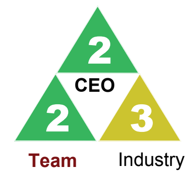
Management CV

Research Note: Best Buy Co., Inc. (BBY)

March 12, 2010

Related Party Transactions Raise Board Issues



Brian Dunn's (48) first 100 days as Best Buy's CEO have gone smoothly and we are generally impressed with him and his senior management team. Dunn is only the third CEO of BBY, following predecessors Brad Anderson (CEO for 7 years) and founder & Chairman Richard Schulze (CEO for 30 years). CEO Dunn faces some daunting challenges in FY 2010 with international same-store comparables and profits declining, and the recent departure of three top executives. Given Dunn's lack of overseas experience, we worry about the international departures and potential execution risk in Europe. Our biggest concerns with management stewardship at BBY however, are the fiduciary issues related to the numerous related party transactions connected to Chairman Schulze's immediate family and numerous Board members that we think are inappropriate for a public company. We think this CEO is likely to deliver strong performance to his shareholders but this Company's Board raises many questions about conflicts of interest that should be considered.

Most senior managers are BBY veterans with extensive operations experience. The firm has a culture of growing internal talent and CEO Dunn is a 24-year BBY veteran who served as President & COO for three years before becoming CEO. He started as a BBY sales associate in 1985, rose from store manager to regional manager in 10 years, then led East Coast operations, U.S. retail and North American retail. Despite his extensive knowledge of domestic operations, Dunn has no international experience which is a concern given the importance of international brand extension in the Company's strategic plans. In addition to BBY, Dunn serves on the board of Dick's Sporting Goods. Jim Muehlbauer (47) became CFO in 2008 after serving as interim CFO, CFO of U.S. operations and CFO of Musicland, a former BBY company. We think CFO Muehlbauer's outside work experience is a plus for the Company. Prior to joining BBY seven years ago, he held senior finance positions at Pillsbury for ten years and eight years at Coopers and Lybrand. Shari Ballard (42), EVP of retail channels management, is a 16-year BBY veteran who previously ran Human Resources and Legal and has held VP and general store manager positions. We think a major caution point for investors is the international management team's churn with the departures of former Int'l. Chairman & CEO Bob Willett (62), COO David Berg (47) and CFO John Noble (50) last year. Their combined experience will be difficult to replace. Scott Wheway (42) continues as CEO of Best Buy Europe but he only joined the firm in May 2009. He has a strong retailing background however as a 20 year veteran of Tesco and is supported by Sean Skelley (42) who heads international retail operations and is a twenty year veteran of BBY. Last year David Morrish (age 51), its EVP of Connected Digital Solutions, took a one-time voluntary separation package as part of a corporate down-sizing, which was a negative surprise. As of today, the Company told us no replacements for these people have been identified. International expansion and digital connectivity solutions are two of BBY's four growth strategies, so execution risk has increased with the loss of these seasoned managers.

BBY earnings dropped sharply last year, and we think it was poor timing for the big salary increases that the Board justified as necessary to boost management pay to peer levels. CFO Muehlbauer received a 71.5% raise, to $552k, and other executives received 15% to 21% salary increases. BBY's short term incentive plan (STIP) structure awards a performance bonus only if targets for EVA, comparable store sales growth and SG&A are all achieved. EVA fell short of BBY's $476 million goal last year, so no STIP awards were made. BBY is using operating income, SG&A and domestic market share goals for the 2010 STIP and has changed the plan so that each metric is measured independently. We like the pure performance aspects of management's LTIP awards which consist entirely of options that vest in two tranches based on three and four-year sales and profit growth. Last year's Target awards were 190,000 shares for CEO Dunn and 100,000 shares for CFO Muehlbauer. The Board is also addressing employee concerns about stock volatility by revamping the LTIP in 2010 to make quarterly awards.

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Executive pay and its allocation across the management team is reasonable. BBY targets compensation levels below the Fortune 100 median but near the peer group median. CEO Dunn was the highest-paid executive, taking home total pay of $3.4 million last year, not an excessive amount for a firm with 155,000 employees. His package consisted of $877k in salary and $2.5 million in stock and options. Now Vice-Chairman, Anderson, took home $1.9 million as the former CEO, and CFO Muehlbauer earned $1.6 million, including $552,000 in salary and $994,000 in stock and options. The team's total cash pay at $4.6 million (0.2% of income) was in line with peers on an absolute basis and very reasonable on relative-to-operating income basis with large retailers comparable figures of $4.7 million (5.8% of income). Given BBY's sizable market value, we think this CEO and management team has good alignment with outside shareholders.

Directors and officers also have real equity risk at Best Buy. Founder and Chairman Schulze beneficially holds 70.9 million shares, still an impressive 17.1% of the stock. Former CEO Anderson is the next largest holder, with approximately 3.8 million shares, and current CEO Dunn beneficially owns 500,000 shares, worth approximately $18 million, or five times his 2009 total compensation. CFO Muehlbauer owns 148,000 shares and the officers and directors as a group control approximately 80 million shares, or 19% of the stock. Half of CEO Dunn's 446,000 options are in-the-money at strike prices ranging from $11 to $34. Insider sales, relatively modest at 1.3 million over the last six months, consisted mainly of sales by former CEO Anderson and Schulze after deep in-the-money options were exercised. Management's capital allocation has been consistent with an aggressive growth focus, and we don't expect that to change. Spending has supported robust store network expansion and international acquisitions. BBY generated $1.9 billion of cash flow last year and used cash flow and debt to make $1.3 billion in capital expenditures, $2.3 billion in acquisitions and $222 million in dividend payments. The Company opened 285 new stores and spent $494 million on information technology. BBY also acquired a 50% stake in Best Buy Europe, consisting of 2,400 stores, insurance, telecom operations, online music provider Napster, and the 25% interest not already owned in Five Star, a China-based retailer. Capital expenditures have been modest thus far this year, at only $405 million. BBY has $2.5 billion available on its existing share repurchase program, but no shares were repurchased in FY 2009, and none are planned for in FY 2010. BBY began paying dividends in FY 2004 and raised the dividend 8% last year and 30% two years ago. Long-term debt is moderate, at 38% of equity this year and 42% of equity last year.

BBY's sizable list of related-party transactions is unusual for a Company of this size a significant fiduciary red flag. BBY paid Chairman Schulze $1.1 million in rent for two of its U.S. based stores last year. The leases on these two stores date back to 1990. Susan Hoff, Mr. Schultze's daughter, is paid $233k a year as the CEO of the Best Buy Children's Foundation. The Company leases its airplanes from a firm owned by the Schulze Trust and paid $895k for airplane leases last year. In fiscal 2009 the Company continued to do business with Phoenix Fixtures and spent $18 million for store fixtures. Phoenix Fixtures is a company owned by Richard Schulze's brother. The spouse of Michael Pratt, President of Best Buy Canada, is the director of merchandising in Canada and was paid $158k in 2009. The Company paid $11 million to law firm Robins, Kaplan, Miller & Ciresi where BBY director, Elliot Kaplan, is a partner. Mr. Kaplan's step-son is a VP of business development at BBY earning over $225k a year. Mr. Kaplan's Daughter, Jane Kirshbaum, is a Senior Corporate Counsel at BBY and was paid $154k in FY 2009. BBY paid $175 million in FY2009 to UnitedHealth, whose CFO is George Mikan, a Board member. The Board conflicts go on: BBY paid $775k to real estate partnership Avalon Group, one-third of which is owned by Frank Trestman, a BBY director, $2 million to Jasper Wireless, whose chairman is Hatim Tyabji, a BBY director. Even if these many transactions are done at truly market rates, as the Board asserts, they are certainly rife with potential conflicts of interest and discordant messages to other BBY employees. *End*