%	70%	70%
Gross profit	31%	31%	31%	30%	30%	30%
SG&A expense	21%	20%	21%	21%	21%	21%
Net ad expense	4%	4%	4%	4%	4%	4%
D&A expense	1%	1%	1%	1%	1%	1%
Asset impairment charge	0%	0%	0%	0%	0%	0%
Operating income	5%	5%	5%	4%	4%	4%
Interest expense	2%	1%	1%	0%	0%	0%
Interest income	0%	0%	0%	0%	0%	0%
Loss from early ext. of debt	0%	2%	0%	0%	0%	0%
Income before taxes	3%	3%	4%	4%	4%	4%
Income taxes	1%	1%	2%	2%	1%	1%
Net income	2%	2%	3%	3%	2%	2%

c. Financial metrics

(Amounts in $000, except per share amounts)	
Current debt	88,341
Current equity	253,408
Current tangible book value	$6.34
Current market value	902,800
Current cash	157,837
Current DSO	2
Current DIO	63

	FY 10	FY11e	FY 12e
EBIT (excluding nonrecurring items)	68,791	82,623	92,576
EBITDA	85,951	107,004	120,099
Free cash flow	50,413	27,334	51,585
Surplus cash flow (net income+D&A-capex)	(963)	27,334	51,585
Capex	57,467	45,000	30,000
EV/EBITDA	9.7	7.8	6.9
EV/(EBITDA-capex)	29.3	13.4	9.2