

## Macy's (M) 4Q19 Update

### Maintain BUY

We are maintaining our BUY recommendation on Macy's after its 4Q19 results that were stronger than expected. The bigger story here is the latest efforts to eliminate laggard operations, right-size the store footprint and emphasize the growing areas of the business – Polaris. We wrote in more detail about that plan and areas where we think Macy's can beat forecasts in our view over the next 3-years. We urge readers to read that report from February 7, 2020 again as we update some trends from 4Q results here.

The company expects the most disruption to the business in 1Q20 and it should be a tough period. That is due to consolidating corporate offices, the closing of the first 30 stores, restructuring in logistics, building out new departments in stores that will remain in the fleet, and adding to loyalty programs. However, management believes the results should improve throughout 2020 as more of these tasks are completed.

Guidance for 2020 calls for sales of \$23.6-\$23.9 billion – down between 3.9%-2.7% with same-store sales comps down 2.5%-1.5%. Margins are expected to be essentially flat with cost savings offsetting areas of margin pressure such as shipping and EPS of \$2.20-\$2.40 before asset sale gains vs. \$2.53 in 2019.

- We believe comp sales will exceed guidance for several reasons. The stores being closed are posting comps 300bp lower than the company overall. The company noted in 4Q that removing the 30 stores that were closed at the end of the quarter boosted same-store comps by 10bp. The 125 store closings are expected over 3-years, but there will likely be a few more in 2020 that further help comp sales by removing them.

- The Growth Model store remodels started with 50 stores in 2018, became 150 in 2019 (51% of sales) and will become 250 in 2020 (78% of sales). The original 50, comped 350bp higher than the total company in 2019. The total 150 Growth Model stores comped 300bp higher than the total company in 4Q19.
- Destination Business - six large categories that are being emphasized as they are 40% of sales were up 2.9% in 2019 and 4.3% in 4Q19. Average Unit Retail here was up 8% for dresses and 11% for fine jewelry.
- BackStage lowers Average Unit Retail – but is still comping mid-single digits. It is seeing gross margin rise and inventory turns increase. Also, BackStage boosts sales of non-closeout items in the store.
- Average Unit Retail is unlikely to face the inventory write-downs Macy’s had in 2Q19 and the company has easy comps there for 2020. The company noted that it exited 4Q with inventory down 1.4% and likes where they are in having inventory to match sales. Also, it has Vendor Direct and Hold-and-Flow more established now which reduces inventories and risk of mark-downs.

	4Q19	3Q19	2Q19	1Q19	4Q18	3Q18
Comps	-0.5%	-3.5%	0.3%	0.7%	2.0%	3.3%
Transactions	-0.5%	-0.4%	5.3%	5.7%	6.2%	3.8%
Items/Trans.	-1.0%	-1.8%	-1.8%	-2.2%	-4.9%	-3.1%
Avg Unit Retail	1.1%	-1.8%	-3.0%	-2.7%	-0.3%	2.6%

We believe transaction figures need to rise, but the company is gaining in both items per transaction and dollars spent per item.

- Total digital sales are growing at high single-digit rates too and are 25% of sales. The lost sales from 30 closed stores is likely no more than \$500 million. The company noted that all 125 stores to be closed are less than 10% of total sales or about \$2.3 billion. Digital sales are \$6 billion and may continue to rise by \$400-\$500 million and offset the sales from the closed stores in 2020.
- We also doubt that Macy’s loses all the sales from the closed stores. Often there are other Macy’s locations nearby and shoppers can also migrate to digital options. Macy’s is working on those transitions. If digital growth and

other stores gain more than the lost sales of the closed stores, and the rest of the store base has a -2% comp – that’s less than \$500 million of lost sales vs. forecasts of \$700 million to \$1 billion in lower sales.

- International Tourists were a -10bp drag on comps in 4Q. With the current strong dollar and coronavirus issues – that seems likely to continue.
- Flat margins for 2020 also may conservative. Macy’s is coming into 2020 with a decent amount of cost-cutting already in place through cutting staff, closing stores, and consolidating overhead locations. It also began work to optimize the supply chain in September. The heavy mark-downs on inventory in 2Q19 was a 22bp drag on margins in 2019. Lower inventories and new inventory control programs seem to mitigate that. Plus, pricing is increasing.
- Offsets to margins are free shipping and deleveraging fixed costs. The company saw a 50bp headwind from shipping in 2019 and sees 50bp more in 2020 for gross margin. That is basically \$120 million. Offsetting that is not repeating 2Q’s mark-downs of over \$50 million. Also, offsetting that is better AUR – which is rising. Gross margin at BackStage is also increasing. Further offsetting comes from having people ship to the store, which is cheaper and where they tend to spend 25% more. Shipping to the store is rising rapidly. Macy’s expects \$600 million in gross margin gains from Polaris by 2022 and thinks \$100 million can be realized in 2022. That is enough to offset the shipping headwind. Deleveraging fixed costs will be most pronounced in 1Q with the turnover of staff, store closings, and consolidations. That impact will be greater in a seasonally weaker quarter too. However, when sales are stronger in 4Q – those cost savings should be having a larger impact.

**Our conclusion here is simple.** Normally when retailers close laggard stores, it helps comps as low figures drop out of the equation and some sales at closed locations transfer to remaining stores and boost the comp there. Macy’s admitted that closing a small part of those stores late in 4Q, helped comps 10bp already. Half the sales at Macy’s are growing at 300bp better than comps for the full company – that would have them at 2% positive comps. One-quarter of the sales is digital growing at 7%-9%. Plus, there are easy comps to match against and pricing is up. To us, that does not add up to a loss of \$500 million in closed locations plus -2% comps overall.

We expect 1Q20 to look awful with the first part of this transition. But we believe that Macy's is set up to beat forecasts for much of 2020 as it devotes more attention and investment to the areas of the company that are working well, and those areas are huge parts of the overall business. Also, Macy's is not a basket case retailer that has been reporting never-ending negative growth figures. Other than 3Q19, its comps have generally been positive for a decent time.

## Starwood Property Trust – 4Q19 Update

### Maintain BUY

**We are maintaining our BUY recommendation on STWD.** The company's \$0.47 in core EPS was a disappointment by 6-cents. The miss comes primarily from the company writing a retail JV investment from \$72 million to zero which impacted core EPS by \$0.24. Offsetting that was an \$83 million gain on its Ireland property. However, there was a \$23 million tax adjustment as part of the deal, reducing the gain to core earnings to \$60 million or \$0.20 per share. There remain several positives going forward:

- **The retail JV may be restructured and bring back some value that was written off in 4Q.** If nothing positive happens, that potential loss is fully recognized. There isn't other retail exposure beyond the soon to open America Dream Mall loan made at a 50% LTV.

- **Commercial and Residential Lending contributed \$0.37 of the \$0.47 in core EPS for 4Q. Commercial set a record for \$2.2 billion in new lending but 60% didn't close until the final two weeks of 4Q.** That sets STWD up for a bigger impact on EPS for 1Q20. The Residential side doubled the loan portfolio y/y and it rose 10% from 3Q. That also should be a tailwind for EPS growth in 1Q and 2020. Residential is producing a double-digit yield.
- **Infrastructure that STWD acquired from GE was only 2-cents of core EPS for 4Q.** The company has been selling GE loans and letting other lower margin loans run-off in order to match durations for assets and funding. **In 4Q, this unit is now growing again and funded \$424 million in loans – with 85% coming in the second half of 4Q.** New loans are coming in with IRRs > 13% and funding is in place to add to this unit. That should create another source of rising EPS in 1Q and going forward.
- **We have talked about STWD setting up its portfolio to profit from both rising and falling Libor rates. A 100bp decline adds about 9-cents and a 200bp decline would add 20-cents at this point.** STWD has 190bp floors on all 2019 originations in CRE and all domestic loans have floors with 32% in the money now. That should also help drive EPS in 2020.
- **STWD sees its property sector continuing to perform well. First, it refinanced its funding on the Medical Office property and first Florida multifamily portfolio. This boosted the cash yield for the property unit to 15%.** Also, the Florida assets can see rents rise based on income growth, but not decline. Finally, cap rates are declining with interest rates and as the cost of new construction is rising – meaning less new supply. The company sees the cash returns rising and accumulated property gains becoming a larger hidden asset for the stock.
- **One mixed item that will hit in 2020 is the adoption of ASU 2016-13 – CECL (Current Expected Credit Loss) model. Under this new accounting treatment, FASB requires firms to evaluate the potential loan losses over the life of the loan rather than booking impairments after a credit issue arises.** The idea is to smooth out potential losses over time and to employ some historical evidence to the model. As a result, STWD has subscribed to third-party databases to incorporate historical losses for Commercial Real Estate Loans and Infrastructure loans. The final outcome is expected to be:

- **STWD's Loan-to-Value on loans is expected to decline below 60%.** It currently uses a more conservative standard in evaluating its loans and the 64% ratio should drop noticeably.
  - STWD has not had a history of loan losses and the prior system worked off losses triggered by specific events. **Therefore, the company estimates that it will set up an allowance of \$30-\$40 million based on third-party historical data of losses.** That will be in addition to \$0 currently reserved at the Infrastructure unit and \$3.6 million of specific reserves.
  - **This charge will not impact core EPS. It will be charged against equity when it is established. After that, changes in the reserve allowance will flow through GAAP earnings.**
- **Europe may get more attention from STWD going forward.** Barry Sternlicht highlighted that the **banks are not involved; rents are rising in Germany, London, Spain; and the spreads are wider given the low borrowing rates there.** Historically, STWD does not gamble - it matches durations on loans, doesn't want to be caught with FX losses, likes a large cushion on what it views as a worst-case scenario for LTV. So, if STWD starts to make more loans in Europe, we believe it will stick with past form and valuing safety and cash on cash returns along with strong credit analysis. This could become an area where returns may rise going forward also.
  - **An interesting comment on the call highlighted that the big tech companies are driving both the stock and real estate markets in several cities. This could be a growing risk factor for real estate – despite several strong tailwinds (low interest rates, low construction rates, high cost of replacement...) Here is the discussion from Barry Sternlicht:**

*“There are markets and cities where you shouldn't invest. We have an interesting portfolio because we don't have a lot of exposure other than WeWork in New York City (Lord & Taylor building), for example. And we are not particularly bullish on the New York City office market.*

*We think expenses might rise faster than the rents and you need to be super careful there. Cap rates are obviously low, but they may change if people get the view that net rents are going to fall. **And what's driving all these major markets is the same thing that's driving the stock market, five companies.***

*They are expanding into Berlin, into New York, into Toronto and even Nashville.* Amazon or what they call you the fangs and you can add three or four other names, Salesforce, these are driving these commercial property markets.

*And if they get in trouble in the stock market, they will get in trouble in the real estate market. The markets have never been more intertwined. And it's a very -- you don't care about banks expanding anymore. In your cities, you have banks. It's not about banks anymore, it's TMC. And same thing in London, like all the incremental space is being driven by what Google wants, what Amazon wants, what Facebook wants. What Netflix wants or Twitter wants and then a dozen other unicorns. So, for them, the cost of space is minuscule on their P&L military and they don't really care what they are paying, kind of like the hedge fund has evolved. And we would just be careful about the exposure of those markets because actually, the thing that will stop these companies is regulation. It's the hardest thing to underwrite, right. If somebody [thinks] that Amazon is destroying the world and we know it and Congress decides to change things, they will change things. So, it's an interesting world. But there are asset classes, I mean the office markets in United States are fairly sound across the board, other than San Francisco or New York. I can't really think of something that I think is in Chicago, there are always more funds. But it's fine, it's stable. But other markets, rents are rising smartly ahead of expenses.”*

# 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.



## Disclosure

*Behind the Numbers, LLC is an independent research firm structured to provide analytical research to the financial community. Behind the Numbers, LLC is not rendering investment advice based on investment portfolios and is not registered as an investment adviser in any jurisdiction. All research is based on fundamental analysis using publicly available information including SEC filed documents, company presentations, annual reports, earnings call transcripts, as well as those of competitors, customers, and suppliers. Other information sources include mass market and industry news resources. These sources are believed to be reliable, but no representation is made that they are accurate or complete, or that errors, if discovered, will be corrected. Behind the Numbers, LLC does not use company sources beyond what they have publicly written or discussed in presentations or media interviews. Behind the Numbers does not use or subscribe to expert networks. All employees are aware of this policy and adhere to it.*

*The authors of this report have not audited the financial statements of the companies discussed and do not represent that they are serving as independent public accountants with respect to them. They have not audited the statements and therefore do not express an opinion on them. Other CPAs, unaffiliated with Mr. Middleswart, may or may not have audited the financial statements. The authors also have not conducted a thorough "review" of the financial statements as defined by standards established by the AICPA.*

*This report is not intended, and shall not constitute, and nothing contained herein shall be construed as, an offer to sell or a solicitation of an offer to buy any securities referred to in this report, or a "BUY" or "SELL" recommendation. Rather, this research is intended to identify issues that investors should be aware of for them to assess their own opinion of positive or negative potential.*

*Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them may have a position in, and from time-to-time purchase or sell any of the securities mentioned in this report. Initial positions will not be taken by any of the aforementioned parties until after the report is distributed to clients, unless otherwise disclosed. It is possible that a position could be held by Behind the Numbers, LLC, its employees, its affiliated entities, and the accounts managed by them for stocks that are mentioned in an update, or a BTN Thursday Thoughts.*

