Alternative Research Services, Inc.

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TPX -- $71.54

- Sell short
- TPX disappoints on guidance, outlook cautious
- Stock down 12+ points pre-market

Market Cap.	$5.3 b
Shares Out.	63.8 m
Short Interest	6.2 m
Days short	6.0 days
Avg. Daily Vol.	2.0 m
St. eps est. 2012	$3.96
St. eps est. 2013	$4.78
Px/book	53.5x
Px/sales	3.7x
Px/ EBITDA	14.8x

Source: Bloomberg

TPX 1Q12 Earnings: Slight Beat, Guided Below Consensus for FY12

Clearly, TPX's fundamentals reached an apex during the quarter. It is too bad short investors had to tolerate a rise from $60 to $90 to get paid. We've heard investors express that it's better to be right on Research and wrong on trading than the other way around. (Sometimes we are not so sure.) Still, TPX is finally going our way. Today, with the stock down 10 points on disappointing guidance, the market is re-pricing the p/e ratio to represent the guidance. Instead of trading at 22x the $3.96 estimate, it's trading at 18x, commensurate with the revenue growth rate. Mattress sales were up 18%, but advertising was up 37% yoy. Going forward, we think the p/e will continue to contract at least through the balance of the year. For at least the last decade, plus, there have been attempts made by competitors to dethrone TPX, without success. They've been bullet proof until now. Now, the lower guidance signals that iComfort is a truly viable competitor. As we've documented in earlier reports, TPX has become the vendor the retailers love to hate. With iComfort's success, all that accumulated negative goodwill from retailers is likely to negatively affect TPX going forward, leading to even greater p/e contraction over time.

Management's comments on the call regarding the outlook for the balance of FY12 were more toned down than in previous quarters, supposedly reflecting conservatism and cautiousness on their part. We think they have good reason to be worried. Serta's iComfort continues to take share at mid-to-lower price points in the space; SCSS is aggressively promoting the growth of the m7 – its first true memory foam offering – at mid-to-high price points. Sealy is rebranding its Embody line in 1Q12, re-launching it as a new 5 model Optimum line with price points spanning the ASP spectrum.

The Quarter

EPS of $0.86 on 65.7M shares, up 26.5% YoY from $0.68 on 70.9M shares in 1Q11. Rev up 18% to $383.4M vs $325.8M in 1Q11. GM 53.6%, up 132 BPs from 52.3% in 1Q11. S&M as a percent of sales 21.7% vs. 19.8% in 1Q11. Advertising was up by 37% to $47 million. Op Inc $86.1M, up 14.3% from $75.3M in 1Q11. Op margin 22.4%, down 71 BPs YoY and down 101 BPs sequentially, continuing last quarter's trend of contraction after being up triple digit BPS YoY from 3Q09 through 3Q11. Net Income $56.2M, up 16.5% vs $48.3M in 1Q11. Net margin 14.6%, down 19 BPs YoY and down 73 BPs sequentially, also continuing last quarter's trend of contractions, after being up triple digit BPs YoY from 3Q09 through 3Q11. Net income aided by the lower effective tax rate in 1Q12 of 31.1%, down from 33.1% in 1Q11 and below two-year average of 32.6%.

<Q>: "We saw one of your competitors out the other night. Where do you think you stack? Are you just in the middle of a product cycle? Or where do you think this looks versus your long-term growth rate?"
<A>: "Well, I'm not quite sure what you mean by long-term growth rate -- what we're -- as we look at the market, we're up 18% this quarter on top of very significant growth last year and consistent with our growth projections for the full-year…But as we look forward to our full year, we're pretty confident that we're going to continue to gain share as we have been for the past years.""On your first question regarding - you were asking about the long-term growth rate, in February at our Investor Day, we talked about - reiterated and talked about the $2-billion growth plan. Obviously, to hit $2 billion in 2014, we have to compound growth at 12%."

<Q>: "And in the first quarter, did you gain share in a specialty?"
<A>: "In specialty, probably not. But remember, that's a challenge when you think that in it -- for a long time, we were a very dominant player. As new people come in, the dominant player is always going to be impacted disproportionately. We look at it as a share of the total category. And in that, we believe we will continue to grow."

<Q>: "I just had a question on the guidance. By my math, the top-line guidance of $1.6 billion to $1.65 million implies growth through the balance of the year somewhat below what you experienced in the first quarter. And, with the launch of Simplicity, the benefit of the incremental advertising spending, it's not immediately intuitive to me why that might be the case. Is there just a - does this more to have to do with conservatism because we're early in a year or is there something else you see there?"
<A>: While we're accelerating the rollout of Simplicity, we haven't changed the plan that we had for the year regarding what Simplicity would do at this stage. It's only been in the market for a couple of weeks.

One other thing that I would comment on from a total year standpoint, at the start of the year we thought FX would be fairly neutral this year. It proved to be a headwind in the first quarter based on how the euro specifically is trading. It doesn't look - and the continued uncertainty around particularly the European markets. We're performing very well there but, well, you read uncertainty as to what the economies really - economies over there are doing. So, we're trying to be a little bit cautious. We've built in - FX is now going to be a headwind for the year. We'll see pressure from FX as the year goes on.

Channel Indicating Headwinds for TPX in the sub-$2,000 ASP market

The Simplicity (new product line) consists of three models offered at the same $1,499 price, differentiated only by relative firmness/softness. There is no "good, better, best" scheme in this product line. The roll-out started in the last days of March and continues through the current quarter (2Q12). Before last night's earnings call, management had a planned 6 to 9-month roll-out for the line. On last night's call, they announced that they are accelerating the roll-out, and expect it to be completed within six months, with "heavy concentration" in 2Q12.

Being this early in the roll-out, what we have heard so far in our channel checks is mostly anecdotal. The feedback we've received is consistently strong opinions from the channel that TPX will hurt its brand equity by venturing into the sub-$2000 ASP market. One of our manufacturer sources said that for the retail price at which TPX is offering the Simplicity, TPX would have to: a) skimp on the amount of foam in each mattress, such that the products will not physically feel like other, higher-priced TPX models; and/or, b) take lower margins on these new lines.

VP of marketing at mid-cap publicly traded furniture retailer: "I will say this to you about Tempur…things will not be as easy for Tempur as they have been in the past because Serta has more leverage in the market and it [Simplicity] will be much more of a product for a price comparison than it used to be. The Tempur brand is very strong, but Serta is making an impact with the new iComfort products."Specialty retailer: "I am receiving my Simplicity floor samples tomorrow, so I have nothing to report. I spoke to a friend who is a big Tempur dealer and he also carries the I Comfort line. He chose not to bring in the simplicity line as he is concerned that the beds won't hold up and will bring down the Tempur reputation. He covers that price point with the IComfort.

According to him, the Icomforts that sell are $1500 to $2500. The more expensive models don't sell because they feel the same as the less expensive models and don't have enough of a selling story to convince customers to upgrade and spend the extra $1000. He said that I comfort hasn't cannibalized his tempur business and he doesn't have the Simplicity line."

Less Help from Pricing in FY12

Recall, TPX increases prices every February. Last year, management took significant price increases, especially on the Cloud line, giving a huge boost to the top line and gm through the year. That level of boost isn't there this year, as TPX finishes anniversary those major price hikes in 2Q12, and has implemented less expensive price increases in the current year. Management doesn't disclose the exact price hikes it takes with any consistency, but on last night's call, they indicated that price increases this year were "heavily weighted to non-high volume sizes," such as twins and kings while leaving Queens untouched.

From what we observed in our research, in 1Q12, TPX took price increases on two lines within the Contour collection only, as follows: Contour - Twin long +$150, Queen +$200, King +$300; Contour Select - Twin long +$100, Queen +$300, King +$500. (Contour is the harder/firmer, pre-Cloud mattress line.) All other prices on Twin longs, Queens, and Kings for all other models remain the same. Most importantly, pricing on the Cloud series — which has been the main driver for TPX's growth over the past six quarters — remain untouched. Our channel checked in December 2011, and January 2012 indicated that Contour is not the market-expanding model for TPX.

SCSS 1Q12 Earnings Call

"…we continue to evolve and invest in our marketing strategy, an optimized approach to media that combines the reach and frequency of national broadcast TV with additional targeted national and local initiatives...[i]n order to raise awareness and reach our redefined broader target customer, we increased our media spend by 48% over the previous year. This supported an additional week of national broad reach TV with improved reach and frequency, resulting in increased traffic over previous quarters."

"During the quarter, we also increased local media spend as part of our local market development plan, which includes the aggressive growth strategy for large metro markets.""Customers and our sleep professionals have responded positively to the introduction of the m7, which resulted in a mix increase of nearly 600 basis points over the prior year memory foam offering.""The second quarter is our seasonal low period. It's always more challenging because the quarter lacks a robust consumer mattress shopping event….[t]o that end, we plan to invest in media at a similar percent of sales to the first quarter."

"Media spend of $35 million was up 48%, and media as a percent of sales increased to 13.4%...[m]arketing, and media, in particular will remain an area of investment, and gross margin is expected to be roughly flat for the full year."

<Q>: "We've been hearing that there have been some cost increases, particularly in foam, announced fairly recently. Did that have any impact on the quarter? And what kind of impact do you see on that for the rest of the year?"
<A>: "Yes, in the first quarter, as we've done in the past, we've managed any increases in commodities with supply-chain efficiencies and also working with our suppliers to mitigate the impact. As we look to the balance of the year, Budd, we expect low single-digit raw material cost increases with, as you mentioned, with most notable pressure in foam, driven by its raw material components. But again, we intend to manage any of those increases with efficiencies in our operations, and again, working with our suppliers to mitigate the impact."

<Q>: “Okay. And then marketing spend, 13.4%, same number, second quarter, maybe an error, but I had 13% in my brain for ‘12. So are we looking at a decline in the second half, or no, we’re just going to keep spending because it’s working?”

<A>: “So what we said there last time was that we expected to -- that we would likely exceed 13%, and we were talking for the full year, and we don’t provide quarterly guidance. But for the full year, we said it could exceed 13%.”