My Best Short Idea: LL Flooring (LL)

Written by a person in the flooring industry who wishes to remain anonymous

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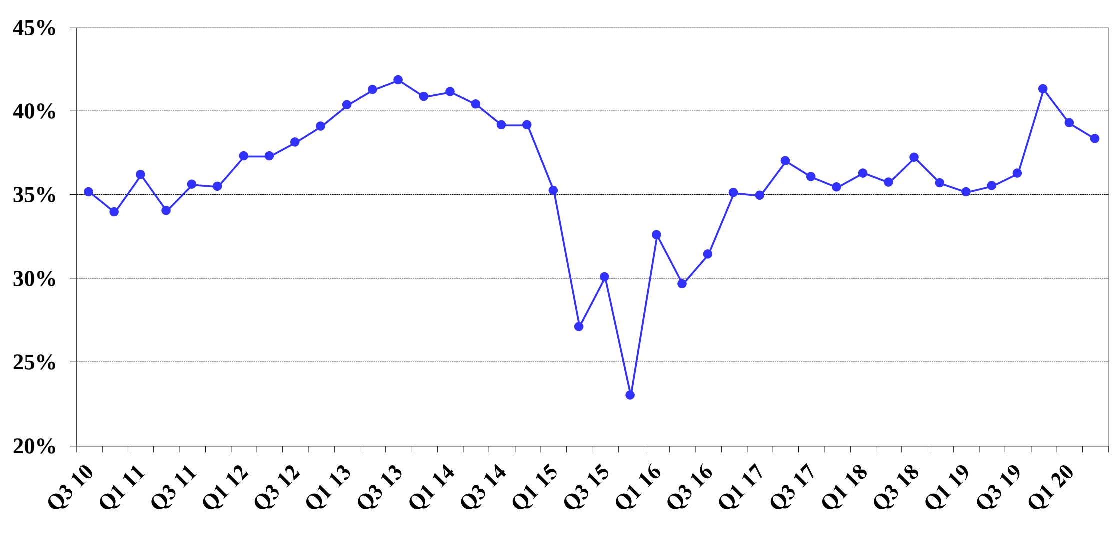
Summary
The stock of Lumber Liquidators (recently rebranded as LL Flooring) has been on a wild ride this year, starting at $9.77, crashing to $3.77 in March, before soaring 685% to a recent high of nearly $30 on the home improvement "COVID bump."

Though the stock has pulled back to $22.36, I still believe it's a great short, as the company is unlikely to meet Wall Street's expectations for the following reasons:

- Gross margins will be under pressure since the List 3 tariff exemption was recently repealed, which means that the ~43% of products LL sells that are imported from China are now subject to a 25% tariff.
- Container shipping rates have jumped dramatically in the last 30 days and will likely remain elevated for some time until supply and demand imbalances are remedied.
- LL imports almost all of its Luxury Vinyl Tile (LVT) from Asia and its laminate and tile from Europe. The USD is weakening as the pandemic recedes and the "fear trade" unwinds, making LL's inventory purchases more expensive in dollar terms.
- LL's total inventory at the end of the second quarter was the lowest it has been since the first quarter of 2016, and on a per store basis it is the lowest since 2009. Replenishing this inventory in a world of elevated shipping rates, a weaker dollar, and an additional 25% tariff will put LL at a disadvantage to its larger competitors.
- The home improvement boom may be fading.
- The core small box concept may prove disadvantageous in the age of social distancing.
- Rebranding may be a distraction.

Gross margin
During LL's best days, its gross margin exceeded 40% before being crushed by the devastating *60 Minutes* story in March 2015, as you can see in this chart:

LL Gross Margin

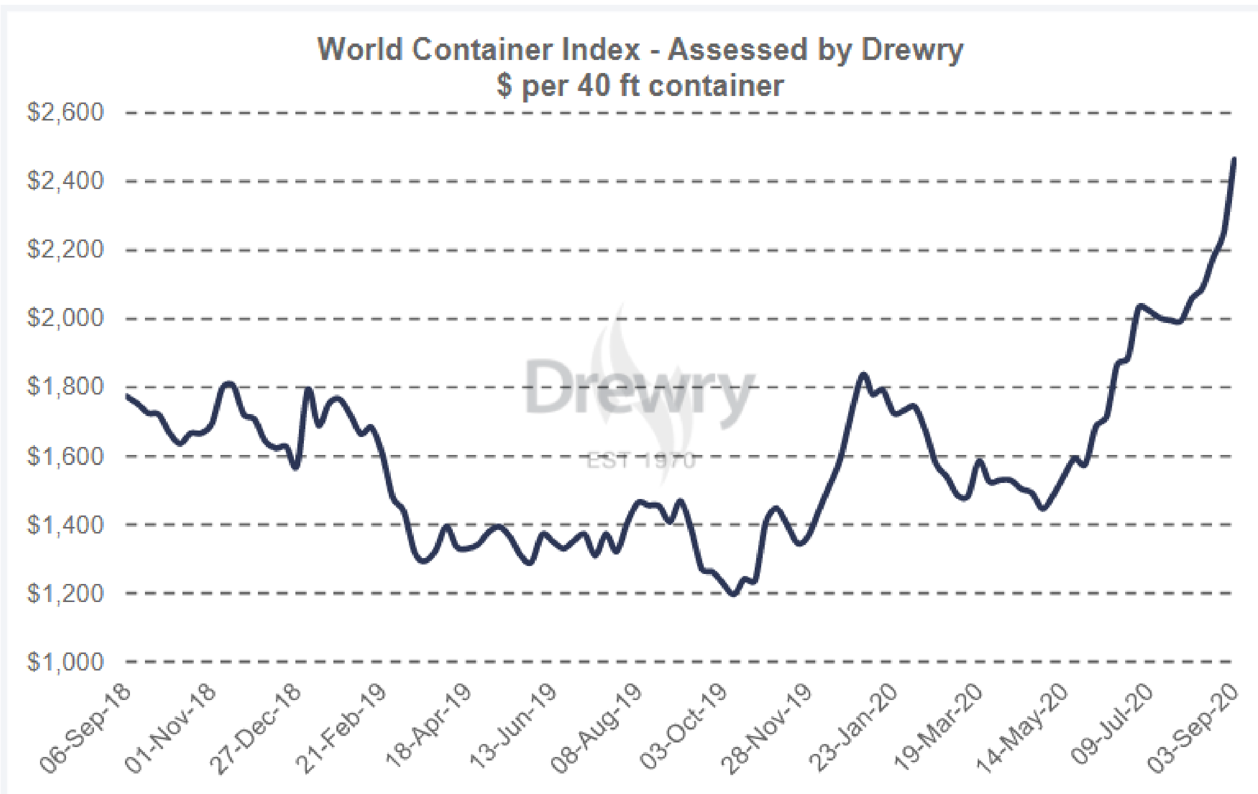


Gross margin reached a post-*60 Minutes* high of 37.2% in Q3 2018, but then in late September 2018 the Trump administration imposed a 10% tariff on many Chinese products (including everything LL sourced there – roughly half of its total business). It then increased the tariff in May 2019 to 25%.

This reduced LL's gross margin to the 35-36% range for most of 2019, until the U.S. Trade Representative granted an exemption to these tariffs in November 2019, which led gross margin to spike up to over 41% and remain above 38% since then.

The tariff exemption expired on August 7, however, which will pressure LL's margins once again.

Container shipping rates
As you can see in the chart below, the COVID-19 pandemic initially caused container shipping rates to plunge by more than 20%, but have since risen by nearly 80%:



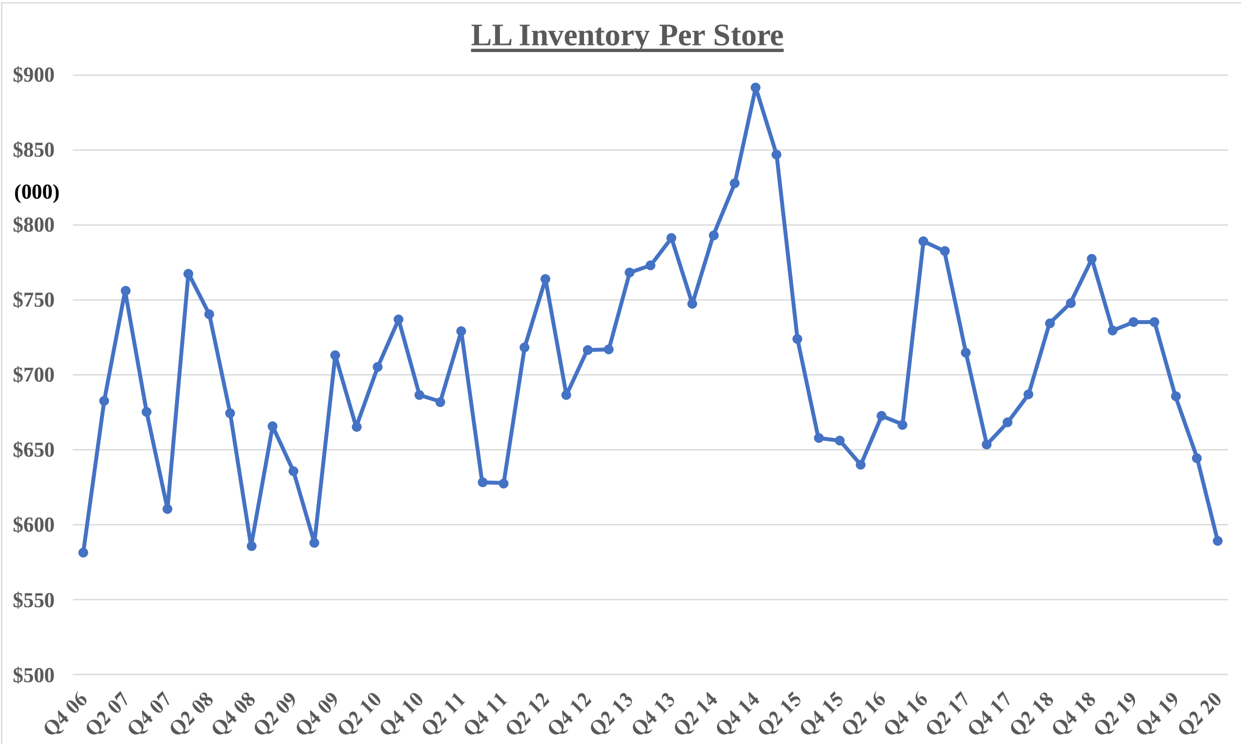
While it's possible that LL hedges some of this with longer term shipping contracts, the company notes in its 10K: "if the cost of fuel or other costs, such as import tariffs, duties and international container rates rise it could result in increases in our cost of sales due to additional transportation charges and fees."

Weakening dollar
Over the last year, the dollar has steadily weakened vs. the Chinese yuan, reaching the lowest level in over a year:

Similar, the dollar has also weakened vs. the euro:

This will, of course, raise the cost of the vast majority of what LL buys.

Inventory
LL's total inventory at the end of the second quarter was the lowest it has been since the first quarter of 2016, and on a per store basis it is the lowest since 2009, as you can see in this chart:



Replenishing this inventory in a world of elevated shipping rates, a weaker dollar, and an additional 25% tariff will put LL at a disadvantage to its larger competitors.

Additionally, the amount of inventory in transit at the end of last quarter was the lowest level in a decade. When you consider that LL has added almost 200 stores in the past decade, doubling in size, there is considerable risk of out-of-stocks and lost sales.

The home improvement boom may be fading
LL no doubt benefited from the Work from Home (WFH) migration, which led many homeowners to build or remodel their home offices. Now, however, families are preparing for the back-to-school season, making traditional purchases of clothes, school suppliers, computers, and tablets, so there may be less money available for flooring.

Indeed, my survey of flooring contractors is pointing to more normalized spending on flooring as delayed spring home improvement projects and demand pulled forward from the fall is starting to wind down.

LL's small box concept may prove disadvantageous
The last pillar of my short thesis is LL's comparative disadvantages vs. its larger peers (HD, FND and LOW). LL's small showrooms (800-1,000 square feet) may be perceived as uncomfortable in a post-COVID world where personal space is a priority. I further suspect that FND's larger (and therefore safer) format will become part of its advertising and value proposition going forward. This, combined with its other inherent advantages (larger sample displays and in-stock job lot quantities), as well as its record high inventory levels thanks to the introduction of its new

Baltimore distribution center, will allow it to grab more market share not only from independents but also from HD, LOW and LL.

Less than five years ago, FND had the same revenue as LL, but is now twice as large – and continues to grow much faster. And of course both are dwarfed by home improvement giants HD and LOW. This means that LL has little or no pricing power.

My recent store visits highlight this. LL has set its pricing for LVT to match FND and HD in markets in which they compete, and has once again taken away its store managers' ability to negotiate pricing with customers. Historically, this has always resulted in lower conversions, reduced traffic counts, and disappointing same-store sales.

And look out below if one or more of the big guys decide to get aggressive on pricing (or, heaven forbid, Amazon decides to enter the market).

Rebranding may be a distraction
LL recently decided to rebrand itself, changing its name from Lumber Liquidators to LL Flooring.

In the past, whenever LL has attempted to multitask, it's lost focus and performed poorly. Previous management frequently cited the company's inability to focus on operations as a major reason for LL's underperformance after 60 Minutes.

I question whether now, in the middle of a pandemic, is the right time for LL to rebrand, especially when it faces the headwinds I outlined above. Time will tell if the company is up to the task...

My financial estimates
Analysts currently estimate that LL will have a gross margin of 38% in 2021, which will translate into earnings of $1.04 per share.

Even if container rates normalize, however, for the many reasons outlined above, I do not see how LL will be able to surpass the 36% gross margin it averaged in 2017, 2018 and most of 2019.

If I'm right that LL's gross margin will be 36%, not the 38% that analysts are expecting, then this will result in nearly a 60% earnings miss next year, as I outline here:

	Consensus	**My Estimate**
Sales	$1,170.0	$1,170.0
Gross Profit	$444.6	$421.2
SG&A	$401.5	$401.5
EBIT	$43.1	$19.7
Other Exp	$3.0	$3.0
Net Income	$30.0	$12.5
EPS	$1.04	$0.43