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Macy's (M) 3Q19 Update
Maintain BUY

We are maintaining our BUY recommendation on Macy's after a disappointing 3Q. The company had guided to a negative sales comp for the quarter from continued weakness in International shoppers and a strong comp in 3Q18 of 3.3%. The company definitely came in below their forecast, posting a -3.5% same-store sales figure. It also lowered sales guidance for the full year to -2% from flat. That would mean sales down $500 million and YTD, they are already down $293 million.

There are several positives still seen in the 3Q such as gross margin bouncing back considerably after the mark-downs in 2Q. New store remodels are complete going into 4Q where the comp is easy and colder weather has already given a pop to sales in early November. Overall, we think too much positive work is in place here for the company's results to languish and expect the longer-term trends of higher customer traffic, better margin control, and completing the refurbishment of many stores to reemerge in results going forward:

- Weaker consumer spending hurt the number of transactions. This was not expected after several quarters of transactions growing above 5% y/y. International shoppers remain weak and tend to generate higher per capita sales and margins.

- We see multiple factors that could lead to Macy's outperforming guidance in 4Q19. It already starts with a 70bp head-start on comp sales by not repeating limitations on its loyalty members' holiday promotions of 2018 or a fire in a key distribution center.

- Work on the e-commerce systems disrupted sales in that area in 3Q – it is now back to normal rates of growth and mobile is accelerating. Physical work on Growth 150 stores is now complete and those stores produce half of Macy's total sales and comp more strongly. Last year there were 50 locations, now there are 150.

- Already, sales have started to improve in 4Q vs 3Q with colder weather and new Ready To Wear offerings that are well-received, plus the roll-out of same-day delivery in some markets and higher SKUs from Vendor Direct should help too.

- Margin guidance is actually pointing to the blood-letting ending. Gross Profit is already down $268 million YTD, guidance points to it ending the year down $285-$310 million. In 3Q19, shipping was a 40bp headwind and total gross margin declined by only 30bp. Macy's is also guiding to zero impact on tariffs now too.

- Other new margin saving programs are in place now that weren't here in 2018 as well. These include more Backstage stores which are seeing faster inventory turn, higher sales and higher margin; productivity gains are expected to add nearly 200bp to margin and are starting to make impacts in 2019 – earlier than expected; preventing mark-downs is also a stronger suit of Macy's now with Hold and Flow that has rolled out.

- More of the lower-tier stores may close in 2020. These are playing a larger role in fulfillment operations and have been losing selling space. Eliminating some more from the retail side may allow Macy's to better leverage the costs in those locations and not lose much in overall sales if their fulfillment operations expand.

Weak Transactions Were the Bad News in 3Q

The biggest factor according to management was weaker consumer spending. In particular, international shopping remains weak down about 6.3% in the 3Q. We have noted in the past that international is a key metric because they pay full price, don't return much merchandise, and buy more per visit.

Sales Comps	3Q19	2Q19	1Q19	4Q18	3Q18
Store Comps	-3.5%	0.3%	0.7%	2.0%	3.3%
Transactions	-0.4%	5.3%	5.7%	6.2%	3.8%
Units/Transaction	-1.8%	-1.8%	-2.2%	-4.9%	-3.1%
Rev/Transaction	-1.8%	-3.0%	-2.7%	-0.3%	2.6%

There is no doubt 3Q18 was a tough comp to match against and Macy's was guiding to a negative same-store sales figure. Spending per transaction actually improved sequentially. That is actually a bigger improvement than it appears given that Backstage has become a larger part of the business. That lowers revenue/transaction but helps boost total volume.

The big disappointment was in transactions. The 5% growth in that area dropped off and that is what Macy's called out as the reason for lowering guidance. It believes the macro environment remains tough for the 4Q and is effectively guiding to a negative comp of about -1.5% for 4Q19.

We believe they may be overly conservative, and sales could bounce back more quickly.

Specific Items Impacting 3Q19 and 4Q18 Sales Have Improved for 4Q

- In 4Q18, the company suffered a fire at a key distribution center that impaired the ability to get full inventory at key points of the holiday season. That's unlikely to repeat.

- In 4Q18, Macy's tried to make its loyalty program more exclusive and only offered some specific holiday promotions to the top tier of the loyalty customers. The offers will return to all loyalty program members in 2019 and the number of people in the program has increased.

- Those two issues cost about 70bp of sales comps in 4Q18.

- In 3Q19, the company disrupted its e-commerce platforms with upgrades, new apps, better navigation, and functions. That hurt e-commerce sales and they did not rise by double-digits in 3Q19. With those changes now complete, e-commerce sales have returned to the normal pace. Mobile growth is running 4x the rate of e-commerce and that is still accelerating. Vendor Direct expansion is also expanding online sales.

- 3Q19 suffered from a late start to winter weather which hurt apparel sales in the period. With a cold spell in early November to start 4Q, Macy's noted that sales have seen a good pop to start the quarter.

- Ready To Wear underperformed in 3Q19. So far in 4Q19, there are signs of improved sales. New merchandise has been well received and sales are up.

- 3Q19 saw the end of the construction disruption to refurbish the Growth 150 stores – 100 new ones in 2019 and it has Backstage up to 215 stores. Both situations are driving comp sales higher than stores without these changes. Backstage is comping at low single-digit rates still. Growth 150 stores produce about 50% of total company sales.

- The tariff issues were expected to hurt sales/margins for an estimated 7-cent impact in 2019. Macy's has worked with vendors to mitigate that entire issue.

- Bloomingdale's posted a -2.9% comp in 3Q19 which is getting better and the trends for more improvement have continued.

Margin Gains Also Appear to be Building

The company has definitely seen gross margin/pricing start to hold better. YTD, gross margin is down 100bp, but it was only down 30bp in 3Q19 despite the weaker sales. Macy's will continue to face pressure from shipping costs and even rolled out same-day delivery in some markets in 3Q. They stated that delivery was a 40bp headwind for gross margin in 3Q, so the rest of the cost savings and pricing efforts have offset part of that already.

Keep in mind the productivity gains and improvement in logistics is expected to produce $400-$550 million in cost savings. The company expected the bulk of that to start flowing through in 2020 but noted that some of that is appearing now in late 2019. They are actually seeing the speed increase and the number of initiatives also increase giving them more confidence in reaching the higher part of that goal.

The productivity gains will produce about 160-225bp of incremental margin. Some of that will recycle back to defray shipping and fund other new operating investments. Other parts should flow to the bottom line as more profitable sales.

The company also called out Backstage as an area where sales are not only building, but margins are improving too, and inventory is turning faster. This is a positive change that was not in last year's margins.

Another program that has rolled out to help sales and margins is Hold and Flow. This allows Macy's to buy less inventory overall and rapidly move inventory to stores where something is selling well. The trite example would be that if it's 60 degrees in Virginia during December, winter coats may not sell as well. But, if It's 10 degrees in Chicago, they can't keep winter coats in stock. In the past, both areas would have had similar seasonal allocations and where sales were weak, merchandise would be marked down. Under the new system, less initial inventory goes to each store with follow-up shipments to those stores selling the most. Plus, inventory in other stores can be moved more rapidly. This is designed to help sales and prevent discounting. Results have been very favorable. This wasn't in place last year and should help margins in 2019.

Macy's is guiding to a modest decline in gross margin for 2019 now, greater than the 30bp of 3Q19 by not anything like earlier in 2019. Gross margin is down 100bp YTD. Given the sales guidance of down about $500 million in sales or 2% and flat credit card revenue, if gross margin falls 40bp for the year – it implies gross profit down $285 million. It's already down $268 million YTD based on the mark-down issue in 2Q. If it falls 50bp, the decline for the years it would fall about $310 million. vs. the $268 million. Either way, we think 4Q at worst shows the blood-letting is stopping and if sales outperform – gross margin could too.

There Is the Potential for More Store Closings Among Smaller Stores

Macy's has been investing in stores located in malls where the mall owners are investing too. The result has been stronger sales in those locations. One of the reasons we never considered Macy's to be like Sears is it operates predominantly in A-class space with more than 75% of stores located in such areas.

It does have smaller stores in C and D-class malls too. Those survived the cut a couple of years ago because they were either owned, had very low rent, and offered potential to be fulfillment centers for online sales, delivery, and pick-up. These stores were a drag on same-store sales in 3Q19 of about 30bp.

Two things are happening in those locations. First, they are not getting the make-overs of other stores in the area and traffic may be switching more toward the other Macy's stores. Second, because these stores are being used to a greater degree for fulfillment – they are losing selling square footage. So, last year some of these stores may have had 40,000 sq. feet of selling space and a larger assortment of inventory vs. today the selling space may be 25,000 sq. feet with less inventory on display. That would certainly have a negative impact on sales comps – but the store is helping boost total online sales still.

Macy's is planning to announce plans for each of these stores on its Investor Day on February 5, 2020. We believe some may cease being retail stores altogether and become fully devoted to fulfillment in particular cities and further boost things like same-day delivery, faster Hold and Flow inventory movement to remaining stores, and lowering delivery costs by having bulk orders sorted at these new fulfillment centers.

It is very possible that closing more of these stores will reduce total expenses and not impact total sales to the same degree. We say that since there are 680 total stores and 150 produce about half the total sales. Closing more of the weaker and smaller stores are unlikely to have a significant impact on sales and wages and operating costs in those stores are probably not leveraging as well as other locations.

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.

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.

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