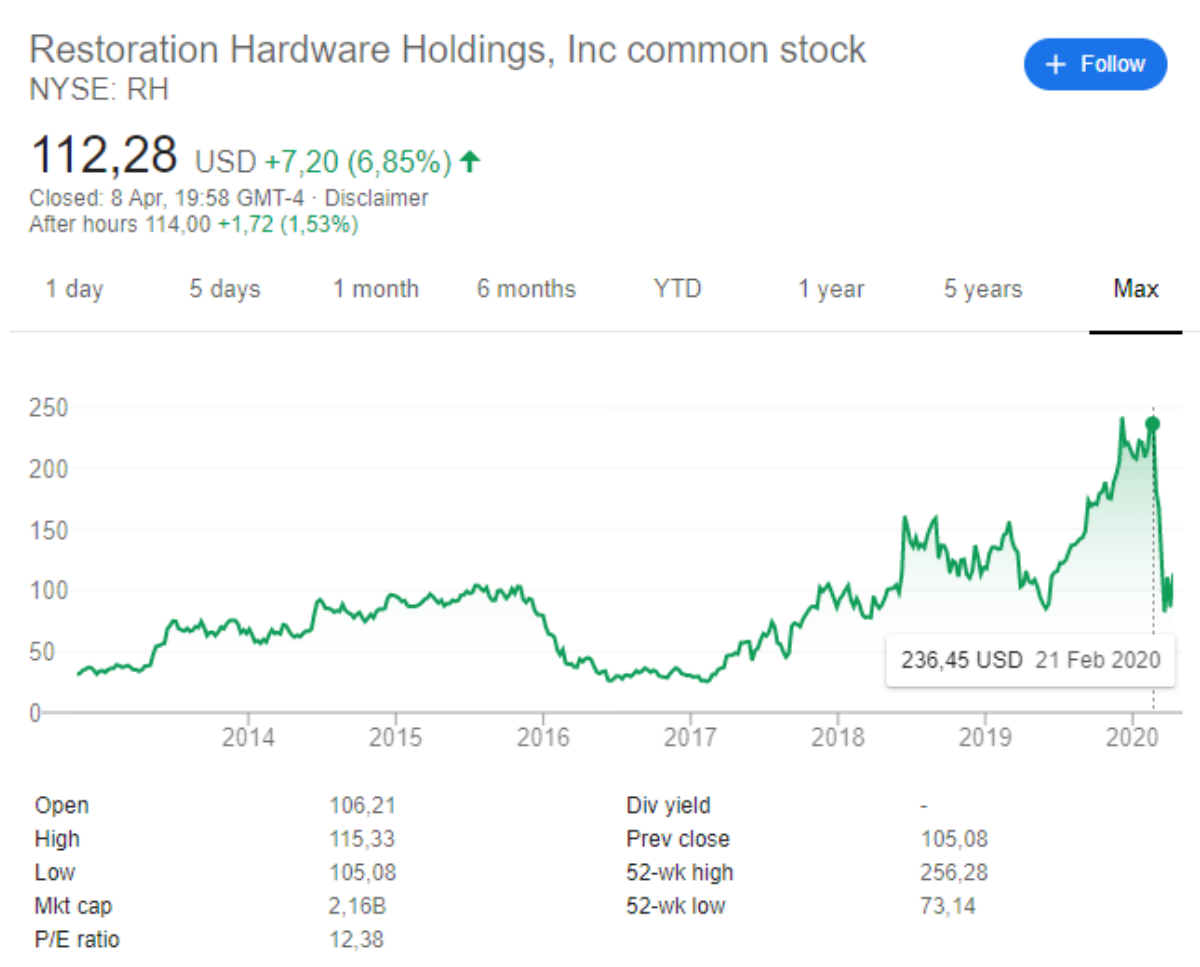


### RH Stock Analysis – Berkshire Owned Upscale Furniture With Luxury Financial Engineering

- Over the past years the business was managed really well. Inventories declined while business expanded.
- Lower inventories, higher traffic and margins increased cash flows. Consequently, those were used to do buybacks. Plus, convertible debt was issued to triple down on buybacks.
- If you invest in RH, you must move fast, as fast as the CEO that recently sold \$115 million worth of shares.
- The financial engineering makes RH more of a trade play based on buybacks rather than a long-term stable investment. It is an extremely cyclical business, a combination that often doesn't do well with aggressive financial engineering.

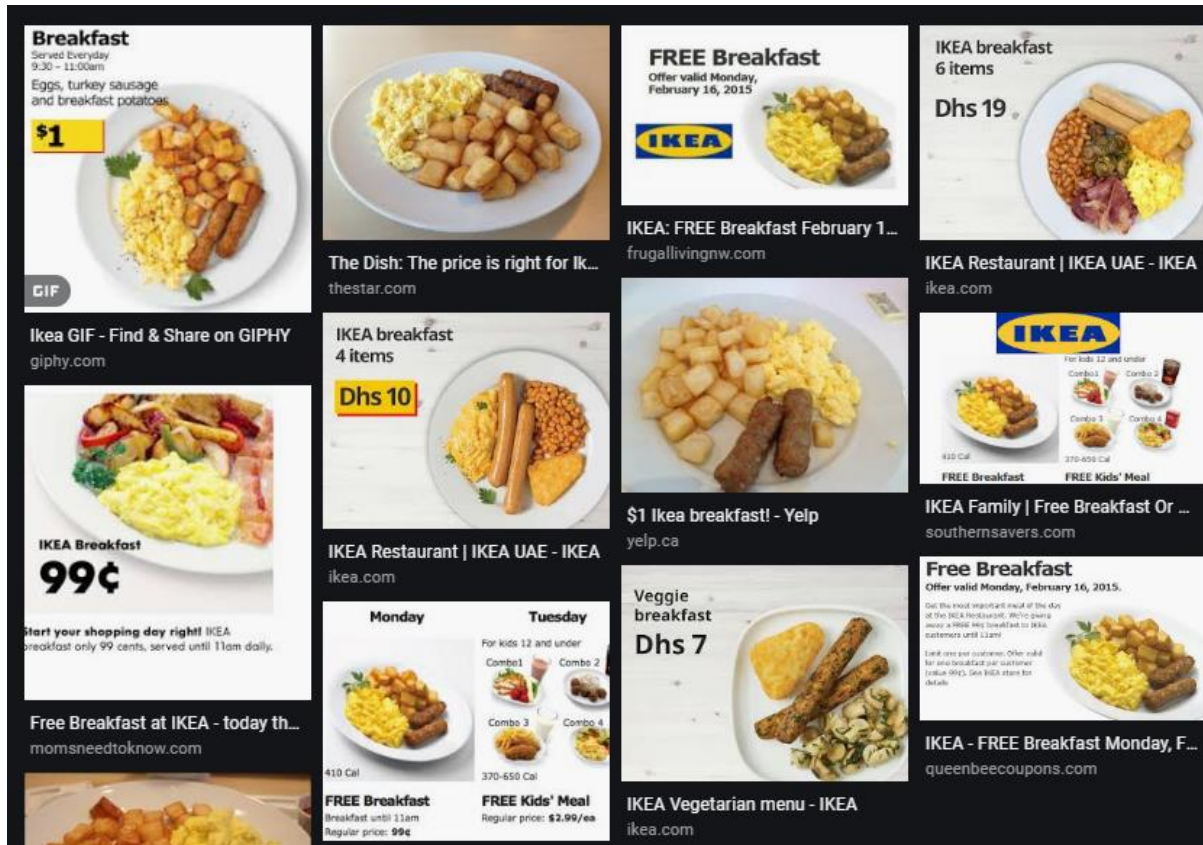
RH, formerly Restoration Hardware, (NYSE: RH) is a stock in the Berkshire (BRK.A, BRK.B) portfolio which makes it an interesting research prospect. Further, the stock was hit hard due to the current situation as shops are closed.

Let's investigate what is the investing risk and reward so that RH's investment proposition can be compared to other options in the current relatively favorable investment environment for value investors.



## Restoration Hardware stock analysis – the business model

A business model that I really admire is IKEA. You are probably familiar with the Swedish, relatively cheap furniture brand, that has managed to scale globally and also get more than 15% of its revenue by selling food, even with \$1 or free breakfasts.



The house we sold in the Netherlands was partly furnished through IKEA and a Dutch IKEA restaurant on a Saturday morning is a scene you better avoid seeing with large families, elderly couples all rushing towards the cheap breakfast. Mea culpa.

However, what if a similar concept can be created where the food is luxurious and the furniture too? You are not competing with IKEA, you have a scalable business model and people love to hang around great furniture. Well, that is the idea RH started developing a few years ago.

You can see the idea behind the business model in this video presenting the Chicago store:

<https://www.youtube.com/watch?v=uBp7TiJCQU>

**IMPORTANT NOTE:** don't make the same mistake I did and discuss this business idea with your spouse as you won't be buying any stock but most likely a \$3,000 chair or sideboard. Then, when you buy the first item, you'll likely become an RH member and redo your complete house. If that happens, you can say goodbye to your retirement savings, will have to work forever and forget about investing. Therefore, keep quiet about this investment idea at home and don't go about testing the product thinking you bring your spouse out and do investing research.



**NEW CAYDEN CAMPAIGN PANEL 4-DOOR DINING SIDEBOARD WITH CENTER DRAWERS**  
 \$4125 - \$4850 REGULAR  
 \$3093 - \$3637 MEMBER



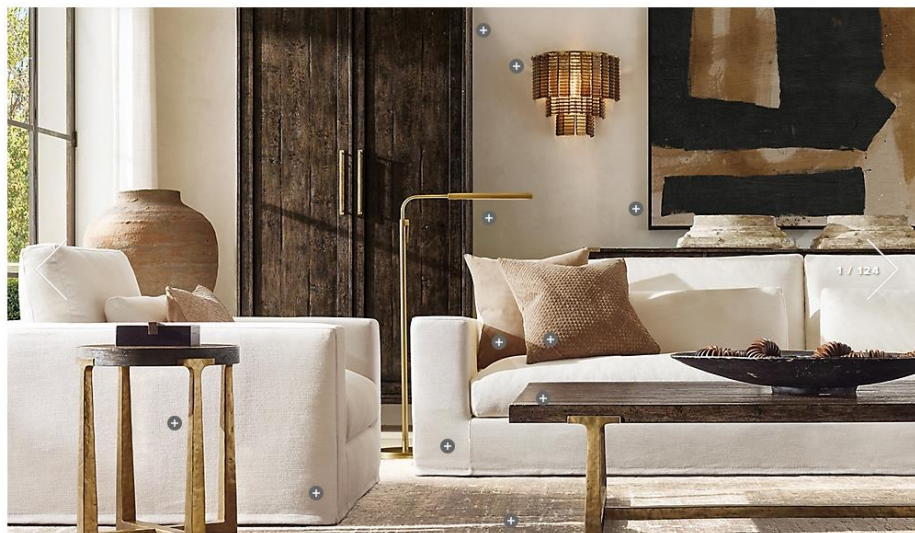
**THADDEUS CHAIR**  
 \$2795 - \$4295 REGULAR  
 \$2096 - \$3221 MEMBER

RH is an American upscale (read: overpriced) furnishing business. Demand for furnishing products depends on discretionary purchasing power, real estate activity and thus the general situation in the economy. The general situation in the economy is currently not a great one, plus the shops are closed and therefore the stock got hit severely. However, investing is about the long-term outlook.

To create an outlook for RH's business we have to estimate when will economic activity return to previous levels which is practically impossible to do. Therefore, it is better to look at fundamentals and see how long might RH be able to survive in different environments, can it take advantage of the situation by gaining market share and consequently what would be a fair price depending on various scenarios.



OUR DOORS MAY BE CLOSED BUT OUR DESIGN TEAM IS READY TO HELP  
 REQUEST A DESIGN CONSULTATION > CONTACT A GALLERY >



Restoration Hardware – The business – Source: [RH](#)

### Restoration Hardware fundamental stock analysis

A look at fundamentals shows interesting things. Revenue has been growing fast over the last decade with earnings and free cash flows following. With a growth company it is important that earnings grow too because earnings and cash flow growth indicate the quality of the business model and its scalability. Margins are high, which is logical on upscale or ‘overpriced’ furniture. On a market cap of \$1.66 billion and \$2,6 billion in revenue, there is more room to scale.

**RH** RH | ★★★★★

#### Financials

	2011-01	2012-01	2013-01	2014-01	2015-01	2016-01	2017-01	2018-01	2019-01	2020-01	TTM
Revenue USD Mil	773	958	1,193	1,551	1,867	2,109	2,135	2,440	2,506	2,647	2,647
Gross Margin %	35.1	37.2	36.6	35.9	37.0	35.7	31.8	34.8	39.9	41.4	41.4
Operating Income USD Mil	-4	27	-69	55	166	186	53	131	289	363	363
Operating Margin %	-0.5	2.8	-5.8	3.5	8.9	8.8	2.5	5.4	11.5	13.7	13.7
Net Income USD Mil	-8	21	-13	18	91	91	5	2	151	220	220
Earnings Per Share USD	-0.22	0.64	-1.36	0.45	2.20	2.16	0.13	-0.10	5.12	9.07	9.07
Dividends USD	—	—	—	—	—	—	—	—	—	—	—
Payout Ratio % *	—	—	—	—	—	—	—	—	—	—	—
Shares Mil	32	32	9	40	41	42	41	27	27	24	24
Book Value Per Share * USD	—	—	7.05	13.08	16.00	20.68	22.10	-1.19	1.51	-3.32	0.97
Operating Cash Flow USD Mil	-12	17	-4	88	82	142	79	555	301	339	339
Cap Spending USD Mil	-40	-26	-49	-94	-111	-134	-158	-112	-137	-94	-94
Free Cash Flow USD Mil	-52	-8	-53	-6	-28	8	-79	443	164	246	246
Free Cash Flow Per Share * USD	—	—	0.37	-0.89	-1.71	-1.04	-0.41	10.61	6.81	11.81	—
Working Capital USD Mil	115	161	273	296	568	861	722	126	-235	-386	—

\* Indicates calendar year-end data information

RH stock fundamentals – Source: [Morningstar](#)

However, one part of the fundamental story is intriguing and has to be researched deeper. Liabilities are huge compared to the equity. This means that, no matter how wonderful the business might be, if there is a dry spell like the current situation definitely is, creditors might quickly want to take advantage and ownership.

#### Key Ratios

Profitability	Growth	Cash Flow	Financial Health	Efficiency Ratios											
<b>Balance Sheet Items (in %)</b>					2011-01	2012-01	2013-01	2014-01	2015-01	2016-01	2017-01	2018-01	2019-01	2020-01	Latest Qtr
Cash & Short-Term Investments					2.66	1.45	1.06	1.31	13.83	23.02	10.48	1.03	0.32	1.95	1.95
Accounts Receivable					0.89	2.00	2.16	2.15	1.70	1.37	2.16	1.81	5.26	2.01	2.01
Inventory					41.12	41.90	44.75	44.27	36.65	34.73	34.31	30.41	29.45	17.94	17.94
Other Current Assets					4.06	9.67	14.44	12.15	7.59	3.78	4.97	3.96	2.76	2.51	2.51
<b>Total Current Assets</b>					<b>48.72</b>	<b>55.02</b>	<b>62.41</b>	<b>59.88</b>	<b>59.78</b>	<b>62.90</b>	<b>51.92</b>	<b>37.22</b>	<b>37.80</b>	<b>24.41</b>	<b>24.41</b>
Net PP&E					15.23	14.24	14.11	20.96	25.61	24.69	31.11	46.21	47.82	56.36	56.36
Intangibles					35.56	29.84	21.87	16.69	11.34	8.28	12.51	14.00	11.65	8.60	8.60
Other Long-Term Assets					0.49	0.90	1.61	2.46	3.27	4.13	4.46	2.58	2.73	10.62	10.62
<b>Total Assets</b>					<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>
Accounts Payable					—	8.08	10.34	11.35	8.72	8.38	6.14	11.27	10.13	7.39	7.39
Short-Term Debt					—	—	—	—	—	—	—	0.35	19.08	14.95	14.95
Taxes Payable					—	1.44	1.62	3.54	1.49	2.26	0.71	1.44	1.02	1.36	1.36
Accrued Liabilities					—	4.88	4.35	4.58	2.94	2.81	2.30	3.25	3.04	2.67	2.67
Other Short-Term Liabilities					25.84	13.20	11.49	11.50	9.42	8.22	9.83	13.66	17.57	13.83	13.83
<b>Total Current Liabilities</b>					<b>25.84</b>	<b>27.60</b>	<b>27.79</b>	<b>30.97</b>	<b>22.57</b>	<b>21.67</b>	<b>18.98</b>	<b>29.97</b>	<b>50.84</b>	<b>40.19</b>	<b>40.19</b>
Long-Term Debt					22.28	20.84	10.45	8.60	19.90	25.82	25.89	52.23	33.03	23.77	23.77
Other Long-Term Liabilities					8.89	8.87	4.57	7.24	11.47	10.08	13.17	18.22	17.40	35.27	35.27
<b>Total Liabilities</b>					<b>57.01</b>	<b>57.32</b>	<b>42.81</b>	<b>46.81</b>	<b>53.94</b>	<b>57.57</b>	<b>58.05</b>	<b>100.42</b>	<b>101.27</b>	<b>99.24</b>	<b>99.24</b>
<b>Total Stockholders' Equity</b>					<b>42.99</b>	<b>42.68</b>	<b>57.19</b>	<b>53.19</b>	<b>46.06</b>	<b>42.43</b>	<b>41.95</b>	<b>-0.42</b>	<b>-1.27</b>	<b>0.76</b>	<b>0.76</b>
<b>Total Liabilities &amp; Equity</b>					<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>	<b>100.00</b>
<b>Liquidity/Financial Health</b>					2011-01	2012-01	2013-01	2014-01	2015-01	2016-01	2017-01	2018-01	2019-01	2020-01	Latest Qtr
Current Ratio					1.89	1.99	2.25	1.93	2.65	2.90	2.74	1.24	0.74	0.61	0.61
Quick Ratio					0.14	0.13	0.12	0.11	0.69	1.13	0.67	0.10	0.11	0.10	0.10
Financial Leverage					2.33	2.34	1.75	1.88	2.17	2.36	2.38	—	—	131.13	131.13
Debt/Equity					0.52	0.49	0.18	0.16	0.44	0.61	0.63	—	—	76.90	76.90

There is practically no stockholder equity or, it is \$18 million on 19 million shares outstanding. If we include the convertible notes and possible dilution, the number of stocks goes up to 24 million. On the other hand, there is more interesting information about sold warrants that are antidilutive etc. However, at current stock prices, nobody will convert, they will all want their money back or even more dilutive shares. Even the 2020 bonds issued in 2015 have a strike price of \$118 which is above the current level.



### Restoration Hardware Holdings, Inc.

Illustrative Table of Potential Dilutive Impact of Convertible Senior Notes due 2020 and Call Spread  
UNAUDITED

In Q2 2015, we issued \$300 million aggregate principal amount of 0.00% convertible senior notes due 2020 (the "Notes"). The initial conversion rate applicable to the Notes is 8.4656 shares of common stock per \$1,000 principal amount of Notes, which is equivalent to an initial conversion price of approximately \$118.13 per share. These Notes have a dilutive effect on GAAP EPS while the Notes are outstanding, but once converted or settled, there is anticipated to be no actual dilution as we entered into a bond hedge in June 2015 that is intended to offset the actual dilution related to these Notes. The bond hedge is not included in the calculation of diluted GAAP EPS as it is anti-dilutive.

In Q2 2015, we also sold warrants for 2,539,680 shares of our common stock, which represents the number of shares of our common stock underlying the Notes. The warrants had a strike price of \$189.00. These warrants could separately have a dilutive effect on GAAP EPS to the extent that the market price per share of our common stock exceeds the strike price and could cause actual dilution.

The following table illustrates the potential dilutive shares that would be included in the calculation of our future reported GAAP EPS assuming various hypothetical quarterly average market prices of our common stock (NYSE: RH). The potential dilutive shares are calculated using the treasury stock method. As mentioned above, total actual dilution at maturity is reduced by the effect of our bond hedge.

Source: [RH investor relations](#)

**RH**  
**CONSOLIDATED BALANCE SHEETS**  
(In thousands, except share amounts)

	February 1, 2020	February 2, 2019
<b>ASSETS</b>		
Current assets:		
Cash and cash equivalents	\$ 47,658	\$ 5,803
Accounts receivable—net	48,979	40,224
Merchandise inventories	438,696	531,947
Asset held for sale	—	21,795
Prepaid expense and other current assets	61,619	104,198
Total current assets	596,952	703,967
Property and equipment—net	967,599	952,957
Operating lease right-of-use assets	410,904	440,504
Goodwill	124,367	124,379
Tradenames, trademarks and domain names	86,022	86,022
Deferred tax assets	45,005	35,603
Other non-current assets	214,845	79,586
Total assets	<u>\$ 2,445,694</u>	<u>\$ 2,423,018</u>
<b>LIABILITIES AND STOCKHOLDERS' DEFICIT</b>		
Current liabilities:		
Accounts payable and accrued expenses	\$ 330,309	\$ 320,497
Deferred revenue and customer deposits	162,433	152,595
Convertible senior notes due 2019—net	—	343,789
Convertible senior notes due 2020—net	290,532	—
Operating lease liabilities	58,924	66,249
Other current liabilities	140,714	109,456
Total current liabilities	982,912	992,586
Asset based credit facility	—	57,500
Equipment promissory notes—net	31,053	—
Convertible senior notes due 2020—net	—	271,157
Convertible senior notes due 2023—net	266,658	249,151
Convertible senior notes due 2024—net	264,982	—
Non-current operating lease liabilities	409,930	437,557
Non-current finance lease liabilities	442,988	421,245
Other non-current obligations	28,520	32,512
Total liabilities	<u>2,427,043</u>	<u>2,461,708</u>
Commitments and contingencies (Note 18)		
Stockholders' (deficit):		
Preferred stock—\$0.0001 par value per share, 10,000,000 shares authorized, no shares issued or outstanding as of February 1, 2020 and February 2, 2019	—	—
Common stock—\$0.0001 par value per share, 180,000,000 shares authorized, 19,236,681 shares issued and outstanding as of February 1, 2020; 20,480,613 shares issued and 20,477,813 shares outstanding as of February 2, 2019	2	2
Additional paid-in capital	430,662	356,422
Accumulated other comprehensive loss	(2,760)	(2,334)
Accumulated deficit	(409,253)	(392,537)
Treasury stock—at cost, no shares as of February 1, 2020 and 2,800 shares as of February 2, 2019	—	(243)
Total stockholders' (deficit)	18,651	(38,690)
Total liabilities and stockholders' (deficit)	<u>\$ 2,445,694</u>	<u>\$ 2,423,018</u>

Restoration Hardware Stock Balance Sheet – Source: [10k – Investor relations](#)

The book value simply isn't there but the value of a business is the “discounted present value of all the cash flows the business is going to deliver from today till judgement day” to quote Buffett on this holding of his.

(In thousands)

	Year Ended		
	February 1, 2020	February 2, 2019	February 3, 2018
<b>CASH FLOWS FROM OPERATING ACTIVITIES</b>			
Net income (loss)	\$ 220,375	\$ 135,731	\$ (2,599)
Adjustments to reconcile net income (loss) to net cash provided by operating activities:			
Depreciation and amortization	100,739	91,372	83,176
Non-cash operating lease cost	65,195	68,612	75,610
Asset impairments	15,168	6,533	8,876
Goodwill and tradename impairment	—	32,086	33,700
Asset held for sale loss (gain)	(1,529)	8,497	—
Amortization of debt discount	46,245	41,868	30,457
Accretion of debt discount upon settlement of debt	(70,482)	—	—
Stock-based compensation expense	21,832	23,983	50,709
Non-cash finance lease interest expense	22,608	16,785	11,154
Product recalls	(3,517)	6,874	7,707
Net non-cash charges resulting from inventory step-up	—	380	2,527
Amortization of purchase premiums and accretion of purchase discount—net	—	—	99
Deferred income taxes	(7,709)	(5,018)	3,733
Loss on extinguishment of debt—net	6,472	917	4,880
Other non-cash interest expense	4,334	3,639	4,768
Change in assets and liabilities:			
Accounts receivable	(7,309)	(8,583)	2,458
Merchandise inventories	93,266	(7,399)	220,767
Prepaid expense and other assets	28,404	(88,434)	27,920
Landlord assets under construction—net of tenant allowances	(64,300)	(59,001)	(81,065)
Accounts payable and accrued expenses	7,445	10,148	65,105
Deferred revenue and customer deposits	9,799	8,413	3,366
Other current liabilities	(45,767)	51,214	5,008
Current and non-current operating lease liabilities	(77,004)	(70,875)	(70,541)
Other non-current obligations	(25,077)	(18,139)	(13,310)
Net cash provided by operating activities	339,188	249,603	474,505
<b>CASH FLOWS FROM INVESTING ACTIVITIES</b>			
Capital expenditures	(93,623)	(79,992)	(68,393)
Deposits on asset under construction	(53,000)	—	—
Proceeds from sale of assets	24,078	—	15,123
Purchase of investments	—	—	(16,109)
Maturities of investments	—	—	46,890
Sales of investments	—	—	145,020
Net cash provided by (used in) investing activities	(122,545)	(79,992)	122,531
<b>CASH FLOWS FROM FINANCING ACTIVITIES</b>			
Borrowings under asset based credit facility	322,500	866,500	600,000
Repayments under asset based credit facility	(380,000)	(1,008,970)	(400,030)
Borrowings under term loans	320,000	—	180,000
Repayments under term loans	(324,000)	(80,000)	(103,000)
Borrowings under promissory and equipment security notes	122,000	—	34,000
Repayments under promissory and equipment security notes	(16,520)	(31,974)	(2,319)
Debt issuance costs	(4,636)	—	(8,298)
Proceeds from issuance of convertible senior notes	350,000	335,000	—
Proceeds from issuance of warrants	50,225	51,021	—
Purchase of convertible note hedges	(91,350)	(91,857)	—
Debt issuance costs related to convertible senior notes	(4,818)	(6,349)	—
Repayments of convertible senior notes	(278,560)	—	—
Principal payments under finance leases	(9,682)	(6,885)	(6,105)
Repurchases of common stock—including commissions	(250,032)	(250,000)	(1,000,326)
Proceeds from exercise of stock options	27,138	44,024	24,896
Tax withholdings related to issuance of stock-based awards	(7,069)	(9,502)	(5,759)
Net cash used in financing activities	(174,804)	(188,992)	(686,941)
Effects of foreign currency exchange rate translation	16	(130)	152
Net increase (decrease) in cash and cash equivalents and restricted cash equivalents	41,855	(19,511)	(89,753)
Cash and cash equivalents and restricted cash equivalents			
Beginning of period—cash and cash equivalents	5,803	17,907	87,023
Beginning of period—restricted cash equivalents (construction related deposits)	—	7,407	28,044
Beginning of period—cash and cash equivalents and restricted cash equivalents	\$ 5,803	\$ 25,314	\$ 115,067
End of period—cash and cash equivalents	47,658	5,803	17,907
End of period—restricted cash equivalents (construction related deposits)	—	—	7,407
End of period—cash and cash equivalents and restricted cash equivalents	\$ 47,658	\$ 5,803	\$ 25,314
Cash paid for interest	\$ 43,278	\$ 31,154	\$ 28,180
Cash paid for taxes	40,126	41,289	4,025
<b>Non-cash transactions:</b>			
Property and equipment additions in accounts payable and accrued expenses at period-end	\$ 5,161	\$ 7,837	7,640
Landlord asset additions in accounts payable and accrued expenses at period-end	19,640	12,142	17,543
Landlord asset additions from unpaid construction related deposits	195	2,807	5,091

RH Stock – cash flow – Source: [RH investor relations](#)

### Cash flows, buybacks and remarkable financial engineering

The current market capitalization is \$1.66 billion. In the last 3 years they have spent \$1.5 billion in buybacks. In 2017, operating cash flows were \$474 million, even if mostly thanks to depreciation and merchandise inventory. On top of that, they managed to spend one billion on buybacks in 2017 and lower the number of shares outstanding from 41 million to 27 million in just one year, a remarkable feat.

What they did over the last few years is the monetization of inventory that has brought \$327 million, they have issued \$685 million of convertible notes and made profits of \$355 million. Sum that up and you come to \$1.36 billion which is close to the \$1.5 billion spent. For a company with cumulative earnings of \$353 million over the last 3 years, to spend \$1.5 billion on buybacks is a remarkable feat of financial engineering in my book.

Now are these guys smarter than the street or will the buybacks come back to haunt them in the future as it is usually the case with those that try to be smarter than the street? Think of Valiant (BHC), Boeing (BA) etc.

Improving inventory days and making the business leaner is what every manager should do and they really did a great job over the years. However, issuing convertible notes, buying expensive bond hedges and selling antidilutive warrants to buyback shares is something interesting. The good thing about the convertible bonds is that those are usually issued with a 0% coupon. So, the current cash flows are not burdened by the debt.

We have to see whether it is profitable to issue convertible stocks, buy bond hedges, issue antidilutive warrants and then buyback stocks. In what kind of scenario, it works and in what it doesn't.

LIABILITIES AND STOCKHOLDERS' DEFICIT			
Current liabilities:			
Accounts payable and accrued expenses	\$	330,309	\$ 320,497
Deferred revenue and customer deposits		162,433	152,595
Convertible senior notes due 2019—net		—	343,789
Convertible senior notes due 2020—net		290,532	—
Operating lease liabilities		58,924	66,249
Other current liabilities		140,714	109,456
Total current liabilities		982,912	992,586
Asset based credit facility		—	57,500
Equipment promissory notes—net		31,053	—
Convertible senior notes due 2020—net		—	271,157
Convertible senior notes due 2023—net		266,658	249,151
Convertible senior notes due 2024—net		264,982	—
Non-current operating lease liabilities		409,930	437,557
Non-current finance lease liabilities		442,988	421,245
Other non-current obligations		28,520	32,512
Total liabilities		2,427,043	2,461,708
Commitments and contingencies (Note 18)			

There is \$290 million of convertible notes due this summer, another \$266 and \$266 million due in 2023 and 2024 respectively. It is important to note that the biggest risk from the bond is dilution as the bonds are convertible into cash, shares or a combination thereof, at RH's election. This means creditors can't come knocking on the door for cash – a good point. However, if RH doesn't have the cash to repay, it might be highly dilutive as the company would have to issue shares at prices that would probably be lower than the buyback prices (even if most of the 2017 buybacks were made at a stock price of around \$50).

# RH

## RH ANNOUNCES PRICING OF \$300 MILLION CONVERTIBLE NOTES OFFERING

**Corte Madera, CA** – September 13, 2019 – RH (NYSE: RH) announced today the pricing of \$300 million of 0.00% convertible notes due 2024 at a 25% conversion premium to yesterday's closing stock price of \$169.12. RH also granted the initial purchaser of the notes a 13-day option to purchase up to an additional \$50 million of the notes on the same terms and conditions, for a total potential offering size of up to \$350 million. The sale of the notes to the initial purchaser is expected to settle on September 17, 2019, subject to customary closing conditions.

In connection with the offering of the notes, RH has entered into convertible note hedge and warrant transactions on terms that have the effect of limiting earnings dilution as a result of the convertible notes issuance up to a 100% premium to yesterday's closing stock price. Under the terms of these transactions, the Company's shareholders are not expected to experience earnings dilution until the Company's stock price is above approximately \$338.24.

RH expects to use the net proceeds from the offering to (i) pay the net costs of the convertible note hedge and warrant transactions, (ii) retire the Company's \$200 million of outstanding second lien debt, (iii) reduce outstanding borrowings under the Company's credit facilities and (iv) for general corporate purposes.

The notes will not bear interest and will mature on September 15, 2024, unless earlier purchased by us or converted. The initial conversion rate is 4.7304 shares of common stock per \$1,000 principal amount of notes, which is equivalent to an initial conversion price of approximately \$211.40 per share representing a premium of 25% over yesterday's closing stock price. **The notes will be convertible into cash, shares of RH's common stock, or a combination thereof, at RH's election.**



RH antidilutive statement – Source: [8K September 2019](#)

The [2024 notes](#) have a conversion price of \$211.4 with an expected dilution of 1,655,640 common stock shares at a conversion rate of 4.73 shares per \$1,000.

To mitigate the effect of dilution, they have sold warrants for the above number of shares with a strike price of \$338.4. A stock warrant gives the holder the right to buy shares at a certain price before the expiration. When a warrant is exercised, the company issues new shares, increasing the total number of shares outstanding.

*Shares in Millions*

Hypothetical Quarterly Average Share Price <sup>(1)</sup>	Net Shares from Notes	Net Shares from Warrants	Total Dilutive Potential Shares for EPS Purposes <sup>(2)</sup>	Net Shares from Bond Hedge <sup>(3)</sup>	Total Expected Dilution at Maturity of Notes <sup>(4)</sup>
\$240.00	0.197	-	0.197	(0.197)	-
\$250.00	0.256	-	0.256	(0.256)	-
\$260.00	0.309	-	0.309	(0.309)	-
\$270.00	0.359	-	0.359	(0.359)	-
\$280.00	0.406	-	0.406	(0.406)	-
\$290.00	0.449	-	0.449	(0.449)	-
\$300.00	0.489	-	0.489	(0.489)	-
\$310.00	0.527	-	0.527	(0.527)	-
\$320.00	0.562	-	0.562	(0.562)	-
\$330.00	0.595	-	0.595	(0.595)	-
\$340.00	0.626	0.009	0.635	(0.626)	0.009
\$350.00	0.656	0.056	0.711	(0.656)	0.056
\$360.00	0.683	0.100	0.783	(0.683)	0.100
\$370.00	0.710	0.142	0.852	(0.710)	0.142
\$380.00	0.735	0.182	0.917	(0.735)	0.182
\$390.00	0.758	0.220	0.978	(0.758)	0.220
\$400.00	0.781	0.256	1.036	(0.781)	0.256
\$410.00	0.802	0.290	1.092	(0.802)	0.290
\$420.00	0.822	0.322	1.145	(0.822)	0.322
\$430.00	0.842	0.353	1.195	(0.842)	0.353
\$440.00	0.860	0.383	1.243	(0.860)	0.383
\$450.00	0.878	0.411	1.289	(0.878)	0.411

*The table above is for illustrative purposes and does not represent our forecast of future stock performance.*

Potential dilution from 2024 convertible note – Source: [RH](#)

However, to cover for the potential dilution between the strike price of the warrant \$338.4 and the strike price of the bond of \$211.4, the company entered into a bond hedge where it paid \$91 million just to have that difference hedged.

In connection with the offering of the 2024 Notes and exercise of the overallotment option in September 2019, we entered into convertible note hedge transactions whereby we have the option to purchase a total of approximately 1.7 million shares of our common stock at a price of approximately \$211.40 per share. The total cost of the convertible note hedge transactions was approximately \$91.4 million. In addition, we sold warrants whereby the holders of the warrants have the option to purchase a total of approximately 1.7 million shares of our common stock at a price of \$338.24 per share. The warrants contain certain adjustment mechanisms whereby the total number of shares to be purchased under such warrants may be increased up to a cap of approximately 3.3 million shares of common stock (which cap may also be subject to adjustment). We received approximately \$50.2 million in cash proceeds from the sale of these warrants. Taken together, the purchase of the convertible note hedges and sale of the warrants are intended to offset any actual earnings dilution from the conversion of the 2024 Notes until our common stock is above approximately \$338.24 per share. As these transactions meet certain accounting criteria, the convertible note hedges and warrants are recorded in stockholders' equity, are not accounted for as derivatives and are not remeasured each reporting period. The net costs incurred in connection with the convertible note hedge and warrant transactions were recorded as a reduction to additional paid-in capital on the consolidated balance sheets.

We recorded a deferred tax liability of \$21.7 million in connection with the debt discount associated with the 2024 Notes and recorded a deferred tax asset of \$22.7 million in connection with the convertible note hedge transactions. The deferred tax liability and deferred tax asset are recorded in deferred tax assets on the consolidated balance sheets.

Source: 10-K

It might be called a zero-coupon convertible bond, but paying \$91 million to borrow \$264 million as it is the case for the 2024 convertible bond, is a pretty high interest rate.

The company also paid \$73 million to hedge the 2019 convertible bond, another \$68 million for the 2020 note and probably a similar amount to hedge the 2023 bond. So, the company is happy to pay \$91.4 million, to hedge for a potential dilution of 1.7 million shares as it is the case with the 2024 bond. On 19 million shares, the dilution would be 9%, or at current stock levels approximately \$170 million. Thus, they are happy to pay half of that to prevent 9% dilution. Thus, actually paying 5% of the market cap to prevent a 9% dilution. Why would they go through such a hustle and why aren't other companies doing the same? Well, there is a person whose incentive is just to push the stock price up, nothing else. Nothing wrong with that, but make sure you as the shareholders are on the same boat.

### **The CEO's mega retirement package – reason for all the financial engineering**

There must be something behind the above insane financial engineering. Even if the company lowered its share count from 41 million in 2017 to 19 million, the market capitalization, the actual value of the business, didn't go up much, actually it declined.

In 2015, there were 41 million shares outstanding and the stock price was \$100. The market capitalization was \$4.1 billion.

### Restoration Hardware Holdings, Inc common stock NYSE: RH

+ Follow

**105,08** USD +1,43 (1,38%) ↑

Closed: 7 Apr, 16:11 GMT-4 · Disclaimer  
After hours 106,35 +1,27 (1,21%)

1 day   5 days   1 month   6 months   YTD   1 year   5 years   **Max**



Currently the market capitalization is \$1.9 billion. Even a month ago, when the stock price was at \$236, the market capitalization was still below the levels from 2015. If we compare the 2017 lows of \$25 per share – the market capitalization was actually lower at \$1 billion compared to the current due to the massive buybacks since (2015 - 41 million shares times \$100, 2020 - 19 million shares times \$105). However, free cash flows went from constantly negative numbers to about \$250 million per year.

### Restoration Hardware Holdings, Inc common stock NYSE: RH

+ Follow

**105,08** USD +1,43 (1,38%) ↑

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After hours 106,35 +1,27 (1,21%)

1 day   5 days   1 month   6 months   YTD   1 year   5 years   **Max**



Given the above, one can argue whether there has been actual shareholder value creation. If you bought in 2015 and didn't sell, you didn't make much.

However, let's take a look at why the CEO would do whatever it takes, do crazy financial engineering just to push the price higher. In 2017 the number of outstanding shares was 33 million and he owned 16.7% of the company. Mind that the number of shares outstanding in Q1 2016 was 40.6 million.

Name	Number	Percent
<b>5% Stockholders:</b>		
FMR LLC (1)		
245 Summer Street, Boston, MA 02210	6,120,382	18.5%
T. Rowe Price Associates, Inc. (2)		
100 E. Pratt Street, Baltimore, MD 21201	4,938,206	14.9%
Blackrock, Inc. (3)		
55 East 52nd Street, New York, NY 10055	4,660,533	14.1%
The Vanguard Group (4)		
100 Vanguard Blvd., Malvern, PA 19355	2,929,025	8.86%
Balyasny Asset Management L.P. (5)		
181 West Madison, Suite 3600 Chicago, IL 60602	2,205,903	6.7%
<b>Named Executive Officers and Directors:</b>		
Gary Friedman (6)	6,184,277	16.7%
Carlos Alberini (7)	66,196	*
Keith Belling (8)	18,608	*
Karen Boone (9)	175,500	*
Eri Chaya (10)	247,769	*
Mark Demilio (11)	57,058	*
Hilary Krane (12)	4,768	*
Katie Mitic (13)	12,119	*
DeMonty Price (14)	111,918	*
Ali Rowghani (15)	6,829	*
Leonard Schlesinger (16)	8,354	*
<b>All current executive officers and directors as a group (11 persons) (17)</b>	<b>6,893,396</b>	<b>18.8%</b>

Source: [RH proxy](#)

16.7% of a company worth \$1 billion was \$160 million but in 2017 the CEO was granted a stock option plan where he could get up to a million additional shares at an exercise price of \$50.

On May 2, 2017, the compensation committee granted a stock option to Mr. Friedman under the 2012 Stock Incentive Plan to purchase 1,000,000 shares of the Company's common stock (the "2017 Stock Option Award"), with an exercise price of \$50 per share,

Years of Service from Award Date	Stock Price			Total
	\$100	\$125	\$150	
First Completed Year of Service	83,333 shares	83,333 shares	83,334 shares	250,000 shares
Second Completed Year of Service	83,333 shares	83,333 shares	83,334 shares	250,000 shares
Third Completed Year of Service	83,333 shares	83,333 shares	83,334 shares	250,000 shares
Fourth Completed Year of Service	83,333 shares	83,333 shares	83,334 shares	250,000 shares

Source: [RH proxy](#)

If you get such an option plan, your only goal is to increase the stock price, at whatever cost. The option plan was granted on the 2<sup>nd</sup> of May 2017 and the company announced a \$700 million buyback plan just 2 days later.



[View printer-friendly version](#)

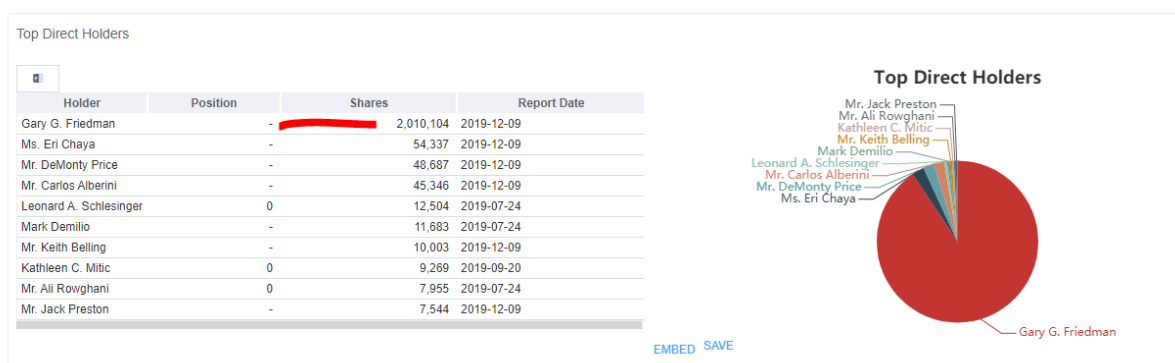
[<< Back](#)

### RH ANNOUNCES \$700 MILLION SHARE REPURCHASE AUTHORIZATION

Company Announces Completion of Previous \$300 Million Share Repurchase Program

CORTE MADERA, Calif.--(BUSINESS WIRE)--May 4, 2017-- RH (NYSE:RH) today announced that its Board of Directors has authorized a common share repurchase program of up to \$700 million.

From the last reporting, the CEO has 2,010,104 shares – source: [Gurufocus](#)



So, over the period of just 3 years, the CEO went from 6 million shares to two million shares and actually sold shares worth \$115 million dollars in December of 2019. It has probably been his plan to simply push the stock price as high as possible, cash out and retire. Few shareholders would complain when the stock price goes up. It is just that this crisis might have postponed the party a bit.

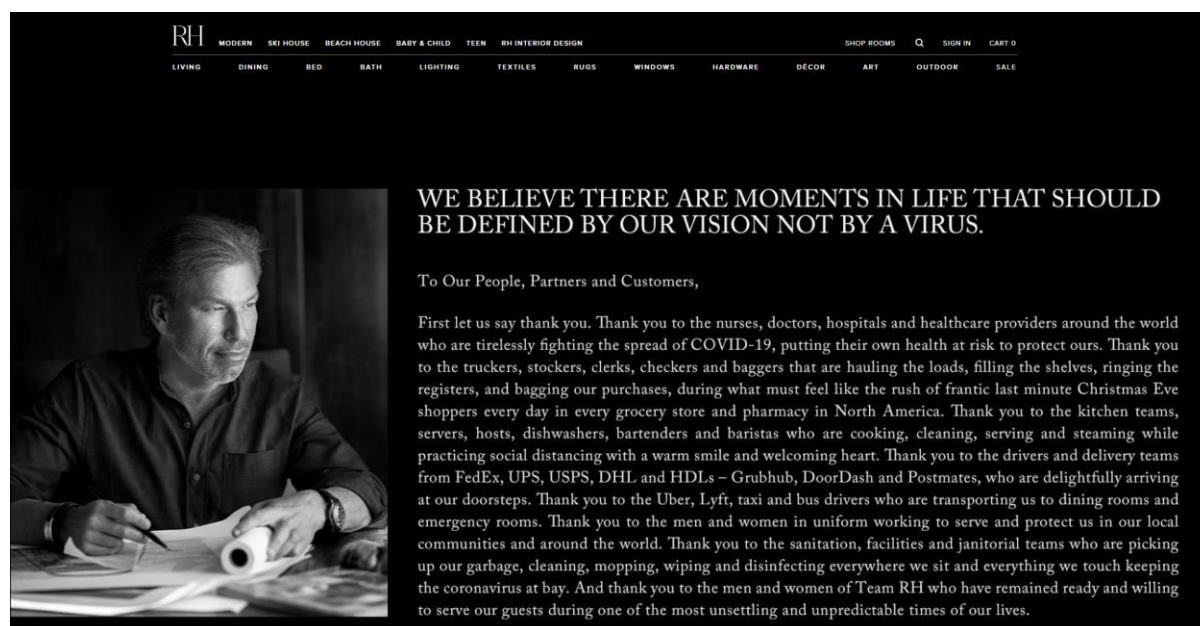
Common stock purchase or sale:

Transaction Date	Reported Date/Time	Company	Symbol	Insider Relationship	Shares Traded	Average Price	Total Amount	Shares Owned	Filing
2019-12-09 Sale	2019-12-11 8:42 pm	RH	RH	<a href="#">Stanchak David</a> See Remarks	11,062	\$238.1	\$2,633,442	16,000 (Indirect)	<a href="#">View</a>
2019-12-09 Sale	2019-12-11 8:41 pm	RH	RH	<a href="#">Price DeMonty</a> See Remarks	22,000	\$238.6	\$5,250,135	48,687 (Direct)	<a href="#">View</a>
2019-12-09 Sale	2019-12-11 8:40 pm	RH	RH	<a href="#">Preston Jack M</a> CFO	13,306	\$235.9	\$3,139,239	7,544 (Direct)	<a href="#">View</a>
2019-12-11 Sale	2019-12-11 8:39 pm	RH	RH	<a href="#">FRIEDMAN GARY G</a> CEO Chairman 10% Owner	179,636	\$231.9	\$41,658,762	1,853,332 (Direct)	<a href="#">View</a>
2019-12-09 Sale	2019-12-11 8:37 pm	RH	RH	<a href="#">FRIEDMAN GARY G</a> CEO Chairman 10% Owner	320,364	\$236.9	\$75,904,502	2,010,104 (Direct)	<a href="#">View</a>
2019-12-09 Sale	2019-12-11 8:35 pm	RH	RH	<a href="#">Chaya Eri</a> Director	17,000	\$239.8	\$4,076,090	54,337 (Direct)	<a href="#">View</a>
2019-12-09 Sale	2019-12-11 8:34 pm	RH	RH	<a href="#">Belling Keith</a> Director	4,500	\$239.7	\$1,078,530	10,003 (Direct)	<a href="#">View</a>
2019-12-09 Sale	2019-12-11 8:33 pm	RH	RH	<a href="#">ALBERINI CARLOS</a> Director	25,000	\$239.9	\$5,997,330	45,346 (Direct)	<a href="#">View</a>
2019-10-15 Sale	2019-10-17 8:38 pm	RH	RH	<a href="#">Belling Keith</a> Director	4,000	\$182.5	\$729,872	14,503 (Direct)	<a href="#">View</a>
2019-09-20 Sale	2019-09-24 8:59 pm	RH	RH	<a href="#">Mitic Kathleen C.</a> Director	7,000	\$168.6	\$1,180,404	9,269 (Indirect Direct)	<a href="#">View</a>
2019-09-20 Sale	2019-09-23 9:00 pm	RH	RH	<a href="#">Chaya Eri</a> Director	20,000	\$167.6	\$3,351,101	59,337 (Direct)	<a href="#">View</a>
2019-09-19 Sale	2019-09-20 8:30 pm	RH	RH	<a href="#">Citragno Glenda M</a> CAO	4,690	\$175	\$820,750	0 (Direct)	<a href="#">View</a>
2019-09-16 Sale	2019-09-18 9:32 pm	RH	RH	<a href="#">Stanchak David</a> See Remarks	6,000	\$172	\$1,032,053	28,462 (Indirect)	<a href="#">View</a>
2019-09-14 Sale	2019-09-17 9:30 pm	RH	RH	<a href="#">Price DeMonty</a> See Remarks	23,900	\$171.3	\$4,093,258	48,687 (Direct)	<a href="#">View</a>
2019-09-10 Sale	2019-09-12 9:32 pm	RH	RH	<a href="#">Citragno Glenda M</a> CAO	2,000	\$155	\$310,000	1,150 (Direct)	<a href="#">View</a>
2019-09-06 Sale	2019-09-09 9:07 pm	RH	RH	<a href="#">DEMILIO MARK S</a> Director	2,000	\$150	\$300,000	6,681 (Direct Indirect)	<a href="#">View</a>
2019-08-21 Sale	2019-08-23 8:58 pm	RH	RH	<a href="#">DEMILIO MARK S</a> Director	2,000	\$145	\$290,000	7,766 (Direct Indirect)	<a href="#">View</a>

RH insider transactions – [SEC form 4](#)

Also, there were no reported purchases by the management over the above period.

Now, the CEO recently wrote a nice letter to shareholders explaining the current situation and how the company will deal with it.



[RH](#) MODERN SKI HOUSE BEACH HOUSE BABY & CHILD TEEN RH INTERIOR DESIGN SHOP ROOMS SIGN IN CART 0  
 LIVING DINING BED BATH LIGHTING TEXTILES RUGS WINDOWS HARDWARE DECOR ART OUTDOOR SALE

**WE BELIEVE THERE ARE MOMENTS IN LIFE THAT SHOULD BE DEFINED BY OUR VISION NOT BY A VIRUS.**

To Our People, Partners and Customers,

First let us say thank you. Thank you to the nurses, doctors, hospitals and healthcare providers around the world who are tirelessly fighting the spread of COVID-19, putting their own health at risk to protect ours. Thank you to the truckers, stockers, clerks, checkers and baggers that are hauling the loads, filling the shelves, ringing the registers, and bagging our purchases, during what must feel like the rush of frantic last minute Christmas Eve shoppers every day in every grocery store and pharmacy in North America. Thank you to the kitchen teams, servers, hosts, dishwashers, bartenders and baristas who are cooking, cleaning, serving and steaming while practicing social distancing with a warm smile and welcoming heart. Thank you to the drivers and delivery teams from FedEx, UPS, USPS, DHL and HDLs – Grubhub, DoorDash and Postmates, who are delightfully arriving at our doorsteps. Thank you to the Uber, Lyft, taxi and bus drivers who are transporting us to dining rooms and emergency rooms. Thank you to the men and women in uniform working to serve and protect us in our local communities and around the world. Thank you to the sanitation, facilities and janitorial teams who are picking up our garbage, cleaning, mopping, wiping and disinfecting everywhere we sit and everything we touch keeping the coronavirus at bay. And thank you to the men and women of Team RH who have remained ready and willing to serve our guests during one of the most unsettling and unpredictable times of our lives.

Source: [front page RH](#)

My first thought was about finding the time to make such a nice picture in these times but I hope he took the picture prior to the crisis. The second thought was about his confident look, laser focused image with a blessed smile telling us everything is going to be great. Well, if you just sold 500,000 shares on the market at a price of above \$230 per share and got \$117.5 million from the sale, it is logical you feel blessed, happy, confident and secure about the future. I wonder whether other shareholders that have been holding the bag since 2015 feel the same?

To remain on the topic of management integrity, something usually very important to Berkshire, if you read the annual report, you find other interesting things like the below class action complaint that was settled for \$50 million.

#### *Securities Class Action*

On February 2, 2017, City of Miami General Employees' & Sanitation Employees' Retirement Trust filed a class action complaint in the United States District Court, Northern District of California, against the Company, Gary Friedman, and Karen Boone. On March 16, 2017, Peter J. Errichiello, Jr. filed a similar class action complaint in the same forum and against the same parties. On April 26, 2017, the court consolidated the two actions. The consolidated action is captioned In re RH, Inc. Securities Litigation. An amended consolidated complaint was filed in June 2017 asserting claims under sections 10(b) and 20(a) of the Securities Exchange Act of 1934, as amended (the "Exchange Act"). The complaint asserts claims purportedly on behalf of a class of purchasers of Company common stock from March 26, 2015 to June 8, 2016. The alleged misstatements relate to statements regarding the roll out of the RH Modern product line and the Company's inventory levels. The complaint seeks class certification, monetary damages, and other appropriate relief, including an award of costs and attorneys' fees. On March 21, 2019, the Company and the individual defendants in the case entered into a binding memorandum of understanding to settle the case. **The settlement amount is \$50 million**, which was funded entirely by the Company's insurance carriers. On May 6, 2019, the plaintiffs filed a motion for preliminary approval of the proposed settlement together with a settlement agreement executed by both parties. The settlement agreement was subject to customary conditions including court approval following notice to the Company's shareholders, and a hearing at which time the court will consider the fairness, reasonableness and adequacy of the settlement. On June 21, 2019, the court issued an order preliminarily approving the settlement. The court granted final approval of the settlement on October 25, 2019.

### **RH stock investment proposition**

RH is a business where the management's priority is to push the stock up, even if just temporarily so that the management and probably other shareholders can cash out. If you want to invest, you have to be in that group.

Index funds and small shareholders that like the buy and hold method are the bag holders. Fidelity, Blackrock and Vanguard are not investors that are going to sell when the stock goes up.

Top Fund Holders					
Holder	Shares	Report Date	% of Total Assets Managed	% of Shares Outstanding	
FMR LLC	2,849,551	2019-12-31	0.07%	14.81%	
BlackRock Inc.	1,915,777	2019-12-31	0.02%	9.96%	
VANGUARD GROUP INC	1,830,350	2019-12-31	0.01%	9.51%	
Warren Buffett	1,708,348	2019-12-31	0.15%	8.88%	
Jim Simons	1,299,277	2019-12-31	0.21%	6.75%	
GOLDMAN SACHS GROUP INC	896,095	2019-12-31	0.05%	4.66%	
JPMORGAN CHASE & CO	767,938	2019-12-31	0.03%	3.99%	
Thrivent Financial for Lutherans	570,554	2019-09-30	0.33%	2.97%	
STATE STREET CORP	520,086	2019-12-31	0.01%	2.70%	
Bill Miller	446,585	2019-12-31	3.45%	2.32%	
MORGAN STANLEY	410,207	2019-12-31	0.02%	2.13%	
BANK OF AMERICA CORP /DE/	385,945	2019-12-31	0.01%	2.01%	
Bank of New York Mellon Corp	373,359	2019-12-31	0.02%	1.94%	
DIMENSIONAL FUND ADVISORS LP	369,635	2019-12-31	0.03%	1.92%	
ARROWSTREET CAPITAL LIMITED PARTNERSHIP	361,280	2019-09-30	0.14%	1.88%	
MILLENNIUM MANAGEMENT LLC	276,730	2019-12-31	0.07%	1.44%	
HHR Asset Management, LLC	235,121	2019-12-31	4.80%	1.22%	
DEUTSCHE BANK AG	225,841	2019-12-31	0.03%	1.17%	
GEODE CAPITAL MANAGEMENT, LLC	219,064	2019-12-31	0.01%	1.14%	
NORGES BANK	212,749	2019-12-31	0.01%	1.11%	

RH stock top fund holders – source: [Gurufocus](#)

Therefore, if you invest in RH, you have to move as fast as the CEO.

The business is of a cyclical nature, leaning towards the luxury side of things. This means that when there is plenty of money in the system, sales will be good and the investments in new stores will look smart. However, at any economic contraction, sales will suffer, stores will be empty and fundamentals will look terrible. At the moment, the only thing holding the business up are cash flows. In a bad year, or two bad years, that will always come as demand depends on the strength of the economy but also on consumer preferences, cash flows might turn negative. When cash flows turn negative, and eventually they will, perhaps already in 2020, the company will have to pay the full price of the financial engineering transactions from the past. A normal company, without this much financial engineering would have a buffer for bad times. RH doesn't have it.

So, for an investment strategy, you have to watch the willingness Americans have to buy overpriced furniture, sorry, upscale furniture, and then try to estimate when will the company be able to borrow more and do more buybacks. The thing is that due to the small float and high short interest, they can push the stock up significantly without much money. Therefore, I would consider RH to be a speculative stock where you can make good money thanks to the company's financial engineering. But, don't forget, when you make you money you have to sell, RH doesn't have a safety buffer for bad times. And, trust me, bad times always come.

From a business perspective, this company will make \$200 million in legit profits and cash flows per year, perhaps \$300 over the next decade alongside growth and thus at the current market cap, it gives a return of around 20%.

However, given the shop closures, and the fact that current liabilities amount to \$982 million against \$438 million of inventories they can't sell at the moment, alongside \$47.6 million in cash, tells me the only question here is whether RH will survive this crisis and if it survives how costly will it be for current shareholders. Dilution would revoke all the good that has been done with financial engineering over the past years. Well, except for those that sold.