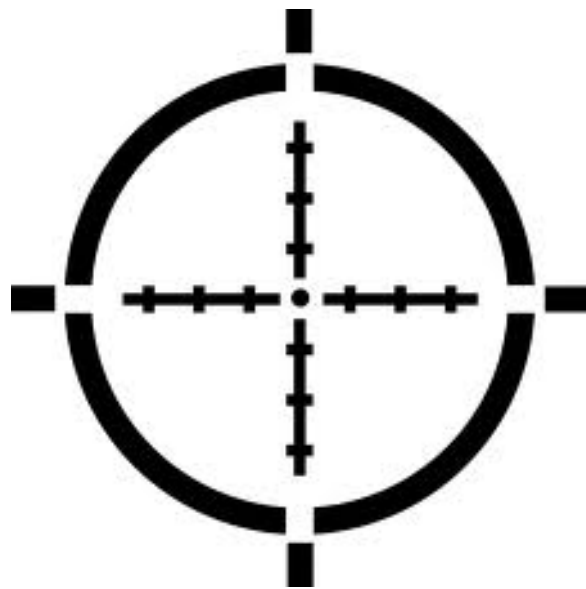


# Restoration Hardware

## Client Report

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## Executive Summary

Restoration Hardware (RH) is chain store of upscale home décor, furnishings, linens, hardware, textiles, bathware and outdoor/garden products. Moreover, Restoration Hardware sells period-inspired décor, traditional furniture and quirky items to give customers an aged touch to their home. They currently target consumers who have annual incomes exceeding \$250,000. As of February of 2013, RH has nearly 3,100 employees, with 2,100 being full-time employees.<sup>1</sup>

The home décor market is littered with competitors, but Restoration Hardware attempts to slide into the upper echelon décor sector. RH's list of competitors includes Crate & Barrel, Pier 1 Imports, and Pottery Barn. Unfortunately, that upper tier market niche is somewhat dissipating and DangerZone Consulting has been hired to help revamp RH's name and market presence.

The current transformation of Restoration Hardware's marketing approach is proving to be successful. Historically, RH has been a traditional décor and furniture store with items clustered and displayed by kind. The progression of Restoration Hardware stores to the showroom layout first executed in the flagship store in Boston not only enhances potential customer's shopping experiences, but also gives the RH brand a new modern edge and opportunities to further the company.

DangerZone Consulting was able to identify certain areas to improve and further separate RH from the competition. Our team believes it crucial that Restoration Hardware continue implementing the showroom stores in large centralized locations. By doing so, Restoration Hardware can allow customers to be their own designers and preview how the products work together for full room décor. Given the narrow consumer market RH targets, the company can help attract their target market through upscale event hosting, such as wine tastings and art galas.

Restoration Hardware seems poised to return to profitable levels as the housing market continues to recover. Small changes in marketing tactics and infrastructure improvement can help solidify the company's future. Restoration Hardware has a strong foundation that can be fine-tuned to help succeed moving forward and build a stature of financial strength and stability.

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<sup>1</sup> <http://ir.restorationhardware.com/phoenix.zhtml?c=79100&p=irol-faq>

## History

Stephen Gordon was in the process of decorating his house in Eureka, California, shortly after finishing a remodel. Gordon desired period oriented décor and furnishings more upscale than cheaper brand name décor, but did not want to overpay a professional decorator who did not necessarily have the same vision as he. There was no such niche in the home decoration market at the time. Thus, Gordon realized the need for upscale period oriented décor in the marketplace and founded Restoration Hardware in 1979.<sup>2</sup>

Gordon opened the first Restoration Hardware store in Eureka and initially stocked the store with unique, miscellaneous and hard to find items aimed to decorate and refurbish older houses. The approach proved successful and by 1990 four additional stores were opened throughout California, with a majority being concentrated in Northern California.

In 1994, the Restoration Hardware Company only operated 5 stores but managed a total retail sale value of \$4.2 million. While Gordon's vision came to fruition, he soon realized he did not possess the knowledge to successfully run the expanding company.

Shortly after experiencing such large revenue streams, Gordon hired Thomas Christopher to a management position to help with the expansion of Restoration Hardware. Christopher was a former executive of Pier 1 imports and Barnes and Noble, making him an obvious choice due to his familiarity with RH's market and consumer base. Gordon did not stop there and proceeded to hire Thomas Low to the Senior Vice-President and Chief Financial Officer positions towards the end of 1994. Low also had experience in the market as he had previously worked for Home Express.

The new management tripled RH's revenues to \$13.2 million in 1995. Moving quickly, Gordon along with the new management team opened their first store outside the western US in 1996 in Detroit. Christopher urged Gordon to take the expansion through Detroit as he previously had much success with Pier 1 and Barnes and Noble in that area. The expansion proved to be effective and revenues kept climbing as new stores were being opened throughout the country. When Restoration Hardware first went public in June of 1998, there were a total of 47 stores throughout

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<sup>2</sup> <http://articles.latimes.com/2001/mar/23/business/fi-41574>

the US, mainly located on the West Coast. Their IPO price was set at \$19 a share and raised nearly \$75 million for the company.<sup>3</sup> Within the first year of being publicly traded, RH nearly doubled the number of stores in operation.

In the early 2000s, the company attempted to continue its rapid expansion, but combining costly expansionary efforts with the housing market downturn resulted in significant losses for RH and its shareholders. With RH's target niche being upscale home décor, their success heavily depends on people remodeling or buying houses to decorate. Thus, RH saw a significant revenue downturn. Attempting to mitigate the free fall, the company experienced a management turnover as Gary Friedman, a former president of Pottery Barn, was appointed to the positions of Chairman and co-Executive Officer.

Over the next few years Restoration Hardware's stock price wavered and there was little to be done in any recovery efforts given the specific high-end nature of their products and the housing market state. Ultimately, Restoration Hardware was taken private in 2008 in an attempt to restructure the company.<sup>4</sup>

After reshaping the inner workings of Restoration Hardware, the company once again went public in 2012 at an IPO price of \$24 a share.<sup>5</sup> When the company went public for a second time, Catterton Partners appointed Gary Friedman to be CEO, as well as hold the title of Chairman, Creator and Curator. Friedman still leads Restoration Hardware with a well-versed team, including Chief Operations Officer Ken Dunaj. Less than a year ago, co-CEO of Restoration Hardware Carlos Alberini announced his resignation from the position.<sup>6</sup> Mr. Alberini accepted the position of Chairman of the Board and Chief Executive Officer of Lucky Brand. Being one of the key cogs in Restoration Hardware's revival, Mr. Alberini continues to serve on the Board of Directors of RH Holdings and remains a significant shareholder of the company.<sup>7</sup>

Recently, Restoration Hardware has explored a shift in store mold by opening what is known as a

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<sup>3</sup> <http://articles.latimes.com/1998/jun/04/business/fi-56354>

<sup>4</sup> <http://www.dmnews.com/restoration-hardware-taken-private/article/111434/>

<sup>5</sup> <http://online.wsj.com/news/articles/SB10001424052748704436004576300181946707482>

<sup>6</sup> <http://www.restorationhardware.com/company-info/management-team.jsp>

<sup>7</sup> <http://online.wsj.com/news/articles/SB10001424052702304477704579254610560853466>

“flagship” store. RH built a sleek and modern showroom style store near Boston’s Back Bay and has already seen a sales increase over the past year. The company hopes to employ more of these larger showroom stores in centralized locations within the coming years.

As the economy recovers and housing market expands, Restoration Hardware hopes to regain its market niche of high-end, high quality, quirky commodities that appeal to those self-decorating. Restoration Hardware sells themselves on high quality American goods that range from mini replica canoes to sleek faucets to hanging curtains that all aim at bringing an upscale historic and nostalgic touch to people’s home.

## Financial Analysis

### Revenues & Profitability

Finishing the year strong, Restoration Hardware recently posted net gains for both Q4 and fiscal 2013. RH reported fourth quarter revenues at \$471.7 million, which despite falling just short of estimates (~\$493 million) reflects the robust 22% increase in direct sales and 16% increase in store sales. Boosted largely by such a fruitful fourth quarter, total net revenues increased by 30% in fiscal 2013, ballooning to \$1.55 billion from \$1.19 billion; this demonstrates an acceleration of revenue growth, as fiscal 2012 only grew total revenues by 25%.<sup>8</sup> Far outperforming the 8.7% industry average of revenue growth, it remains somewhat unclear whether or not this success is trickling down to the company's bottom line.

Fourth quarter adjusted net income, posted at \$26.64 million, allowed RH to bounce back from losses in both the previous quarter and year in 2012. On the whole, fiscal 2012 was in the red at a loss of \$12.79 million, as Q4 alone saw a loss of \$28.36 million. Luckily, the recent standout fourth quarter was able to compensate for similar losses that occurred in Q2 2013, at \$17.84 million. Fiscal 2013 was the second of the last five years to post a positive net income after taxes, at \$18.2 million.

Gross profit margin demonstrated a steady upward trend throughout the year, and continues to hover around 35%, as it has at the close of the last 5 fiscal years; this remains above the industry and market medians, 31.1% and 33.48% respectively.<sup>9</sup>

Net profit margin increased from 2.41% to 5.65% from Q3 to Q4 2013, which is up from a negative 7.13% margin the same quarter the year prior. The profit margin (ttm) is 1.17% from -1.07%. While more sustainable, this low margin is still not competitive within the industry, where the median is 3.31% and top competitors such as Ethan Allen, Pier 1, and Williams Sonoma boast margins of 4.10%, 7.60%, and 6.35% respectively.<sup>10</sup>

For fiscal 2013, RH achieved return on assets of 2.01%, return on equity of 3.65%, and return on capital of 2.4%. These are all up from negative returns in fiscal 2012, of -1.86%,

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<sup>8</sup> <http://subscriber.hoovers.com/H/company360/cashFlows.html?companyId=5694300000000&newsCompanyDuns=092554427>

<sup>9</sup> <http://subscriber.hoovers.com/H/company360/overview.html?companyId=5694300000000>

<sup>10</sup> <http://finance.yahoo.com/q/co?s=RH+Competitors>

-3.64% and -3.62% respectively. However, all of these remain far below industry averages of 5.24%, 13.76% and 13.05% respectively. This may indicate inefficient management of equity base, investments and capital. Even more concerning, is that some of RH's top competitors, for example, Williams-Sonoma and Pier 1, are able to maintain returns between 12%-25%.<sup>11</sup>

Restoration Hardware currently maintains an intermediate leverage ratio within its peer group, at 1.75. RH and top competitors Ethan Allen (1.85), Pier 1 (1.60), and Williams-Sonoma (1.67) all fall below the industry average of 2.68.

### **Balance Sheet**

Total assets have increased from \$789.6 million to \$1.03 billion. This gain largely reflects the increase in inventories from \$353.33 million to \$453.85 million, as well as acquisition of property and equipment, which roughly doubled from \$111.4 million to \$214.9 million.

Total liabilities increased from \$338.0 million to \$479.83 million, and Stockholders' equity rose to \$545.27 million from \$251.61 million - composed entirely of common stock equity.

### **Cash & Liquidity**

With a quick ratio of .23, sinking as low as .1 in the latest quarter, there exist some concerns regarding the company's ability to meet short-term obligations with its most liquid assets. Competitor Williams-Sonoma sits around the industry median at .70, while Ethan Allen and Pier 1 are doing slightly better at .93 and 1.22 respectively. Since RH retains large inventory stock, its current ratio is more promising, at 1.93. This is somewhat reassuring, except for the fact that inventory turnover for RH is at 2.53, which is below the industry median of 5.03. Comparatively, Ethan Allen maintains a current ratio of 1.96, and Pier 1 stays ahead at 2.66 - both companies have inventory turnovers comparable to RH. Williams-Sonoma has a lower ratio at 1.65, but compensates with faster inventory turnover at 4.11.<sup>12</sup>

Net cash provided by operating activities was \$87.52 million up from a loss of \$3.86 million in the previous year. The largest contributor to this improvement was the increase of net income,

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<sup>11</sup> <http://ir.restorationhardware.com/phoenix.zhtml?c=79100&p=irol-sec>

<sup>12</sup> <http://finance.yahoo.com/q/co?s=RH+Competitors>



rebounding from a loss of \$12.79 million to a gain of \$18.20 million. The elimination of a large loss in other non-cash items was also helpful.

Capital expenditures almost doubled, putting cash flows from investing activities at \$93.87, compared to \$49.37 in fiscal 2012. Without repayment of term loans and revolving credit lines, cash and cash equivalents at the end of fiscal 2013 increased to \$13.39 million, from \$8.35 million the prior year.<sup>13</sup>

### **Stock Performance, Valuation and Outlook**

Investors were not complaining about hefty price tags after RH posted better-than-expected results for Q4 2013 and a bullish forecast; shares surged despite ratios showing a high premium. Shares closed at \$71.93 on March 28, 2014 on the NYSE, and were predicted to keep rising in the following weeks. There are 38.57 million shares outstanding, and reported Market Capital of 2,781.32 million.<sup>14</sup>

RH currently has a price-to-book ratio of around 5.1, slightly above the industry average of 4.7, yet remaining below competitor Williams-Sonoma's 5.39. The Price-to-sales, at 1.7, is also slightly above the industry average of 1.2, as well as competitors with similar market cap - this may suggest overvaluation. Price-earnings ratio soared to a 163.53 high, suggesting that investors are expecting higher earnings growth in the future; a forward P/E of 27.08 reflects more stability. EPS increased to \$1.71, up 38% on a comparable week basis, and GAPP diluted EPS came in at \$0.45.<sup>15</sup>

The Company provides an estimate of \$1.825 billion to \$1.860 billion in net revenue for the fiscal year ending January 31, 2015. Another prediction places adjusted diluted EPS in the range of \$2.14 to \$2.22.<sup>16</sup> With plans for new and more elaborate stores and strong organic growth, it is possible that RH can overcome their painfully low profit and operating margins by continuing to increase total sales and speed up inventory turnover.

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<sup>13</sup> <http://finance.yahoo.com/q/ks?s=RH+Key+Statistics>

<sup>14</sup> <http://finance.yahoo.com/q/ks?s=RH+Key+Statistics>

<sup>15</sup> <http://www.morningstar.com/invest/stocks/223738-rh-restoration-hardware-holdings-inc.html>

<sup>16</sup> <http://investing.businessweek.com/research/stocks/snapshot/snapshot.asp?ticker=RH>

## Five Forces Analysis

### Internal Rivalry

Restoration Hardware belongs to the home furnishing store market, an industry that is characterized by intense competition. This industry is rather fragmented with the 50 largest companies representing only 35 percent of revenue.<sup>17</sup> The market itself can be broken into several different categories/tiers based upon the targeted customer and demographic. The highest tier is composed of a number of designer furniture stores and upscale independent stores that fill particular niches and sell primarily to interior designers who are shopping for their clients. These designers are looking for very high quality pieces for their clients' homes that are unique/one of a kind. The middle tier targets upper to middle class customers that buy for themselves and are looking for higher-priced, high-quality furnishings. The lower tier that includes stores such as IKEA and a number of furniture departments of stores such as Target and Wal-Mart offer mass-produced, cheaper furniture and furnishings that target lower income customers who cannot afford the more expensive furniture offered by the upper and middle tiers. Restoration Hardware finds itself located somewhere between the upper and middle tiers as it targets upper-middle class customers who are unlikely to hire an interior designer but still desire that experience and are looking for unique, high-quality, and interesting pieces for their homes.

In prosperous economic times, companies in each tier tend to compete primarily with other companies within the same tier and the different targeted demographics has the effect of reducing competition between companies from different tiers. That being said, competition within each tier is very high given the low switching cost between products. A customer can easily pick and choose different pieces from different stores in order to furnish a single room within their house and have it look appealing. Buying a couch from Williams Sonoma does not commit a consumer to buying drapes, coffee table, and chairs from the same firm. As such, the industry experiences intense competition as firms engage in aggressive marketing and advertising campaigns in order to attract customers. At the same time, stores are constantly trying to expand and update their offerings in order to tap into changing customer preferences. The recession and the still recovering state of the economy have only intensified competition within the industry as they have increased competition between industry segments. With individuals hesitant to make big-ticket purchases, disposable

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<sup>17</sup> <http://subscriber.hoovers.com/H/industry360/financials.html?industryId=1518>

income decreases and the housing market being down with much fewer new homes, demand for home furnishings as a whole has decreased in recent years. At the same time, higher income individuals who previously would have bought from stores such as Restoration Hardware may now be looking to purchase cheaper furniture from discount stores and lower tier retailers. That is, a struggling economy intensifies competition within and between tiers in the home furnishings industry as firms compete for a significantly diminished demand.

Restoration Hardware competes with several major groups. First among them are stores similar to themselves that sell exclusively home furnishings to a targeted demographic of upper to middle class customers. Williams-Sonoma and Ethan Allen are chief competitors at the higher end of the price spectrum and stores such as Pier 1 Imports and Crate & Barrel offer up competition at the lower end of the price spectrum.<sup>18</sup> These stores operate primarily through showrooms and engage in dedicated advertising campaigns, increasingly through the Internet but also more traditionally catalogues, in order to attract customers to their stores. In addition to this group, Restoration Hardware competes with the home-furnishings segments of upscale department stores such as Macy's and Nordstrom. However, these department stores follow a slightly different business model in that they emphasize offering a wide variety of different styles, colors, and fabrics whereas companies such as RH tend to focus on providing more unique and distinct products that often come in fewer variations. Furthermore, the industry has also seen the rise of many direct to consumer online retailers in recent years that do not often operate showrooms themselves but still provide considerable competition for the traditional furnishing stores given how much online shopping as a whole has evolved.

Lastly, in recent years, Restoration Hardware has been attempting to further separate itself from other high-end furniture stores by offering its customers more of an interior designer experience without actually hiring one. As part of this strategy, RH has been altering the design of their stores by drastically increasing their size and amenities. The company plans on opening and updating stores so as to include wine bars, performance spaces, and rooftop gardens. With their larger floor space, these stores will offer fully-staged bedrooms, living rooms, dining rooms, and other various rooms including nurseries and billiard lounges. With this strategy, Restoration Hardware has moved itself into competition with major design centers which tend to be large buildings complete

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<sup>18</sup> [http://biz.yahoo.com/ic/737\\_cl\\_all.html](http://biz.yahoo.com/ic/737_cl_all.html)

with a sizable number of showrooms that display products from hundreds of manufacturers. Many of these design centers also offer gardens, restaurants, and other luxurious amenities.

### **Entry**

Entry into the home furnishings industry can be challenging given the existence of several barriers to entry. Chief amongst them is the need to build up a sizable inventory of different products as well as a functional and efficient distribution network/supply chain. Major retailers in a number of industries rely upon a strong inventory in order to handle fluctuations in consumer demand and to ensure that when a customer orders a product, the seller has it in stock and ready to deliver. This inventory buildup represents a major expense for any firm considering entry to the home furnishing industry and may deter them from doing so. In addition, home furnishings stores need to establish efficient distribution networks so that they can effectively deliver their goods to consumers. Many of the larger furnishings stores rely upon major distribution centers/warehouses that serve a number of different stores and show rooms, which themselves carry little inventory. In 2013, RH opened a new \$22 million dollar distribution center in northern Texas to serve as the hub of its southeastern U.S. operations.<sup>19</sup> For large pieces of furniture, companies tend to deliver the good directly to the consumer and in order to accomplish this successfully, firms either own their own fleet of delivery trucks or utilize third-party logistic companies to handle deliveries.

With online shopping becoming a major factor in the home furnishings market and for Restoration Hardware in particular, successful distribution network and inventory management are increasingly important to the success of the firm. In today's society, people expect the goods they want to always be in stock and to be delivered within a couple weeks of purchase and hence, retailers must adapt to meet these expectations by improving inventories and distribution networks. The creation of these distribution networks and delivery services represents another major cost for potential entrants and may deter many from attempting entry. In addition to these high costs of entry, there are also economics of scale within the industry as large chains possess advantages in their ability to reduce costs through large volume purchases as well as offer a diversified and expansive product line that are unsustainable by smaller firms who tend to cater towards niche markets and specialized offerings.

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<sup>19</sup> <http://www.bizjournals.com/dallas/news/2013/05/15/restoration-hardware-to-hire-300.html?page=all>

Another essential aspect to consider with regards to entry into the home furnishings industry is the importance that effective marketing and development of a brand play in the success of firms. Switching costs in the industry are extremely low for consumers and as such, advertising, marketing, and brand establishment are vital to attracting new customers and forming customer loyalty. Restoration Hardware utilizes extensive and detailed catalogs of products that they distribute to millions of potential customers at considerable expense to the company with RH's 2012 catalog reportedly costing the firm \$3 per unit in printing and shipping. With this catalog being shipped to millions of potential customers, this advertising endeavor represents a major expense to the firm. Due to this necessity for brand development, marketing and advertising costs will be extremely high for new entrants as they attempt to develop and market their brand, offering another barrier to entry for potential new firms.

That being said, smaller firms and online-only furniture companies have shown an ability to circumnavigate some of these barriers to entry in recent years. With the increased popularity of online shopping, the industry has seen the emergence of direct-to-consumer, online-only stores that are able to dodge the capital costs associated with establishing showrooms and building up sizable inventories. In addition, online marketing has reduced certain advertising costs as these new firms do not rely upon expensive, lengthy catalogues sent through the mail to attract customers. These online stores and smaller companies tend to target a very narrow demographic and establish themselves within a small niche that eliminates the need for an expansive product line, massive inventories, or costly marketing.

### **Supplier Power**

Home furnishing retail stores such as Restoration Hardware tend not to manufacture the furniture and other home decorating goods themselves but rather rely upon purchasing from external manufacturers, importers, or distributors in order to stock their stores and warehouses with inventory. Due to the broad product line and diversity of products offered by stores in this industry ranging from sheets to clocks to sofas, most retail chains purchase from hundreds if not thousands of suppliers. As such, the industry is characterized by fairly low supplier power as it is distributed across so many different suppliers reducing dependence of the retailer on any one supplier. Furthermore, with so many different manufacturers of furniture and housewares, retailers such as RH have access to a wide array of similar products and substitutes which reduces the bargaining

power of suppliers.

In recent years, the industry has seen a considerable shift with retailers now receiving a great majority of their products from foreign manufacturers and producers. Restoration Hardware gets an extensive percentage of their products from overseas manufactures, particularly from Chinese producers. Such a reliance on imports can expose retailers such as RH to a number of issues, chief amongst them are trade disruptions and price swings. Trade disputes and tariffs as well as changing exchange rates can greatly impact the price the retailers pay to their foreign manufacturers for the products they require for their substantial inventories. These fluctuations in turn can affect the profitability of the firm and impact its ability to effectively purchase the necessary goods for its stores. This dependence on foreign manufacturers does yield some degree of supplier power because the lower costs that these overseas manufacturers can offer that U.S. based manufacturing firms cannot compete with provide greater bargaining power for suppliers in dealing with the contracts they make with retailers such as RH.

### **Buyer Power**

The home furnishings industry is characterized by considerable buyer power due primarily to the extremely low switching costs between brands. As described above, intense internal rivalry exists in this industry as there are a wide variety of retailers appealing to similar demographic of customers. As such, with a large number of stores offering rather similar products, buyers exert a great deal of power, as they are easily able to switch between firms and their products. What gives a great deal of power to buyers is that one can decorate a room in a house with pieces from several different stores. Due to similar products, an individual could place a sofa from Macy's, a rug from Williams-Sonoma, a coffee table from Restoration Hardware, and a chair from Ethan Allen and all the pieces would look good together. Furthermore, one could even slip in pieces of furniture or decorations from lower quality and lower price stores such as IKEA and they would not look far out of place with the rest of the higher priced products. This ability to mix and match and switch between firms grants the buyers great bargaining power over the retail stores. The presence of high buyer power further reinforces the need for companies such as Restoration Hardware to market effectively so as to instill customer loyalty and attract repeat customers as well as entice individuals away from stores they previously visited. Many firms such as RH utilize customer rewards programs and company credit cards in an attempt to encourage loyalty and repeat customers.

Firmly establishing a brand can be vital for the success of large retail stores especially with the emergence of many small niche firms that cater to a specific group and online firms that make it incredibly easy and convenient for consumers to get information on so many different products and offerings. As such, it is easy for customers to be well informed on products, which increases buyer power.

Stores must constantly change up their offerings and store appearances and layouts to attract customers and in doing so, they cater to the whims of the consumer. The low switching costs of buyers encourage suppliers to offer low, competitive prices. The price sensitivity of consumers has become a major factor in recent years with the decline in the economy and consumer spending which has pushed many customers to switch to home furnishing retailers that offer low price options. At the same time as offering low prices, due to low switching costs and similar product offerings across stores, firms tend to spend considerable money on providing quality service in showrooms. Superior service may enable a firm to set itself apart from competitors and increase consumer loyalty and brand recognition. Such costs include the size and appearance of the physical store and in offering competitive pay to workers and salesman to incentivize quality service. As such, these high selling costs and pressure to offer low prices work together to drive down profits for many firms in the industry.

### **Substitutes and Complements**

One of the major driving forces of the home furnishings retailer industry is the housing market. When the housing market is healthy and people are buying and building new homes at a high rate, the home furnishing stores profit greatly as demand for furniture and housewares increases in step with demand for housing.<sup>20</sup> As such, the homes in which consumers place furnishings are a key complement to the industry and a strong determinant of the health of the home furnishings industry. The recent recession and the pop of the housing bubble hit retailers hard, especially for the upscale stores that offered high quality, high priced products that people have shown reluctance to spend their money on in the midst of a slumping economy. This drop in the housing market had a major impact on the industry as it greatly reduced demand and thereby intensified competition between firms as they were all fighting for a limited demand. While many firms suffered in recent years, the

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<sup>20</sup> <http://dhbusinessledger.com/Content/Kim-Mikus---Local-Business/Local-Business/Article/As-the-housing-market-improves--the-furniture-industry-does--too/98/186/9921>

economy as a whole and the housing market in particular appear to be on the way to recovery which is a positive sign for the home furnishings industry as demand and sales will likely follow in the wake of the economy as individuals increase consumption and new homes are built and sold which will drive demand for furniture and housewares needed to decorate these new homes.

Aside from similar products offered by other home furnishings retailers, there are very few substitutes available to consumers. The one possible exception would be for consumers to make their own furniture or home furnishings such as drapes, carpets, and bedspreads. However, very few individuals have the skills or desire to follow this path so the industry as a does not face a great deal of substitutes.



## SWOT Analysis

| Strengths                              | Weaknesses                                   |
|--|--|
| Brand Recognition                      | Distribution Infrastructure/Customer Service |
| Recognized Attractive Designs/Products | Housing Market Dependency                    |
| Diverse Revenue Stream                 | Reduction in Quality                         |
| Direct to Consumer Sales               | Online Presence                              |
|  | Small Profit Margins                         |
| Opportunities                          | Threats                                      |
| Flagship Store Expansion               | Intense Competition                          |
| Online Improvements                    | Decreasing Market Niche                      |
| Designer Partnerships                  | Costly Branding Efforts                      |
| Overseas Expansion                     | Knock-off Goods                              |

### Strengths

- Brand Recognition:** Restoration Hardware has worked hard to earn the reputation of producing high quality quirky merchandise. This title has stuck with RH even through the down years and RH is still a commonplace name within the home décor industry. The Restoration Hardware “lookbook” aided in reinforcing the RH name as well as offering insights to the products appearance in a full room setting. Although the eleven million copies of the 5 lb. catalog may have been costly, the original lookbook remains relevant by serving as a noteworthy volume that sits on coffee tables as décor ornaments in and of themselves.
- Diverse Revenue Streams:** While Restoration Hardware solely exists in home furnishings and décor, within the Industry RH does well in selling a wide range of products. Some companies in the same industry struggle in selling their full range of products; RH does not appear to be one of them.
- Recognized for High Quality Attractive Product:** Over the years, Restoration Hardware has made a commitment to only produce the highest quality goods and pride themselves on that standard. Additionally, consumers seem to admire RH’s products and find them to be attractive. The designers at Restoration Hardware

do a superb job of offering many styles of décor as well as a wide breadth of products within each style. These commodities span from replica globe bar carts and horse figurines to leather framed wall mirrors and window curtains.<sup>21</sup> Restoration Hardware does well in offering many different styles, and then further broadens selections with various color schemes within each design style.

- **High direct to consumer sales:**

Sales made directly to consumers through the RH website and in stores account for a large percentage of RH's revenue. Restoration Hardware also dwarfs its competitors in direct sales giving RH a market edge. In Q4 of FY 2013, the company managed to account for \$183 million in direct sales, which make up nearly 40% of RH's total sales.<sup>22</sup> Direct sales to consumers are not only the least expensive sales method, but also results in the highest profit margin possible on each good, as RH does not have to pay a premium like they do when other stores sell their products.

#### **Weaknesses**

- **Poor distribution infrastructure & customer service:**

One of the biggest complaints with RH is the slow shipping process and that not all online purchases are properly handled and shipped. In addition to the slow processes, there are numerous reports of goods being damaged upon arrival to customer, and an even slower process in fixing problems and replacing damaged products. These reviews can be destructive to Restoration Hardware's efforts of centralizing stores as this method heavily relies upon the shipping of items to be done in a timely, efficient, and protected manner.

- **Industry dependent on housing market:**

For better or worse, Restoration Hardware's success is tied to state of the housing market. The housing market currently shows signs of improvement but still has not recovered to the pre-2001 levels. As with all companies in the home décor industry, their sales and revenues depend heavily upon people furnishing and decorating homes. Restoration Hardware is even more sensitive to housing market than its competitors by being an upscale décor

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<sup>21</sup> <http://www.restorationhardware.com/>

<sup>22</sup> <http://ir.restorationhardware.com/phoenix.zhtml?c=79100&p=irol-sec>

provider; RH relies heavily upon the economy being strong and people willing to spend significant amounts of money to lavishly decorate a new or remodeled home.<sup>23</sup>

- **Reduced quality undercutting own business model:**

Attempting to increase profits and profit margin, RH outsourced some production lines to China in an effort to cut costs, but the process also resulted in a reduction of quality.

Consumers noticed the decreased quality of goods and wrote scathing reviews of Restoration Hardware and its management. Reviews like these will have a drastic impact on RH given that the company worked so hard to build a reputation of quality; any public perception of a decrease quality could have serious prolonged negative effects on Restoration Hardware's sales.

- **Poor website design:**

The world is amidst an age of technology. People do almost everything online, including shopping. This online trend has given way to companies such as Amazon that thrive by solely existing on the web. Restoration Hardware currently operates an online website, but a poor one with glaring flaws. First off, the RH website does not allow users to preview some products in all of the available color designs. Rather, a generic color scheme is chosen and modeled to the potential consumer. At the item's page, the buyer can choose to purchase a different color, but for some items there is no feature to preview such color before being purchased. Based on consumer reviews, there appears to be a problem with online purchases actually being recorded and customers often note that they must try purchasing an item online multiple times before they receive a receipt of purchase. Overall, Restoration Hardware's online presence and network is bad at best.

- **Historically small profit margins:**

Although the past quarter's profit margins were up, Restoration Hardware has typically recorded small profit margins. As a result, profits on items actual sold were minimal, making it difficult to earn large profits. RH management attempted to aid the issue by outsourcing some production to cheaper areas, but as a result produced lower quality goods. Being built on quality, Restoration Hardware realized their blunder and recommitted to high

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<sup>23</sup> <http://dhbusinessledger.com/Content/Kim-Mikus---Local-Business/Local-Business/Article/As-the-housing-market-improves--the-furniture-industry-does--too/98/186/9921>

quality products. The past quarters result could be a positive sign that RH has found a way to supply high-end quality goods while still recognizing higher profit margins.

## Opportunities

- **Increase “flagship” stores:**

Given the success of the Boston flagship store, there is an opportunity to downsize the number of smaller retail stores and increase the large centralized showroom stores. This will help reduce inventory costs as all merchandise will be stored at these central locations and distributed accordingly. Additionally, the flagship stores could help RH add to customers shopping experience by making their stores unique and enjoyable to simply walk around and look at the fully designed rooms.

- **Expand market base through Internet and Web Design:**

The age of technology has found its way into almost all companies and businesses. Restoration Hardware currently operates a poor online shopping experience, which could potentially be losing customers in more rural areas. By increasing online presence, RH could reach a larger market audience and limit costs by centralizing storage locations and enhancing shipping processes.

- **Partner with interior designers:**

The private interior design market is one of Restoration Hardware’s biggest competitors. Rather than treat interior designers as competitors, Restoration Hardware has the opportunity to pair with some of these designers and create profitable partnerships. These partnerships will be a win-win as Restoration Hardware will be able to distribute more merchandise, whereas the interior designer knows he is using high quality products and paying significantly less than market value.

- **Potential for International Expansion:**

Restoration Hardware does not currently operate outside the US. With cities rapidly modernizing in China, Japan, and the Middle East, there is an opportunity for RH to break into those markets. The demand for high-end luxury goods in these markets is present and RH could expand and profit from developing internationally.

## Threats

- **Intense competition & high substitution effect:**

With the décor market littered with companies that range from bulk warehouse stores (Ikea, Target’s Home, etc.) to smaller detailed stores (Crate and Barrel, Pier 1 Imports, etc.) to

private home design companies/ individuals (Cannon Design, Gensler), Restoration Hardware is fighting for its place within the market. The intense competition could limit RH's ability to profitably exist in the home furnishings industry. Moreover, there is a high substitution effect between companies as most of the companies in the market have similar products and competitive prices. Restoration Hardware attempts to distance itself from this competition by producing unique high-end merchandise that rivals interior designer's products, while enabling their customers to self-decorate.

- **Decreasing market niche:**

As the quality and design of lower end décor goods improves, the higher end target market is diminishing. People are shying away from spending large sums of money on furniture and décor when home decorating because the cheaper goods, e.g. Ikea Brand, are closing the gap in quality despair, while increasing the gap in cost by offering even more affordable prices. Moreover, the people who will spend thousands of dollars on interior décor generally are shying away from self-decorating and simply hiring an interior designer. The market niche RH once targeted is shrinking as they are losing lower end customers to cheaper yet still good quality products while the upper echelon is taking all hassle out of the décor process and hiring an interior decorator.

- **High cost branding efforts:**

Restoration Hardware has done well in making its name known, but also must recognize the costly catalog circulation and expensive real estate locations may prove to be unsustainable. Continuing the yearly lookbook catalog would simply force Restoration Hardware to recognize much larger costs than needed each year.

- **Knock-Off goods:**

Restoration Hardware is known for its attractive décor and high price tags. Unfortunately, for companies that fall into this mold, competitors will mimic designs and sell them for cheaper. A home furnishing store called Home Emporium has realized the allure of RH's products and produces and sells goods that are remarkably alike for around a third of the cost.



In looking at the two chests above, there is little stylistically different between them. Unfortunately however, there is a very real price difference. Home Emporium sells the chest on the left \$398 while Restoration Hardware sells the chest on the right for a massive price tag of \$1025.<sup>24</sup> The problem of knock-offs will never dissipate for the company, as competitors will ride the coat tails of Restoration Hardware's attractive products. Producers of cheaper home merchandise will continue to mimic RH's products and attempt to sell them for cheaper because there is undoubtedly a market for such good.

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<sup>24</sup> <http://www.drivenbydecor.com/2011/11/love-restoration-hardware-but-dont-love.html>

## Strategic Recommendations

### **Upsize by downsizing**

After announcing the implementation of a “flagship” store where the old historic Museum of National History was located, Restoration Hardware saw a stock price increase from \$32.75 to \$77.18 per share over the next few months.<sup>25</sup> This style of store is supposed to revitalize Restoration Hardware and give them a hint of modern in their stores and designs. Thus far, the public has responded extremely well to the flagship store approach. As Restoration Hardware management, you should focus on centralizing these flagship locations to limit supply and inventory costs. Currently, inventory costs plague Restoration Hardware and concentrating merchandise to larger stores rather than spread out amongst retail stores will help decrease RH’s costs.

Additionally, we recommend that the interior of RH stores be set up in a showroom style manner, rather than categorized one. By displaying how the products look together and providing a more notable shopping experience, RH could bring more potential customers in to stores purely based on interior layout enhancing the shopping experience. The company hopes to compete with interior decorators and designers. If RH adopts the showroom store layout, they allow customers to be their own designers and see how the products work together to create full room décor, which could help expand the company’s consumer base. Additionally, Restoration Hardware should furnish the various showrooms with as many in-house products as possible, but then enter into partnerships with other furnishing companies that can help complement and complete RH’s showrooms. The partnerships would help RH not only exhibit complete eye-catching showrooms, but also receive financial compensation for displaying and selling other companies items.

By introducing a showroom style layout, Restoration Hardware can branch out and further market itself by hosting events at these flagship stores. RH should team up with various party planning groups to host higher end parties, such as wine tasting events or art galas, to bring in potential customers. The people at these events most likely correspond with Restoration Hardware’s target consumer base. With hosting such upscale events, RH will be able to display their products to target customers in a different social setting. This approach has been successfully employed by the San Francisco Design Center.

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<sup>25</sup> <http://finance.yahoo.com/q?s=RH>

In order for this transformation to be successful, the online catalog and supply infrastructure must improve. By focusing on using stores to showcase designs and merchandise to customers but enabling the actual sales to be through online resources, Restoration Hardware can reach a broader audience while minimizing costs of storage to central locations. We strongly recommend that RH focus on constructing a user-friendly online shopping experience and commit to restructuring their supply chain infrastructure.

RH also tends to have abnormally high shipping costs. There have been numerous consumer reviews that identify the issue of a particular store not having their desired item in stock, and then charging unreasonably high shipping charges because of the store's lack of inventory. Shipping and customer satisfaction will be a forefront in determining the success of RH's transformation into more showroom style décor outlets. If customers do not trust the companies shipping process or feel the costs are too outrageous, they will simply look elsewhere when furnishing their homes. Losses like these are unnecessary and avoidable if Restoration Hardware commits to rebuilding their distribution process as well as finding a way to minimize shipping costs. One way to potentially entice online shoppers is to offer shipping promotions where orders of four or more items are shipped for free, assuming the purchase totals to a minimum dollar figure.

### **Reinvent marketing approach by bolstering online presence**

Restoration Hardware's main advertising efforts have been concentrated on their lookbook catalog. The most recent edition totaled 992 pages and weighed a tad over 5 pounds. The catalog was then sent out to nearly twelve million homes, which naturally represents a significant cost to Restoration Hardware. One key component of the lookbook is the breakdown into style section, and then within each section taking time to note the importance of each item. Within each style, RH advertises a wide range of products, including linens, paint colors, furniture, light fixtures, etc., that are all geared toward the stylistic look. Customers then have the freedom of self-decorating with the comfort of knowing that the items will look good and match as a whole. RH seems to have found a successful tactic that enables customers to feel as though they are receiving interior design quality and look for substantially less cost than hiring a private designer.

The lookbook was successful at circulating the Restoration Hardware name, but unfortunately may



be unsustainable. We believe that given the splash the lookbook created, cheaper and more sustainable efforts can prove to be effective in keeping Restoration Hardware's name on the forefront of home décor and furnishings. One thing RH could do to limit costs of catalog circulation is limit the looks offered in each catalog. By simply showing items in a room as a whole and tagging each individual product on that page can cut down the size of each lookbook. Also, there is no need to show every possibly look coupled with elaborate descriptions of the items. Restoration Hardware should rather use the lookbook catalog as a teaser to entice potential customers to RH, then direct them to the RH website where all products and looks are displayed/sold.

### **Partnerships with Design Companies**

Rather than compete with Interior Designers and Decorators, Restoration Hardware should pursue profitable partnerships with such companies. Both RH and Interior Decorators target the high-end wealthy consumer that wishes for luxury furnishings that both companies offer. The DangerZone team has concluded that the overlap of upper tier RH consumers and lower end Interior Designer clients can potentially turn to one through a profitable partnership.

By joining forces with Design Companies, Restoration Hardware can hope to sell more merchandise and help expand the company's market share. One stipulation that could help RH reach agreements with these Design Companies is to allow some of the Private Designer's items to be displayed in their flagship stores. Any potential partnership appears to be ideal for both sides involved, as both companies will be able to advertise a wider selection of products as well as receive benefits from each other's success.

### **Summary**

The home furnishings market is changing and Restoration Hardware must adapt to ensure they can maintain their competitive advantage. Restoration Hardware is firmly entrenched in the upper tier of the home décor industry and has worked hard to solidify their high-end brand title.

As the housing market improves and the décor industry as a whole continues to recover, potential RH customers are choosing to purchase lower-priced goods that have increased in quality. Restoration Hardware will not be able to compete with the likes of Ikea and Pier 1 Imports on

simple price wars, and cannot always succeed in combating the low price with higher quality and design alone. DangerZone feels it necessary that RH find a way to attract potential customers and enhance their brand name through shopping experience. By centralizing stores into large showroom stores, Restoration Hardware can enhance customers shopping experiences while boasting luxuriously designed rooms to customers.

The company continues to see revenues rise and maintain strong financials. As the company implements these adjustments, RH will continue to expand their consumer base and look to take a more prominent stance in higher end market control. Restoration Hardware is currently in a strong position while maintaining a real potential to expand and further their company and shareholder's profits.