

BRICKS AND CLICKS: Profile, Coldwater Creek

You are more likely to know the company for its catalogs than for its retail stores. But **Coldwater Creek** (Dennis Pence, chmn. & CEO), Sandpoint, Idaho, is betting that it can make a successful transition from clicks to bricks.

Bucking a trend in retail, the company plans to open hundreds of women's clothing stores in the next decade. The company will focus on geographic areas where high concentrations of potential customers already know the brand from its selling via catalogs and its web site.

Founded in northern Idaho in 1984 as a catalog retailer by Dennis and Ann Spence, Coldwater Creek specializes in high-quality women's apparel, jewelry, footwear, gift items and accessories. The company added an e-commerce web site in mid-1999.

The company targets upscale women, specifically those between the ages of 30 and 60 with annual household incomes exceeding \$50,000.

Coldwater Creek became profitable within two years of mailing its first catalog, and sales skyrocketed from \$11-million in 1992 to nearly \$100-million in the fiscal year before the company's initial public offering in early 1997.

Why the move to retail stores? A spokesman explains, "When you look at the women's apparel industry, it's roughly an \$85-billion industry where 92% of all purchases are done in the brick-and-mortar arena."

He adds: "Unlike the male, [the typical female customer] really enjoys the shopping experience. She wants to validate the size and quality of a garment, and that's a lot easier to do in a retail setting. This is a real opportunity to grow the company and take it to the next level – while also leveraging the brand awareness we've developed."

Coldwater Creek opened its first full-line retail store in November 1999 – in the former **Nordstrom** flagship store in downtown Seattle – and has since tested and refined the format for national build-out.

A company spokesman notes that Coldwater also "has built management-team bench strength in the last 18 months in order to ramp up store growth."

And on the catalog front, the company faces what a senior officer calls a "shrinking universe for catalog sales in general [and] a decrease in market share for apparel every year since 1999." Coldwater's own catalog sales "are experiencing continuing softness," adds the officer.

Mailings to prospective customers also continue to produce declining response rates. Accordingly, Coldwater has reduced the number of catalogs it mails from a peak of 183-million in 2000 to 119-million in the current fiscal year, and it is combining the two smallest of its three catalogs into one starting this month. Coldwater Creek's catalog segment "is in an evolutionary stage," adds the spokesman. "It's still the largest source of our revenue, but now it's more of a promotional tool. We have 14-million house-file names that tell us where to put the stores. It's a two-pronged approach: The catalogs are a due-diligence tool for where to locate stores and to keep in contact when we locate stores."

Coldwater also has promoted the migration of active customers from catalogs to its more cost-efficient e-commerce web site. The site offers all the full-price merchandise found in the catalogs and retail stores and also helps dispose of excess inventory.

The company now has more than 2-million "opt-in" e-mail addresses to which it regularly sends e-mails to drive sales, while numerous "affiliate" websites – popular Internet search engines and consumer and charitable websites – receive sales commissions for providing

hotlink access to Coldwater's site.

Coldwater now has 66 full-line retail stores, up from 38 in November 2002. It plans to open 40 to 50 new full-line stores in each of the next two fiscal years and says "there is an opportunity to grow to 400 to 500 stores in up to 275 identified markets nationwide."

The company also has two resort stores – in Sandpoint and Jackson Hole – and 15 outlet stores that sell excess inventory.

The refined core retail store model introduced in mid-2002 includes 5,000-6,000 sq. ft. of selling space. Coldwater assumes a 5,500 sq. ft. store requires net total investment of \$561,000, with projected annual sales in the third year of operation of \$2.78-million based on net sales per sq. ft. of \$505. (At Nov. 1, 2003, its 37 full-line stores that had been open at least 13 months – most had been open between one and two years – averaged 7,269 sq. ft. and had net sales per sq. ft. of \$467.)

A smaller store format of 3,000-4,000 sq. ft. first tested in six markets late last year is designed to access smaller markets and to increase the company's presence in larger metropolitan markets. The company assumes a 3,500 sq. ft. store requires net investment of \$399,000, with estimated annual sales of \$2.1-million in the third year of operation based on sales of \$600 per sq. ft. Coldwater's Dennis Pence told Wall Street analysts in a mid-November conference call, "The combination of core and smaller-format stores provides opportunities to explore a large number of options for malls, lifestyle centers and street locations."

Lifestyle centers, described by the Coldwater spokesman as "the town square suburbia never had," cluster upscale retailers in outdoor settings. The company estimates that roughly 60% of its new store openings over the next 12 months will come in upscale malls, about 35% in lifestyle centers, and the remaining 5% in street locations.

The spokesman tells us the new store openings "will be pretty well balanced across the U.S." To this point, the primary growth for retail stores has come in California, the Eastern Seaboard, and the Denver and Chicago areas. About 60% of Coldwater Creek's customers live east of the Mississippi.

The company expects retail stores to generate 50% of total sales by the close of the fiscal year that ends in January 2005 – up from 39.3% in the latest quarter ended Nov. 1. Catalog sales accounted for 32.4% of total sales in the most recent quarter, down from 40.5% in the year-ago quarter; e-commerce represented 28.3% of sales in the quarter, down from 30.6% a year earlier.

Year-over-year comparisons are tricky for Coldwater Creek. It decided in late 2002 to switch its fiscal year end from the Saturday nearest Feb. 28 to the one nearest Jan. 31 to align its financial reporting schedule with most national retail companies, so the fiscal year that ended in January 2003 was an 11-month transition period.

And Coldwater will not provide quarterly same-store sales comparisons until retail stores generate half of total sales and the comp-store base reaches 100.

Coldwater's spokesman declines to characterize 2003 holiday business other than to say that fall and Christmas remain the "strongest selling periods of the year."

Asked if any product areas were especially strong, he responds: "We've always done well with color and novelty and took that approach this year to outerwear, which did extremely well. Dresses also did well. For the last couple of years, [customers] shied away from a little more festive mood, but earlier this year we made the call that the consumer might want to go out and celebrate."

In nine months to Nov. 1, Coldwater earned a little over \$6-million (25 cents a share) on sales of \$350-million. Sales were up about 7% from the year-earlier period, but net income rose 48% from \$4.1-million; the earnings-per-share increase was 47% (25 cents vs. 17 cents).

In November, Coldwater provided guidance to Wall Street for the quarter that ends this month: earnings per share of 19 to 21 cents (vs. 16 cents a share in the year-earlier quarter) on sales of \$170-million to \$180-million (vs. \$174-million in the year-ago quarter). For the coming fiscal year, it expects net sales growth of approximately 10% and earnings per share growth of 20% to 25%.

Some analysts believe Coldwater's shift to a store-oriented growth strategy provides a buying opportunity for risk-tolerant investors.

The stock (symbol CWTR; \$11.55 Jan. 5) exceeded \$18 (adjusted for subsequent splits) in early 1998 and reached \$18 again in the summer of 2000. Shares have doubled from the 52-week low of \$5.70 in March, but are down from the high of \$15.13 in late November.

Recent weakness is likely due to Coldwater's announcement last month that it will sell up to 2.5-million new shares to fund expansion, diluting the 24.2-million now outstanding. Wall Street also might be concerned that holiday sales were on the soft side. The next earnings announcement and conference call are due in early March.

Analyst Lauri Brunner of **RBC Capital Markets**, Minneapolis, rates the stock "outperform, above average risk," with a 12-month price target of \$18. She writes, "Coldwater Creek is a company with nothing to fix in merchandising or at the stores, with a strong infrastructure of systems and management already in place, operating in the great women's 35-and-over specialty apparel segment, with the opportunity to take its store base from 65 stores to 500 in the years ahead."

Brunner's \$18 price target is based on a multiple of 30 times her earnings estimate of 60 cents a share for next fiscal year – "a premium to the company's peer group that reflects our assessment of the rapid-growth nature of store development, and strong margin and earnings growth prospects."

Prospective investors should approach Coldwater Creek with caution if for no other reason than its small size. Market value of shares outstanding currently is under \$300-million. About half of outstanding shares are held by insiders; institutional investors own about 44% of outstanding shares, so individuals could get crushed if sentiment shifts suddenly among institutional holders.

The company also has relatively sparse following on Wall Street; standard sources show only four analysts cover Coldwater Creek. On the plus side, the company has a whistle-clean balance sheet, with no long-term debt. Directors expressed their confidence in the outlook recently by twice splitting the common stock 3-for-2 in 2003; splits were effective Jan. 31 and Sept. 9.