BEHIND THE NUMBERS
EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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General Motors (GM) - EQ Review

Current EQ Rating*	Previous EQ Rating
3-	na

*For an explanation of the EQ Review Rating scale, please refer to the end of this report

We initiate earnings quality coverage of GM with a 3- (Minor Concern) rating.

There are several areas that are starting to get worse but may not be at serious problem stages yet. The dividend coverage has jumped from 25% to 34% of free cash flow last year and may be closer to 40% this year. There are also many of the same larger risks facing GM that we talked about with Ford. Essentially, larger vehicles such as trucks and SUVs produce a large percentage of profits and cash flow yet tightening fuel economy standards may depress sales of those vehicles within 4-5 years.

The balance sheet is not as strong as Ford's, in our view, given lower credit quality. Its JV exposure is heavy in China and is already resulting in lower earnings and cash dividends

from China. 2018 results also benefited from lower sales incentives, lower pension costs, lower advertising, and a nice boost in North American pricing – all of which appear to be reversing.

- Liquidity looks solid and GM's cash and securities exceeds debt. It would not cover its pension shortfall with cash on hand like Ford.

- The pension befitted from a lower PBO resulting from boosting the discount rate in 2018 and cost fell due to using a lower interest rate on that lower PBO. This added about $0.12 to EPS last year. We think both situations could reverse this year and pensions can become a headwind. The underfunding level could also rise and lead to cash contributions in future years.

- GM Financial has a lower Debt/Equity ratio than Ford Credit – however, it takes more risk. Nearly one-quarter of retail loans are to people with subprime credit and delinquencies are 3.8% vs. 1.1% at Ford. Also, GM Financial rates only about 50% of its dealers as having strong-superior credit while Ford is over 75% for that metric. Weak dealers are 13% of total loans at GM vs. less than 5% at Ford. GM may have more exposure for loan losses.

- JVs are highly linked to China. In recent years, China has been about $2 billion in income and $2 billion in cash dividends to GM. The income has been 14%-16% of total earnings. That is falling rapidly in 2019. Both earnings and cash dividends have been cut in half YTD.

- GM says the carrying value of JVs is $4.4 billion higher than its share of underlying asset values. When the carrying value is $9 billion and $1 billion in cash is coming in – that may be more likely to trigger a write-down than when the $9 billion value was being supported by $2 billion in cash flow. Conversely, GM may be a company to look at more closely if trade disputes with China brighten as results may bounce back.

- Receivables DSOs have jumped noticeably y/y in recent quarters. With cars, we're less inclined to call that channel stuffing. Given that it is dealing with subprime credits who are buying based on monthly payment – the higher DSOs may reflect longer loans. It also may represent customers unlikely to be in the market for a new car very soon.

- Inventory DSIs are also up in the last two quarters and may require greater discounts and incentives to reduce those levels, which would impact profits and margins.

- Total sales growth has been weak to negative at GM in recent years and that has worsened in 2019. We are also surprised that several discretionary cost items that often help sales – were lower last year and helped earnings such as advertising and incentives.

- So far in 2019, incentives have picked up over 17% y/y and cash warranty payments leveled off after both fell in 2018. R&D is rising and that is expected to continue. We also doubt cutting advertising can remain a tailwind for earnings.

- GM also looks very dependent on selling trucks in North America where Trucks and Crossovers are 81% of sales volume. Higher pricing on those vehicles has also had an outsized impact on earnings.

General Motors Overall Debt and Liquidity Looks Solid Now – Watch Pensions and Subprime Loans

Just like Ford, GM has a high cash balance and has a net cash position for the Auto business. Unlike Ford, GM does not have a net cash balance after factoring in the pension underfunding level:

GM Auto	2Q19
Cash	$11.4
Securities	$6.1
Financed Debt	$15.4
Net Cash	$2.1
Pensions	$10.5

It is a notch below Ford in this regard. There is some seasonality to working capital and that could boost cash levels later in the year too.

As we discussed last week, we think there are areas where the pension underfunding level and expense figure came in unsustainably low last year. The US pensions saw obligations fall by over $4 billion last year as the discount rate used in the calculation rose from 3.53%

to 4.22%. That seems likely to decline again this year and boost the PBO figure again. Also, while not part of the debt calculation – GM did gain about $0.12 by our estimate from using a lower interest rate to compute interest expense on the lower PBO figure. That equation could see both components move in the other direction and bump up pension cost and GM called that a headwind last quarter. If the PBO rises, the annual cash contribution could also increase for GM to the US pensions from essentially zero. This is unlikely to be a major problem as the dividend is only $2.2 billion, but free cash flow has been under pressure:

GM	1H19	1H18	2018	2017	2016
CFO	$5.0	$5.6	$15.3	$17.3	$16.6
CapX	$3.5	$4.4	$8.8	$8.5	$8.4
FCF	$1.5	$1.2	$6.5	$8.8	$8.2

Capital spending is forecast to be $8-9 billion in 2019 so that is not out of the ordinary. It should be noted that GM has a deal to fund some of the capital spending for the Korean investment. That has been adding $0.3-$0.5 billion to the funding per year.

GM Financial has a debt to equity ratio of 6.8x vs. 8.3x for Ford Credit. Like Ford, GM Financial has a large percentage of its debt as a result of securitizing receivables, which are still listed on the balance sheet.

Where we see differences between the two companies is it appears GM Financial is willing to take on higher risk loans and specifically offers subprime loans in the US to people with FICO scores below 620. Also, the dealer network's credit quality appears a notch below Ford:

GM Financial	2Q19	%	4Q18	%
Group I - superior financial metrics	$1.9	15.3%	$2.2	17.9%
Group II - strong financial metrics	$5.1	40.6%	$4.4	35.8%
Group III - fair financial metrics	$3.9	30.8%	$4.1	33.1%
Group IV - weak financial metrics	$1.1	9.1%	$1.1	9.1%
Group V - special elevated risks	$0.4	3.3%	$0.4	3.4%
Group VI - substandard/doubtful	$0.1	0.9%	$0.1	0.7%
Total	$12.6	100.0%	$12.3	100.0%

Ford Credit	2Q19	%	4Q18	%
Group I - Strong-Superior Fin.	$26.3	77.6%	$27.0	78.6%
Group II - Fair-Favorable Fin.	$6.0	17.7%	$5.6	16.4%
Group III - Marginal-Weak Fin.	$1.5	4.3%	$1.6	4.6%
Group IV - Poor-Doubtful Fin.	$0.1	0.3%	$0.1	0.4%
Total	$33.9	100.0%	$34.4	100.0%

For Strong-Superior financial metrics, only about 52%-56% meet that level, while Ford is at 78%. GM has over 13% in weak, substandard, troubled dealer loans while Ford is under 5%.

Ford has the larger consumer book of loans too, but its credit quality also appears better:

GM Fin.	2Q19	4Q18
Consumer Loans	$42.6	$40.6
Delinquent	$1.6	$1.7
% Past Due	3.8%	4.2%

Ford Credit	2Q19	4Q18
Consumer Loans	$74.2	$76.1
Delinquent	$0.8	$1.1
% Past Due	1.1%	1.4%

So, GM Financial has a consumer loan book that is just 3.4x the size of its dealer book, which also appears of poorer quality. GM reported 23% of its outstanding retail loans in June 2019 were with subprime credits. Its delinquency rate is higher than Ford's too. Ford's book is also more balanced with retail at 2.2x its superior quality dealer book size.

We are giving GM a lower EQ rating because while it has a lower debt/equity ratio for its financial unit, there appear to be higher risks. At the same time, the overall auto operations have lower net cash position relative to pensions.

Joint Ventures Highly Linked with China

We could not find any mention of GM guaranteeing the debt of its joint ventures. The various ventures do not appear overleveraged more than what GM's US operations are showing in total. It seems the exposure would likely come from falling equity income, declining dividends, or a potential write-down in carrying value for GM. The deals focus heavily on China and income and dividends have started to decline this year:

GM's JVs	1H19	1H18	2018	2017	2016
China Eq Income	$611	$1,189	$1,981	$1,976	$1,973
Other JV Eq Inc	$74	$96	$182	$156	$309
Total Eq Inc.	$685	$1,285	$2,163	$2,132	$2,282
Dividends Received	$941	$2,000	$2,022	$2,000	$2,120

GM saw income from China fall in half in 2019 and expects the pressure on pricing and competition to continue in the rest of 2019. It appears that dividends will be coming in below income this year and be less than half the cash flow GM has been receiving. As noted in the last section, cash from operations fell $0.6 billion in the first half of 2019 with the China dividend coming in $0.6 billion lower.

Without forecasting GM's Chinese JV's sales, income, and cash flow – the risk of a write-down may be increasing. GM noted that in 2018 its carrying value of its JV investments of $9.2 billion ($7.8 billion is China) exceeds its share of net underlying assets by $4.4 billion. When cash flow of $2 billion is supporting over $9 billion – we can understand that. If the cash flow falls to $1 billion, $9 billion in carrying value may not be sustainable.

At the same time, China is a significant part of GM's adjusted operating income. It is declining now – if that continues, it's not as though the rest of the business units are growing either:

GM adj EBIT	1H19	1H18	2018	2017	2016
North America	$4,918	$4,903	$10,769	$11,889	$12,388
Intl less China	-$628	-$857	-$1,558	-$676	-$1,206
China	$611	$1,189	$1,981	$1,976	$1,973
Cruise	-$448	-$320	-$728	-$613	-$171
GM Finance	$895	$979	$1,893	$1,196	$763
Total	$5,348	$5,894	$12,356	$13,772	$13,747
China %	11.4%	20.2%	16.0%	14.3%	14.4%

While this looks like a decent headwind for now, GM could be a quick beneficiary of improved trade relations with China.

Working Capital May Be Flashing Minor Trouble

The total receivables have been rising for two years at this point. This is where we see a bigger issue. DSOs have taken big y/y jumps the last 3Qs in a row. It's not coming from dealer financing as that has been around $12 billion for several quarters now.

	2Q19	1Q19	4Q18	3Q18
Accounts Receivable DSOs	163.4	169.5	139.0	147.6

	2Q18	1Q18	4Q17	3Q18
Accounts Receivable DSOs	135.7	136.7	120.7	136.9

	2Q17	1Q17	4Q16	3Q16
Accounts Receivable DSOs	121.5	140.4	107.1	120.9

We think GM was able to make some sales in recent quarters by boosting incentives – which rose to $2.0 billion in 1H19 vs $1.7b in 1H18. Also, to the extent it is making about one-quarter of its loans with subprime credits, those are people buying a car based on monthly payment and probably longer-term loans, which could boost DSOs too. So, to some extent, GM may have over tapped its market and will have many customers upside-down for some time before they can trade cars again.

Inventories are seasonal and building in 1Q and drop significantly in 4Q. The DSIs are up y/y the last two quarters but are not at multi-year highs like receivables.

	2Q19	1Q19	4Q18	3Q18
Inventory DSIs	36.9	35.9	28.1	36.3

	2Q18	1Q18	4Q17	3Q18
Inventory DSIs	32.9	34.7	32.4	40.6

	2Q17	1Q17	4Q16	3Q16
Inventory DSIs	35.3	40.5	30.8	45.2

To us, we believe this could indicate GM is in for more incentives to move cars, which is accounted for as a reduction of sales. That, in turn, lowers gross profit. It appears that inventory needs to be worked down a bit too, which also may pressure gross profit.

Sales Growth Is Weak – but Contra-Sales Items and Costs that Drive Sales Have Not Hurt Much Except R&D – Can this Continue?

Total sales growth at GM is weak:

GM Sales Growth	1H19	1H18	2018	2017	2016
Sales	$70.9	$72.9	$147.0	$145.6	$149.2
Growth	-2.6%	-0.6%	1.0%	-2.4%	

However, we are surprised to see cash warranty claims also falling as cars get more advanced equipment added to them. This isn't an expense, it is cash claims paid out of accruals. But, with more features on higher-end cars/trucks – we're surprised to see this outflow falling in recent years. It may be reversing in 2019.

GM Growth	1H19	1H18	2018	2017	2016
Warranties Paid	$1.5	$1.5	$2.9	$3.1	$3.4
Growth	0.6%	-9.0%	-7.2%	-7.3%	

This has actually been a tailwind for them. It's a small one, and it has leveled off in 2019.

GM Growth	1H19	1H18	2018	2017	2016
Incentives to GMF	$2.0	$1.7	$3.8	$4.3	$4.2
Growth	17.6%	-22.7%	-11.6%	2.4%	

Incentives have picked up significantly in 2019 and we expect this may be the case going forward if GM needs to work off inventory. This was $0.25-$0.28 in EPS in 2018. It's becoming a headwind now.

We also noted that GM has been cutting advertising the last few years. The higher inventory levels and weak sales numbers make it tough to forecast that this source of earnings can continue.

GM Growth	2018	2017	2016
Advertising	$4.0	$4.3	$4.6
Growth	-7.0%	-6.5%	

R&D is definitely increasing as GM works to build more electric cars, hybrids, and other new technology. This is not broken out quarterly, but the annual growth wiped out the incentive windfall last year:

GM Growth	2018	2017	2016
R&D Spending	$7.8	$7.3	$6.6
Growth	6.8%	10.6%	

We would have some concern here. Sales growth is under pressure, some of the pension issues mentioned above should be a headwind in 2019. Incentives and R&D should also grow faster than sales and all three helped 2018 EPS.

GM Is Also Dependent on Selling Trucks and SUVs

According to the 10K:

*“**Our profitability is dependent upon the success of SUVs and full-size pick-up trucks.** While we offer a balanced portfolio of cars, crossovers, SUVs and trucks, we generally recognize higher profit margins on our SUVs and trucks. Our success is dependent upon our ability to sell higher margin vehicles in sufficient volumes. Any shift in consumer preferences toward smaller, more fuel- efficient vehicles, whether as a result of increases in the price of oil or any sustained shortage of oil, including as a result of global political instability or other reasons, could weaken the demand for our higher margin vehicles.”*

The company’s sales mix in the US last year was 46% trucks and 35% cross-overs:

US Units	2018
Trucks	1,360
Crossovers	1,034
cars	560
Total	2,954

… And Pricing

In 2018, $1.4 billion of the total $2.4 billion in sales growth for North America came from pricing. That is more important considering EBIT came in at -$1.1 billion y/y with the same $1.4 billion positive impact from pricing. In the first half of 2019, pricing was only $0.1 billion and sales fell $1.5 billion. North American EBIT fell $2.0 billion with only a $0.1 billion in pricing gain.

For 2018, GM specifically called out part of weakness in EBIT as being due to downtime on full-sized truck production and a decrease in sales of mid-sized trucks.

We already know that incentives are increasing in 2019 – that is reported as a reduction in sales. We also know that inventories are higher than normal, which may also impact pricing especially if the seasonal decline of inventories is anywhere close to normal levels seen in prior years.

Quick Thoughts on Altria (MO) – Philip Morris (PM) Merger Rumors

Current rating on MO: SELL
Current rating on PM: NEUTRAL

This idea that MO and PM will get back together has been floating around for a few weeks now. No details have been announced beyond it would not involve a premium paid by either company to acquire the other in a stock deal. What is touted is additional cost-cutting and closer relationship to roll out JUUL overseas and IQOS (Heated Tobacco) in the US. There has been no news or new numbers on the situation so we are going to make some quick observations.

On the surface – PM is basically $75 per share and MO is $45. So, either MO sends 1.66 shares of its stock to PM investors, or PM sends 0.6 shares of its stock to MO stockholders. The latter makes much more sense because it would allow a stealth dividend cut for MO and save cash. PM's $1.17 quarterly dividend becomes $0.70 when traded as 0.6 shares of PM for 1.0 share of MO. Currently, MO is paying $0.84 per quarter in dividend. On 1.87 billion MO shares, that would save $1 billion in annual cash outflow for dividends. Given the cash inflow vs. outflow squeeze at MO – that would be the main goal of a deal in our view. The combined company may use the name Philip Morris if this is done.

Beyond that, we're not seeing many other positives for the companies by doing this deal:

- They still would own 35% of JUUL and be earning non-cash equity income. The media continues to tout that JUUL could be distributed in a faster way overseas via the PM infrastructure – WHY would this be a huge goal at PM? It would take share away from cigarettes and heated tobacco (which they also want to grow) where they own 100% of the business and earn cash profits.

- PM's own history has been a country-by-country model with the motto – "If it ain't broke, don't fix it!" In areas where cigarettes continue to see minimal decay or even growth in volumes – they aren't introducing anything new in those markets. That is a strong admission that they make higher profits on cigarettes that occur in cash than any of the new products.

- JUUL has taken share in the US very quickly and is starting to feel the heavy hand of regulation coming after it. The minimum age to purchase has been raised, the various flavors have been taken out of convenience stores, discussions are now to ban even menthol and any other flavors even in Age-21 restricted vape shops.

- Investors should be wary of yesterday's news that the FDA called for a ban on menthol flavored e-cigarettes. The only reason they have kept menthol available for JUUL and other products is they did not want people who use menthol flavored nicotine to only have the option of buying cigarettes. We think this moves the ball forward again on a menthol cigarette ban – which has been one of the few areas where cigarette demand has been more stable with lower decay rates in volume.

- How much cost-cutting is possible here? The manufacturing facilities in the Eastern US for MO vs. Russia, Turkey, Indonesia, et al for PM have no geographic overlap to make easy closing decisions. Will rolling out new products mean less marketing and work with distributors? They don't sell in the same areas at all by design – so there's nothing to consolidate geographically for distribution. Smaller volumes allow consolidation over time, but both companies are already doing this. Combine the accounting systems, insurance, one board – sure. But, it's not as though both companies are selling Marlboro cigarettes in the same market now.

- The Cronos cannabis deal doesn't make money for MO either. Its sole source of profits of late has been gains on the reduction in liability in valuing MO's warrants in the deal. Cronos had a going concern warning when MO bought in and its operating losses are getting larger at this point as it works to build a larger distribution network. From our anecdotal observations, cannabis is also now everywhere – my dry cleaner now sells some type of Organic CBD. Cereal companies have talked about adding to food. I can think of a small strip-center with a Panera Bread that has three stores advertising that they sell cannabis products. This may be a much more difficult market to consolidate and control with oligopoly pricing like tobacco.

We think MO's Cash Squeeze Is the Rationale to Pursue a Merger

We have written about this many times and won't rehash it all here. MO is seeing its volume decay accelerate and has raised its guidance for the decay in each of the last 3 quarters. It has responded with price increases that further hurts volumes. With the $0.84 dividend –

MO's total dividend outlay is $6.3 billion per year. Here is cash flow from operations adjusted for working capital:

MO Cash Flow	1H19	1H18	2018	2017
Reported CFO	$2,392	$3,850	$8,391	$4,901
Work Cap Chg.	$1,158	$14	-$1,100	$2,200
Adj. CFO	$3,550	$3,864	$7,291	$7,101

In 2018, MO lost $400 million per year in BUD dividends and it added $500-$600 million per year in higher interest expense for money borrowed to buy stakes in JUUL and Cronos. We think the company's cash flow before working capital changes is going under $7 billion this year just from those factors.

On top of that, the full cannibalization of JUUL against Marlboro has barely started where MO will trade 100% cash earnings for a 35% share of equity earnings from JUUL. That will drain cash flow too.

Capital spending remains about $200 million and the dividend is now $6.3 billion. They are at 100% payout as all the other problems build: lower volume from people quitting, higher taxes and higher prices; rollout of IQOS – which should take more cigarette volumes and cost MO payments to PM; JUUL rollout; with several FDA hammers coming for graphic packaging, potential bans on menthol and reducing nicotine content in cigarettes.

And don't forget, MO is promising investors it will repurchase shares as well as continue to grow the dividend. The numbers simply do not add up to a sustainable situation in our view. Hence the merger could give some relief via a stealth dividend cut at MO. Getting 0.6 shares of PM for every share of MO would also mean getting 60% of PM's $1.17 quarterly dividend or $0.70 instead of MO's $0.84. That alone would save $1.0 billion in cash flow.

PM's situation isn't much better either. It's cash flow before working capital changes is $9.0-$9.3 billion, which covers capital spending of $1.4 billion and a dividend of $7.3 billion. Both companies could benefit from retaining part of $1 billion via lower dividends.

We Do Not See JUUL Growth Overseas as a Reason for PM to Chase this Deal

In the first place, PM already has an agreement to market JUUL overseas. Merging with MO doesn't change that. Second, it has the same problem as MO – what is the big incentive

for PM to give up cash earnings from IQOS or cigarettes to get a 35% share of non-cash equity income from selling JUUL? The rationale of 35% is better than 0% is fine. But, why race to zero?

PM already has a substitute product in IQOS that it owns 100% of and has been rolling out. The company has also been very strategic in rolling out IQOS because it knows it takes share away from cigarettes. It has been asked when they want to roll out IQOS in larger markets like Indonesia and the Philippines. PM has essentially said, if a market is seeing minimal decay in cigarettes, why should we mess up the situation by bringing in IQOS early. We believe PM would have the same rationale for JUUL.

We Do Not Have Extra Insight into JUUL – But Is Its Growth Rate Now the Same as 2018?

We have never been as fascinated with JUUL as the market. The FDA has specifically said it will not allow e-cigarettes/vaping to become a gateway for kids to get addicted to nicotine as one of its major goals. Just to get the purchase approved for MO to buy a stake in JUUL, the parties had to agree to support a federal minimum age of purchasing of 21, and limit availability in stores. On top of that, they agreed to limit widely distributed flavors to tobacco and menthol – with all others only available in specialty 21-and-over stores.

Teens are using 3rd party refills with pot in JUUL devices and many are suffering significant health issues. The FDA has been very critical that teens have gone to vaping and e-cigarettes via menthol, candy, and fruit flavorings. Just yesterday the FDA announced it will ban menthol and other flavors for JUUL products. That's a big part of JUUL's past growth rate.

The first commentaries we saw indicated JUUL will simply move overseas away from the heavy hand of the US FDA. We think that ignores that the rest of the world has regulators too. For example, the EU and Canada have bans on menthol in place and rolling out. Numerous countries have age limits and graphic packaging on tobacco products already in place too. Moreover, many other countries are already adjusting taxes to raise consumer prices on non-cigarette purchases of nicotine products. On top of that, PM operates in all those countries now with cigarettes and many with IQOS – they are the ones that will be distributing JUUL. Everything in the basic math tells us that JUUL is last page in their pitch-book.

What should scare MO investors is the FDA already believes menthol makes it easier for people to smoke and harder to quit tobacco. It has long been moving toward a menthol ban in cigarettes. Its focus is on what is the most harmful way to get nicotine – that should be a top priority to eliminate - and its answer is cigarettes. It allowed JUUL and other e-cigarette makers to keep menthol and sell those more broadly (making other flavors unavailable in convenience stores) because it didn't want the logic being the only menthol flavor available is in the form of cigarettes and have more people opt for that purchase over a less-harmful menthol e-cigarette.

If the FDA is going to pull all menthol and flavors of e-cigarettes – what rationale is there anymore to keep menthol in tobacco cigarettes? We have noted in past reports if there has been one place of some resilience in demand for cigarettes – it has been menthol. Our view based on yesterday's news is menthol's future in the US may be seriously impaired today.

Also, is MO's investment possibly impaired if the growth rate at JUUL slows? We know it doesn't provide cash flow now.

Macy's (M) Update
Maintain BUY

Macy's held a presentation at the Goldman Sachs Global Retailing Conference last week. It gave more details on forecasts with numbers for its plans that we've talked about in several of our reports on M. One of the reasons we think Macy's is a BUY is that in addition to the valuation of under 6x EPS of essentially $3.00, there is also the potential for earnings growth. We are amazed that people look at actual results and say – "Oh that cannot happen" after it has already occurred for two straight years. The company has been very good at rebuilding the business and posting 7-quarters in a row of positive sales comps. Here are some of the items the company highlighted last week:

- They are taking market share in some new products such as furniture to help drive sales. Its comp sales are being fueled by more transactions by customers tied to Macy's via credit cards, marketing, and reward points. It is further fueling sales gains with Vendor Direct where it boosts the total amount of inventory that is available to customers but held by the vendor until it is purchased. Wider selection and lower inventory investment are the results, and this is already being seen.

- The Backstage and Growth 150 stores are both comping at mid-single digits. More of those stores will be in place for 4Q19 and going forward. Offering free shipping to the store also creates what Amazon cannot match – customers making incremental purchases at the store driven by an online order. All of that should help drive sales and comps.

- The last 6-quarters of comp sales have been 0.3%, 0.7%, 2.0%, 3.3%, 0.5%, and 4.2%. As we noted after 2Q19 results, the 0.3% comp last quarter was hurt by mark-downs that have been rare at Macys over several years. Without the mark-down, the comp would have been 1.4%-1.5%. These comps do not bring extra SG&A, rent, wages, etc. The gross margin is historically about 40%. Every annual 1% comp gain at a 35% gross margin is worth 20-cents in annual EPS growth.

- Lower mark-downs can also help comps as well as margins. The company has outlined several areas where it has programs rolling out that will lower the risk of mark-downs. They believe they can add $275-$375 million to gross profit over 2-4 years. That is 110-150bp in gross margin. They see $200 million by the end of 2020

and $300 million by the end of 2021. Every $100 million in improvement is worth 24-cents in annual EPS.

- These gross margin programs include Hold and Flow – where they distribute a smaller volume of seasonal items to each store and then add additional volumes to the stores that sell out. This can include taking merchandise from stores that are not selling that merchandise. The testing has shown 3%-4% higher sales and $2/unit higher margin. That is expected to reduce total inventory investment, risk of mark-down and deliver $80-$100 million of the gross margin benefits.

- Another program will pull merchandise from the store most likely to see a mark-down (say a winter coat in Florida) and transfer it to the store that needs it more. Results of testing have shown a net $0.60 boost/unit in margin - $0.70 offset by $0.10 in shipping. This will have 100% roll-out in 4Q19.

- Switching to a store-by-store mark-down process from a 6-region computer process has also already shown improvements. Sales of tested products have posted 1.6% higher sales and 110bp of gross margin improvements. This will be rolling out too.

- Macy's knows it has headwinds from offering shipping and higher wages. It believes that as it continues to work with vendors on the Vendor Direct program and increases the size – it can get help on reducing shipping costs by sharing some of it, shipping more orders in bulk and trading inventory among stores. They plan to expand self-checkout and in-store tablets to help customers shop as well. The SG&A is expected to be a smaller part of the equation, but still produce about $70-$80 million in savings in 2020 – that is 17-19 cents in EPS and is expected to double by 2023.

We continue to see Macy's as a company that has laid the groundwork for considerable success and much of it is already visible. As JC Penny and Sears, among others, are failing – Macy's is already posting growing sales and creating higher numbers of frequent customers. Many of the systems intended to drive improvement are already in place. It has already rationalized its footprint and unlocked billions of dollars in cash that helped the balance sheet improve and the actual operations of the company modernize. EPS forecasts are basically $3 a share and the dividend yields 8.8% that it can comfortably afford and free cash flow should grow with sales, margins, and capital spending should decline.

Let's assume they can achieve $200 million of their gross margin gains – that would push EPS to basically $3.50. Let's assume all the SG&A savings are recycled against shipping

costs and other fulfillment costs and net to zero – other than they help drive sales. The sales comps grow at 1%-2% which adds 20-40 cents to annual EPS. On top of that, they free up $100 million from working capital with these programs. That retires more debt and saves interest expense. In addition, these programs do not require additional capital spending and the years of hefty capital spending for remodeling are essentially past the company after 2019.

In our view, it simply isn't much of a stretch to see a company growing EPS at 13-20% for the next few years that is trading for less than 6x EPS right now, with one of the strongest balance sheets in the industry.

Explanation of EQ Rating Scale

Rating	Explanation
6- "Exceptionally Strong"	Indicates uncommonly conservative accounting policies to the point that revenue and earnings are essentially understated relative to the company's peers. Higher possibility of reporting positive earnings surprises
5- "Strong"	Indicates the company has no areas of concern with its reported results and we see very little risk of the company disappointing due to recent results being overstated from aggressive reporting in recent periods.
4- "Acceptable"	Indicates the company may have exhibited a minor "red flag", but the severity of the issue is not yet a concern. Minimal risk of an earnings disappointment resulting from previous earnings or cash flow overstatement
3- "Minor Concern"	Indicates the company has exhibited either a larger number of or more serious warning signs than companies receiving a 4. The likelihood of an immediate earnings or cash flow disappointment is not considered to be high, but the signs mentioned deserve a higher degree of attention in the future.
2- "Weak"	Indicates the company's recently reported results have benefitted materially from aggressive accounting. Follow up work should be performed to determine the nature and extent of the problem. There is a possibility that upcoming results could disappoint as the impact of unsustainable benefits disappears.
1- "Strong Concerns"	Indicates that the company's recent results are significantly overstated and that we view a disappointment in upcoming quarters is highly likely.

In addition to the numerical rating, the EQ Review Rating may also include either a minus or plus sign. A minus sign indicates that our analysis shows the overall earnings quality of the company has worsened since the last review and there is a possibility the numerical rating will fall should the problem continue into the next quarter. Likewise, a positive sign indicates that the overall earnings quality is improving, and the company may see an upgrade in its numerical rating should the trend continue.

Key Points to Understand About the EQ Score

The EQ Review Rating is much more than a blind, quantitative scoring method. While we utilize proprietary adjustments, ratios, and methods developed over decades of earnings quality analysis, the foundation of all of our analysis is reading recent SEC filings, press releases, conference call transcripts and in some cases, conversations with managements.

The EQ Review Rating is not comparable to a traditional buy/sell rating. The Rating is intended to specifically convey the extent to which reported earnings may be over/understated. Fundamental factors such as forecasts for future growth, increasing competition, and valuation are not reflected in the rating. Therefore, a high score does not in itself indicate a company is a buy but rather indicates that recent results are a good indication of the underlying earnings and cash generation capacity of the company. A low score (1-2) will likely result in us performing a more thorough review of fundamental factors to determine if the company warrants a full-blown sell recommendation.

Disclosure

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