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Best Buy Corporation

BBY - BUY

May 16, 2013

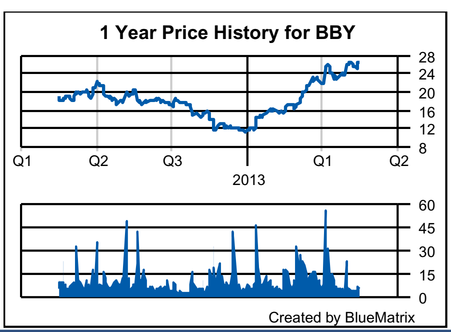
Retail - Hard-line

Best Buy Corporation (BBY) - BUY

Price:	**$26.40**
Fair Value Estimate:	$36.00
52-Week Range:	$11.20-$27.15
Market Cap (MM):	$8,926
Shr.O/S-Diluted (mm):	338.1
Average Daily Volume:	11,877,927
Dividend:	$0.68
Yield:	2.6%
Book Value:	$12.24

FYE: Feb	2012A	2013E	2014E
EPS:	$3.59A	$2.59A	$2.30E
Prior EPS:			NC

Quarterly EPS:			
Q1	$0.64A	$0.72A	$0.21E
Q2	$0.39A	$0.20A	$0.03E
Q3	$0.46A	$0.03A	$0.14E
Q4	$2.20A	$1.64A	$1.92E



Equity Research **Note**

Solidly Over $4.00 in EPS By 2015; Can Drive BBY Shares Much Higher

INVESTMENT CONCLUSION:

The Path to $4.25+ in Earnings Is Pretty Achievable - BBY stock is up 125% YTD. We attribute this move to four key factors: 1) it's not going out of business, 2) a new management team that has excited investors, 3) a massive opportunity for SG&A cuts, and 4) favorable market conditions. For continued outperformance, BBY will need to print significant earnings growth over the next several years. Additionally, we believe there is still an opportunity for multiple expansion, but only as the street gets more comfortable with earnings growth. We estimate a $36 fair value, and believe that this could prove conservative in a likely to positive EPS growth scenario.

In this note, we outline a road to $4.25+ in EPS by 2015. Embedded in our model is an assumption of modest 1% annual sales growth, about 40bps improvement in gross margin over three years, SG&A that is down about $320 million, slightly lower interest expense due to repayment/ favorable refinancing of $500 million of debt (7.25% coupon), and share repurchases of about 5 to 6% of total shares outstanding. Revisiting the drivers of each line item and evaluating the benefits, we have increased confidence in the company's path to $4.25+. In our calculation, we have attempted to normalize the 53rd week in 2012 which impacted EPS by $0.12. Additionally, we have excluded Europe, assumed China breaks even, and that the operating results are almost all Canada with immaterial benefits in Mexico.

KEY POINTS:

Modest Sales Recovery, The Result of Company-Specific Initiatives: Our assumption of 1% annual sales growth could prove conservative given multiple initiatives at BBY. However, this clearly remains the biggest variable, and the one most feared by the Street. We are not considering benefits from product cycles that could provide a tailwind to this estimate, of course that also could drive the downside as well, but rather internal initiatives such as remerchandising, higher close rates/price match guarantee and fixing the Rewards Zone buyer program.

- **Store Remerchandising/Sq.ft. Reallocation:** 1) CD/DVD sq.ft. allocation is getting cut in half from 12-13% to about 6-7%. This open space will be re-allocated to: A) Store within store concepts, beginning with the recently announced Samsung store. We anticipate other vendors including GOOG, MSFT, SNE and LG to name a few, to possibly announce new merchandising relationships with BBY. These companies are all looking to grow the number of consumers within their ecosystems. BBY with leading market share offers that opportunity. It is also why we believe that AAPL could begin another Capex cycle inside the store; B) Expansion of mobile sq.ft. to allow for more accessories and better presentation. This is long overdue considering the productivity of BBY mobile; C) Expansion of both small and large appliances. Small appliances approximate a $250 million dollar business at BBY, but we think it could easily be $500+ million as the company expands the assortment of categories that include juicers, coffee machines and kitchen appliances. Large appliances (about 9% to 10% sq.ft.) are likely to get more space as the company rolls out Pacific Sales in more stores, add more high end brands, and optimize the counter-seasonal nature of the business. This category is about 1.25x average gross margin and should disproportionately benefit the P&L.

Research Analyst Certifications and Important Disclosures are on pages 4 - 5 of this report

D) We look for more audio/headphones displays as this category is hot and highly profitable; and E) Increased accessories and attachment across all categories. Over time, we see car audio (4 to 5% of the sq. ft.) going away, and being re-allocated to newer categories including furniture, sports equipments or other products. BBY's remerchandising is likely to some degree be driven by vendors adding greater exposure inside BBY.

- **Close Rates:** Price match guarantee, along with increased service levels through training, and better in-stock levels should help drive higher close rates. These initiatives will be partly financed by SG&A cuts. Online close rates at bestbuy.com are about 1.3% on about 1 billion hits. In-store, the close rate is about 40% on about 600 million visits. It would take very little to drive meaningful benefits to revenue. Key issues impacting close rates are price, service and inventory - A) On pricing, it is easy to argue that BBY has been hurt by lower online prices, but now with price match guarantee, along with vendors getting much more aggressive with MAP, UPP and hard MAP, along with higher hopes for internet sales tax fairness, pricing will be much less of an issue in the near future. The impact on gross margin by price match will be less than the market anticipates as the key category for price match is large screen TVs, where today the majority of price match has occurred, is also a category where vendors are forcing price parity via more aggressive minimum prices. B) Online (about $2.3 billion), BBY continues to add SKUs, be price competitive, and improve website navigation and functionalities including site to store pick up. We acknowledge that few retailers have yet to figure out online dominance, and BBY is no exception. A low teens growth rate for this segment should add about $300 million+ or about 0.5-1% comp, and C) within Store, effectively training associates along with improving customer service levels, and incentivizing profitable sales through team based incentive programs should help.
- **Leveraging The Reward Zone:** Not talked about a lot in the BBY restructuring story is their loyalty program that has over 75 million members with about 40 million active members. This program has been run poorly, to date, but driving sales from this data base remains a real opportunity. New CFO Sharon McCollam was very influential in leveraging database information while at WSM.

We assume about 40bps of gross margin expansion by 2015: This still remains well below their 25% margin in 2005 and 2010. Improvement in gross margin should be driven by initiatives that include 1) leveraging vendor relationships – with 15+% total market share in the CE industry, there is more leverage than the company has exercised in recent years. We look for new rounds of product line reviews and negotiations. As BBY embraces showrooming, vendors are likely to work much closer with the company, as vendors need the merchandising showroom more than ever. This should prove a profitable partnership for both vendors and BBY, and one that will restore profitability in the industry, 2) Product return optimization – Currently, returns are 10% of sales. Effectively managing returns has been a key success story for CFO Sharon McCollam at WSM, and she has a playbook to lower costs. 3) Private label penetration is currently 5% of sales, and growth will come predominantly around entry level price points including attachments and accessories. These items carry gross margins about 1000 bps above the company average, meaning every 1% increase in penetration could drive 10 bps of gross margin, 4) improve supply chain/fixed costs leverage, which has not been touched in years. This could include consolidating orders per parcel, refining order management to fill orders from optimal locations, transportation efficiencies and product flow movement, and 5) benefits from re-merchandising/sq.ft. re-allocation to several higher margin/highly productive categories.

SG&A Reductions To Help Earnings And Finance Sales/Margin Initiatives: BBY has talked about $400 million of SG&A reductions, but we think the real number is much higher. Corporate G&A is about $4.2 billion, while store labor is $2.4 billion. We believe over time the company can bring corporate G&A inline with store SG&A (that would be optimistically $1.8 billion). We believe store G&A dollars are about right, but could be used more efficiently. This $320 million SG&A reduction would add about $0.60 to EPS. Recently, BBY implemented about $150 million of cuts related to corporate labor, consultants, consolidation of advertising and discretionary expenses. This is a start, and only a start.

International Is Now Essentially Canada: Post the European exit, BBY has Canada, China and Mexico. Canada (70-75% of segment sales) is the biggest part of the international business which has seen sales and profitability decline over the past year. We expect stabilization of sales in Canada, along with implementation of initiatives similar to the US (close rates, supply chain, loyalty etc) to drive operating margin close to 3.5%. We simply assume no EBIT from China, and that the current $140 million of EBIT from Canada will grow to about $200 million in the next 3 years as initiatives similar to the US make their way up to a less efficiently managed Canadian operation.

Projected EPS Model – BBY's Path To $4.25+ In EPS By 2015

	2012*	2013E	2014E	2015E	Change (2012-2015)
Domestic:					
Revenue	36,193	36,565	36,928	37,297	3.0%
Revenue Growth		*1.0%*	*1.0%*	*1.0%*	
Gross profit	8,643	8,614	8,832	9,051	
Gross margin	*23.9%*	*23.6%*	*23.9%*	*24.3%*	0.4%
Gross Margin Change		*-0.31%*	*0.36%*	*0.35%*	
SG&A	7,308	7,383	7,136	7,030	$ (278)
SG&A ratio	*20.2%*	*20.2%*	*19.3%*	*18.9%*	
SG&A Growth		*1.0%*	*-3.3%*	*-1.5%*	
Operating income	1,335	1,231	1,696	2,020	$ 685
Operating margin	*3.7%*	*3.4%*	*4.6%*	*5.4%*	1.7%
International					
Revenue (ex-Europe)	7,250	7,250	7,322	7,396	2.0%
Revenue Growth		*0.0%*	*1.0%*	*1.0%*	
Gross profit	1,733	1,730	1,757	1,790	
Gross margin	*23.9%*	*23.9%*	*24.0%*	*24.2%*	0.3%
Gross Margin Change		*0.0%*	*0.1%*	*0.2%*	
SG&A	1,646	1,656	1,615	1,603	$ (42.4)
SG&A ratio	*22.7%*	*22.8%*	*22.1%*	*21.7%*	
SG&A Growth		*0.6%*	*-2.5%*	*-0.7%*	
Operating income (estimate)	87	74	142	187	$ 99.6
Operating margin	*1.2%*	*1.0%*	*1.9%*	*2.5%*	1.3%
Sub International - Canada					
Revenue (estimate)	5,256	5,282	5,335	5,391	2.6%
Revenue Growth		*0.5%*	*1.0%*	*1.0%*	
Operating income (estimate)	147	145	173	189	
Operating margin	2.8%	2.8%	3.3%	3.5%	0.7%
Sub International - China/Mexico/Others					
Revenue (estimate)	1,994	1,968	1,987	2,006	0.6%
Revenue Growth		*-1.3%*	*1.0%*	*0.9%*	
Operating income (estimate)	(60)	(71)	(31)	(2)	
Operating margin	-3.0%	-3.6%	-1.6%	-0.1%	2.9%
Total EBIT	**1,422**	**1,305**	**1,838**	**2,207**	$ 785
Net interest income (expense)		(90)	(74)	(74)	
Earnings before income taxes		1,215	1,764	2,133	
Income tax		437	635	768	
Tax Rate		*36%*	*36%*	*36%*	
Minority Interest		0	0	0	
Earnings		778	1,129	1,365	
EPS	***2.47***	***2.30***	***3.41***	***4.27***	
Share Count	339	338	331	320	
% Change		*-0.3%*	*-2.2%*	*-3.3%*	-5.8%

Notes:

- *2012 Domestic segment sales and margin numbers are excluding the 53rd week based on Janney's estimate. We have also adjusted 2012 EPS by $0.12 to exclude 53rd week.*
- *2012-2015 International segment sales exclude Europe and are calculated based on Janney's estimate. The company will provide restated financials in Q1 press release, and we will adjust our international segment model accordingly.*

Source: Company reports, and Janney Research

Company Description

Best Buy, Inc is a consumer electronic retailer.

IMPORTANT DISCLOSURES

Research Analyst Certification

I, David Strasser, the Primarily Responsible Analyst for this research report, hereby certify that all of the views expressed in this research report accurately reflect my personal views about any and all of the subject securities or issuers. No part of my compensation was, is, or will be, directly or indirectly, related to the specific recommendations or views I expressed in this research report.

Janney Montgomery Scott LLC ("Janney") Equity Research Disclosure Legend

Janney Montgomery Scott LLC currently acts as a market-maker in the securities of Best Buy Corporation.

Janney Montgomery Scott LLC intends to seek or expects to receive compensation for investment banking services from Best Buy Corporation in the next three months.

The research analyst is compensated based on, in part, Janney Montgomery Scott's profitability, which includes its investment banking revenues.

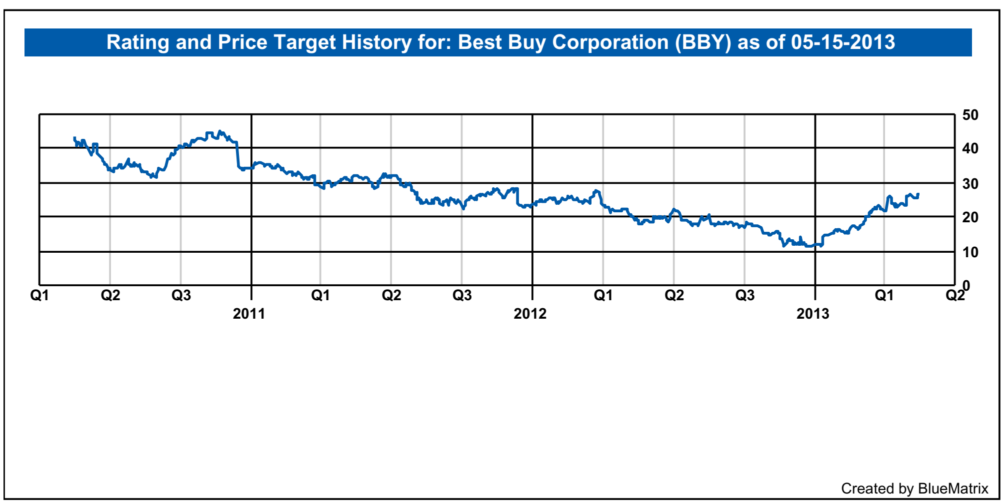
Definition of Ratings

BUY: Janney expects that the subject company will appreciate in value. Additionally, we expect that the subject company will outperform comparable companies within its sector.

NEUTRAL: Janney believes that the subject company is fairly valued and will perform in line with comparable companies within its sector. Investors may add to current positions on short-term weakness and sell on strength as the valuations or fundamentals become more or less attractive.

SELL: Janney expects that the subject company will likely decline in value and will underperform comparable companies within its sector.

Price Charts



Janney Montgomery Scott Ratings Distribution as of 3/31/13

			IB Serv./Past 12 Mos.	
Rating	**Count**	**Percent**	**Count**	**Percent**
BUY [B]	214	52.58	38	17.76
NEUTRAL [N]	189	46.44	20	10.58
SELL [S]	4	0.98	0	0.00

***Percentages of each rating category where Janney has performed Investment Banking services over the past 12 months.**

Other Disclosures

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