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BTN Research

November 20, 2020 | www.btnresearch.com

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Macy's (M)- 3Q'20 Update

We are maintaining our BUY recommendation on Macy's after 3Q results that beat estimates on EPS and revenues. As the company comes out of COVID, there remain several catalysts for further sales growth. The restructuring and movement toward more digital sales, its inventory movement, and Vendor Select appear to show very positive results.

- **Inventory Appears to be in Great Shape. The DSIs are down considerably y/y** in both 2Q and now 3Q. This is by design and the company's goal is to have more inventory in the Vendor Select program where the vendors drop ship to customers. Also, the company's efforts to move inventory among stores also reduces the amount of inventory that needs to be held.

Inventory DSI	3Q	2Q	1Q	4Q
2020	183	120	180	90
2019	213	135	147	91
2018	202	136	143	89

The amount of cash pulled out of this area is $2.1 billion so far. **Taking down inventory levels was one of the goals, but this has also been fueled by lower COVID sales. As sales recover, we expect the inventory levels in dollar terms to increase and consume cash – perhaps $1 billion.**

The lower DSIs have helped Macy's avoid mark-downs and allowed gross margin to recover considerably:

Gross Margin	3Q	2Q	1Q	4Q
2020	35.6%	23.6%	17.1%	36.8%
2019	40.0%	38.8%	38.2%	37.5%
2018	40.3%	40.4%	39.0%	38.6%

- **Payables are up too in 3Q.** They jumped in 1Q20, but we are treating that one as an anomaly related to the start of COVID. The 3Q jump was significant.

Merch Payables DPOs	3Q	2Q	1Q	4Q
2020	116	47	80	29
2019	101	45	52	29
2018	96	49	55	27

In dollar terms, inventories still exceed the payables for merchandise by $1.9 billion ($5.1 billion vs. $3.2 billion). However, payables fell with lower sales in 2Q more than 3Q (-$265 million vs. -$160 million). Macy's noted that it saw some holiday sales beginning earlier than normal and that more people entering the stores made purchases. That could have resulted in some timing issues where the trade hasn't been fully paid, but the inventory is sold. Seasonally, we anticipate that the payables will decline in 4Q. However, 16-days of payables is about $450 million and we expect that to be the incremental cash use this 4Q to normalize payables.

- **Liquidity is very high even if 4Q cash flow could be weaker than last year given where working capital is.** We believe payables will see a greater decline than inventories. That could mean working capital consumes cash in the current quarter. Offsetting that is Macy's has $1.6 billion in cash on the balance sheet and an untapped credit line of $3.0 billion. Also, EBITDA was positive in 3Q and should be in 4Q too.

- **The expense ratio has also improved too – Macy's just needs some normalized sales to leverage the cost-cutting.** SG&A was $1.7 billion in the quarter down $476 million. As a percentage of sales, it was 43.3%. Sales are still building back and it is actually some of the flagship stores where sales remain the most impaired due to their downtown locations in cities like NYC and San Francisco.

  The restructuring program that Macy's was building toward pre-COVID was focusing on taking $1.5 billion annualized out of SG&A. They are exceeding that goal at the moment. Sales were weak in 2019 as they built out more of the digital model and BackStage. **Sales were down $1 billion y/y in 3Q. If they recover $500 million, SG&A falls to 38.4% of sales down 490bp.** If sales recover by $1 billion, SG&A becomes 34.6% of sales down 870bp. That is where the operating leverage is for Macy's going forward.

- **Areas where sales can recover**

    - At some point, international tourism will resume – that represents large purchases at Flagship stores with almost no returns.
    - Loyalty programs and the credit program – added 1 million new bronze customers in 3Q and there are now 9 million bronze members. Loyalty members spend more money/capita than non-loyalty customers.
    - Digital and Omni-channel continue to grow. Digital was up 27% in 3Q.
    - Macy's stats show that as they get people more focused on digital shopping, shipping to stores, visiting Backstage, loyalty rewards, those customers spend nearly 4x the amount of non-engaged customers.
    - Sales haven't recovered yet in key areas like women's wear for office and social events. That is a large part of sales historically and where Macy's should see a pick-up as more of the economy is opened up.
    - We think Macy's is in good shape on costs and should continue to see sales growth rebounding.

Explanation of EQ Rating Scale

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.

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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.

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