

Company: Floor and Decor	Ticker: FND Price: \$76.59	Industry: Home Improvement Retail Sub Industry: Hard-Surface Flooring	
Target Price: \$87.63	TTM P/E: 29.94x	Beta: 1.81	Market Cap: \$8.12 Billion
Stop Loss: 25%	Forward P/E: 25x	Credit Rating: Aa3 (Moody's)	Avg. Vol. (12 M): 1.2M
52 Week High/Low: \$133.31/\$51.91	EPS: \$2.95 LTM	Rating Outlook: Stable	Div. Yield: 0.00% annual

Company Background:

FND operates 133 warehouse-format stores across 30 states. The stores are large, averaging 76,000 square feet (about twice the area of a large mansion), and unique, offering an unparalleled selection of tile, wood, laminate, and natural stone flooring. In addition, the company sells decorative accessories and flooring installation accessories, such as underlayment, grout, and tools.

The warehouse-style store features soaring ceilings, clear signage that displays products and their prices, and merchandise displays which allow customers to visualize how the product would look like in their home. Each store also includes a design center, which highlights project ideas and offers free consultation with a design expert. A Floor and Decor store is a one-stop-shop for customers looking to complete flooring projects.

Industry Outlook:

The hardwood flooring industry is a fragmented \$24B industry that has grown at 6% per year in the last five years and is estimated to grow 3%-6% per year through 2024. Currently, 35% of the market share is held by local "mom-and-pop" shops, 30% by home improvement retailers (Home Depot, Lowe's), and 27% by large distributors. Floor and Decor has an 8% market share.

The Tile Shop and LL Flooring (formerly Lumber Liquidators) are two other niche flooring retailers that compete directly with FND. Unable to match FND's prices and selection, both businesses have been losing share to FND at expeditious rates. After years of stagnating revenues and declining earnings, The Tile Shop delisted from the Nasdaq in Q4 2019. LL Flooring, unable to match FND's combination of price, service, and in-stock SKU selection (the pro customer needs to purchase materials today, so the in-stock selection means a great deal), has been unable to attract a meaningful pro-customer demographic. Currently, Floor and Decor's revenue is 3x the size of LL Flooring's revenue and 10x the size of the Tile Shop's revenue. In the next five years, the revenue gap should widen even further as FND grows its store base by 20% p.a.

Home Depot and Lowe's will remain formidable competitors to Floor and Decor but will never come close to matching FND's in-stock selection and pricing, given FND's relentless focus on the hardwood flooring category and the inherent inability of HD/LOW to devote focus to the niche. In fact, the selection and pricing gap between FND and the big box home improvement centers should widen over time as FND leverages its scale, cost advantages, and relationships with flooring manufacturers.

Investment Thesis:

When scalable physical retail concepts work well, the returns can be remarkable given the high ROIC per store, the ability to use vendor payables to finance working capital, and the inherent leverage that occurs when you spread supply chain and SG&A costs over a larger store base. In the past five years, however, Amazon and e-commerce have disrupted the physical retailing business and driven countless brick-and-mortar retailers out of business. Nevertheless, there is a small subset of physical retailers with structural characteristics that allow them to thrive in an era otherwise dominated by e-commerce.

One physical retail sector that has been especially resilient to the threat of e-commerce has been the home improvement industry, as projects tend to require technical knowledge, materials are bulky and difficult to ship, and customers prefer to see and touch the products in real life before making a purchase decision. Additionally, the installed base of homes is always growing – or at the very least, not shrinking – which provides a favorable backdrop for companies specializing in home improvement niches.

One exceptionally high-quality company I like in this space, due to its long growth runway, increasing market dominance, and significant scale advantages, is Floor and Decor (FND).

Floor and Decor is a niche retailer of hard-surface flooring and related accessories. The company is a category-killer with a differentiated business model, talented management team, and long reinvestment runway.

Founded in 2000, FND occupies a single digit percentage (8%) of the highly fragmented and growing \$24B hardwood flooring industry. Their unique supply chain, impressive scale, and relentless customer focus allow them to be the hardwood flooring industry's low-price leader, inventory leader, and sourcing leader.

Operating on the Everyday Low Price (EDLP) model, FND is razor-focused on providing a superior customer experience via better selection, lower prices, larger in-stock inventory, and better service than its competitors. These structural characteristics will allow FND to continue to take market share from both big box home improvement retailers (Home Depot, Lowe's) and small independent flooring companies for years to come.

In the next decade, the company should be able to 4x store count, grow same store sales (SSS) by 10% per year, and significantly increase EBITDA margins as its stores mature and it spreads its expenses across a larger store base. In the next five years,

Investment Risks:

Housing weakness: FND's business depends upon remodeling of existing homes and new home construction, both of which are heavily influenced by interest rates, consumer confidence, credit availability, and external macroeconomic factors outside of the company's control.

Competition adopts FND's model: Competition to Floor and Decor in the hardwood flooring industry right now is, in a word, weak. If the big box home improvement retailers increase their focus on this category, that could hurt Floor and Decor's sales and margins. However, to compete with FND in flooring selection, Home Depot/Lowes would have to dedicate a far larger section of their store to flooring, and to compete on price, they would have to alter their 3rd-party distribution supply chain model and rely on direct sourcing like FND. I view both scenarios as highly unlikely.

New e-commerce competitor emerges and disrupts FND's model, similar to what Carvana is doing to the used car industry: Currently, there is no e-commerce company that comes close to FND's combination of pricing, selection, and service. However, this will be an area to closely monitor. If this happens, it will take incredible sourcing and inventory resources and will likely occur over several years. This gives me plenty of time to change my mind if it is indeed a legitimate threat to FND and management does not address the threat accordingly. It will also be an opportunity to use Polen Capital's "moat attack" framework to determine how strong FND's competitive advantages truly are (I for one think they are pretty strong and will take a pretty formidable competitor to dislodge).