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Macy's (M) 4Q18 Review – Maintain Buy

Macy's released 4Q results this week with some positives and negatives to report. The company beat forecasts for EPS handily but gave guidance for a weak first quarter and forecast results should improve throughout 2019. We think this stock is worth over $60 eventually and the 6.2% dividend gives ample reward to wait for higher earnings and some multiple expansion. We believe the story remains intact for comp sales that rise annually, creating operating leverage, and faster EPS growth. Essentially 2% comp growth on flat gross margin is worth about 50-cents in annual EPS by our estimates. SG&A reductions as new investments are completed are worth 25-cents in EPS for every $100 million of cost cuts that are already in place and will be revealed as heavy levels of new investment slows. At 7x EPS and a high dividend yield, this still looks very cheap.

- **The sales comp came in at 2% for the 4Q and 2.4% for 2018 hitting January guidance targets. Two negative items cost the 4Q comp 70bp** – a fire in a mega fulfillment center in 4Q hurt sales by creating delays and making some inventory unavailable during parts of Christmas shopping and a promotion that in the past was extended to all customers was only offered to loyalty members. Neither situation is likely to repeat.

- **4Q results also saw margin pressure as staffing levels were raised to serve a forecasted 2.3%-2.5% growth rate is sales but came in at 2.0%.** Also, gross margin was hurt by free shipping not leveraging as transactions rose, but dollars per transaction fell. The company also worked down some inventory after Christmas.

- **Gross margin is expected to fall y/y in 1Q with a tough comp and inventory clearing. Margins pressure will also come from heavy investment in new store make-overs in early 2019 that boosts SG&A.**

- **Guidance for 2019 appears low in our opinion at flat to +1% comp sales. There are simply too many areas that have proven to be drivers of sales that are rolling out to additional stores and entering comps.** Backstage is boosting total sales in initial stores by 5% and Backstage are running at double digits and will enter comps in 2019. Growth 50 will expand to 150 stores in 2019. Stores with that treatment are growing faster and the 150 stores already represent 2/3 of sales done in physical stores. Online sales are still growing at double digits, online pick up at stores is boosting store sales, Vendor Direct is looking to double SKUs and that is already growing sales, and Loyalty programs are creating customers who shop more and spend more.

- **Even management expects to see margin leverage in 2019 after a period of heavy investment early on.** They are cutting management numbers to save another $100 million that will materialize during 2019. Rollout of more Backstage and Growth 50 will concentrate in the first half of 2019 and add to SG&A, but that should mitigate in the second half. Macy's is working to leverage its supply chain to allow it to move inventory more quickly between stores to carry fewer total seasonal items that need to be discounted if unsold while avoiding lost sales due to out of stocks. That should improve gross margins too.

- **Leverage targets are being met and should be complete in 2019 with share repurchases becoming the next use of free cash flow.** Macy's has reached its target for debt/EBITDA and is at the low end of the range. It now wants to reach 2.5-2.8x on EBITDA that excludes gains on asset sales. We believe that would be met if debt fell $400 million in 2019. With a dividend of about $475 million, free cash flow of about $1 billion should make that possible. As investment activities are completed, lower SG&A and cap-ex should boost EBITDA and Free Cash Flow – pushing the debt ratio lower in 2020 and giving cash for share repurchases.

Summary of 4Q18 – Comp sales came in a 2% adjusted for 53rd week in 2017

We believe many areas of Macy's continue to show improvement and it is becoming more obvious in the sales:

Adj. Comps	4Q	3Q	2Q	1Q	Annual
2018	2.0%	3.3%	0.5%	4.2%	2.4%
2017	1.4%	-3.6%	-2.5%	-4.6%	-1.9%

The 4Q17 had a 14th week and 2017 a 53rd week. The 2017 comps vs. 2016 are adjusted to 13 and 52 weeks. The reported 13 weeks in 2018 vs. 14 weeks in 2017 result in a comp of 0.7% which would make the year a 2.0% figure. Under either situation, Macy's hit the guidance given on January 11 for 2.0% annual comp growth unadjusted for the extra week and beat the 2.3% guidance with the adjustment.

Guidance had been cut in January. Macy's started 2018 forecasting flat to 1.0% on comps, boosted that after 3Q18 to 2.3-2.5% and then reduced to 2.0% in early January. Two things happened here, which in total are estimated to be a 70bp negative for 4Q comps. There was a fire in one of the mega centers which caused some inventory to be unavailable for online sales and caused delays as fulfillment had to be transferred to other centers at a busy time. Also, in the 2017 holiday season, a key pre-Christmas promotion was made to all customers. During 2018, the promotions focused on loyalty members only. They could have boosted sales further had they expanded the size of the promotion and Macy's will increase the exposure of this promotion in 2019.

Gross margin fell 110bp in the 4Q. We believe this will be a wild card and show some volatility. In the 4Q, it was caused by having higher total transactions, but the value per transaction was down. That meant shipping costs rose with transactions but did not leverage as well with lower retail dollars per shipment. This is an area where Macy's will permanently invest some of its cost savings – free shipping. It is offered to Platinum and Gold loyalty customers, higher price points, and to people who ship to the stores for pick-up. The last part is leading to higher additional sales made at the stores. Also, the company had higher mark-downs after Christmas in the 4Q which hurt gross margin. That is an area where the volatility will bounce around in our view.

SG&A saw some pressure from adding more hours and staff when the forecast for sales was 2.3%-2.5% for the year and having sales grow at only 2.0% instead.

Guidance Appears Low for 2019

The company laid out a weak 1Q19 and results that will improve each quarter through the year. Guidance is for flat to 1% comps for the year. The company plans to clear more

inventory in the 1Q19 and that should pressure pricing for the sales figure and there is a tough comp from 1Q18 at 4.2%.

Also, gross margin was exceptionally strong in 1Q18 so there is a tough margin comp, which they do not expect to top with some pricing promotions and rising fulfillment costs will not leverage as easily if the comp is lower:

Gross Margin	4Q	3Q	2Q	1Q	Annual
2018	37.5%	40.3%	40.4%	39.0%	39.1%
2017	38.6%	40.3%	39.6%	38.3%	39.1%

The company also expects a heavy roll-out in the early part of 2019 for more Backstage stores within Macy's locations as well as the $3 million per store investment for Growth 50. While they seek to minimize disruption, it still involves areas where inventory is moved, some floor space is not available for selling, and work crews in place. That should also disrupt 1Q sales a bit and pressure margin.

However, we still see too many areas where sales growth should continue to rise faster than Macy's outlook to have comps finish 2019 between 0%-1%. For example:

Backstage sales are boosting sales for the total store they are located in by 5% as it drives sales in other departments. Backstage was initially rolled out in smaller and lower performing stores and in less than 50 locations as the company experimented with the concept, made changes, and worked to optimize the performance. For the few Backstage locations over 1 year old – same-store sales are reporting double-digit growth. **The company added 120 Backstage stores in 2018 that will be entering comps throughout 2019. It will add 45 more Backstage locations in 2019 too. That will put them in about one-third of Macy's stores.** If Backstage drives a 5% comp at one-third of stores at points during 2019 – even if the rest of the stores do a 0% comp – total comps would still rise 1.6%.

The Growth 50 program is now the Growth 150 program. These are stores that have added new facilities, fixtures, food/beverages, greater selection, more staff training, virtual reality, etc. Macy's built out the first 50 of these stores in 2018 and will do 100 more in 2019 now that they have tested the results and found what works and what does not. **These stores are showing higher repeat customer shopping and are outperforming the rest of the store portfolio. This will be in approximately one-quarter of the stores by the end of 2019. These 150 stores already produce two-thirds of bricks and mortar sales.** If Backstage can produce

a comp over 1% for the full portfolio, and this area is producing better results too on two-thirds of store sales – it should add to the comp.

Online sales and BOPS/BOSS (Buy Online Pickup Store or Buy Online Ship to Store). **Online sales are growing at double-digit rates still. 7% of total online involves store pick up and that is growing. Macy's has found that online sales picked up at the store result in an additional 25% more spending as the customer stays to buy more.** All of this should get a further push from Vendor Direct which is allowing customers to buy directly from suppliers through Macy's online channels. This boosts inventory selection, more brands, more sizes without making the inventory investment to carry all of it at the store. This has already become 10% of online sales in 2018. Macy's is doubling the number of SKUs there for 2019.

The loyalty program is also showing strength. **The platinum loyalty shoppers are already 30% of total sales. They shop more frequently and spend 10% more.** These results are beating Macy's forecasts and the sales trends are getting stronger. Macy's has 3 million signed up at the Bronze level since it was introduced last spring with forecasts to add 4 million more in 2019. We also think sales and the loyalty program could grow as Macy's moves from 20% to 40% of merchandise that is private label or brand-name but exclusive to Macy's.

Our view is that Macy's is an operating leverage story. It has suffered sales losses over the years, closed many laggard stores and has reduced costs. If it can grow the top-line over the next two-three years, EPS could rise rapidly. Moreover, as we noted in January, the growth rate required for 50-cents in EPS growth is essentially 2% sales comps on a flat gross margin. They hit that comp in 2018. Given the momentum behind some of the positive changes, it appears doable in 2019. If physical disruption in the stores is largely complete in 2019 and use of Vendor Direct and Loyalty shoppers increases further, it is probably not too tough to see that still producing sales gains in 2020 and beyond.

Margin Leverage Is Still Expected in 2019

Macy's announced that it will lay-off more people in management to streamline costs further and generate about $100 million in annual savings from lower wages. That will start to flow into earnings in greater amounts throughout each quarter in 2019.

Another interesting part of building such a huge supply chain model to deal with growing online sales at double-digit rates, increased shipping to stores, Vendor Direct, and stocking Backstage, all after having closed about 100 stores in prior years has been that it allowed the company to boost sales. As noted above, while many of these initiatives are new, they are already generating incremental sales at the physical stores. The company also talked about new test programs to more quickly move inventory among the stores. That would do two things – 1) prevent lost sales from out of stock if store B doesn't have the item, but store D does, 2) reduce the quantity of inventory for particular items among the entire store base and prevent mass seasonal mark-downs. The first helps sales. The second helps margin by selling less seasonal inventory on discount.

The company also mentioned the $200 million in lower SG&A that is already producing compared to levels seen before all store closings and rethinking the retail model. As we noted in January – this $200 million is a net figure of $850 million of cost savings with $650 million of it being reinvested. This will be another year of heavy investment. For example, the Growth 50 stores cost about $3 million each to get that treatment – some of that is capital spending but other parts are going through SG&A. Macy's will modify 100 stores in that manner in 2019. We still expect things such as incentive pay for employees, higher technology spending, more marketing to permanently absorb some of the $850 million every year. However, we do believe that as these significant store models are completed and employee training is completed, Macy's will simply run out of new places to spend all the cost savings and SG&A costs will decline more. The lower wages from streamlining managers should flow start flowing through in 2019.

When we read the plans and guidance for 2019, we came away with gross margin pressure in 1Q19 based on a tough comp and some higher promotional mark-downs to clear inventory. Gross margin will then improve throughout the rest of the year. Rolling out so many new Backstage and Growth 50 stores early in the year means heavy SG&A in 1Q and 2Q that subsides in 3Q and 4Q.

If the sales comps continue to be positive and the fixed costs leverage better at the same time the new investments in 2019 start to slow – that could lay the groundwork for boosted guidance later in 2019.

Leverage Continues to Decline and Shares are Next

Macy's first goal was to get its Debt/EBITDA ratio to between 2.5-2.8x. That has been achieved. Macy's paid down about $1.15 billion in debt during 2018. The ratio currently stands at 2.5x.

The next goal is to reduce adjust the EBITDA down to remove gains from asset sales (primarily real estate). On that ratio, Macy's is 2.9x and would still like to be at 2.5-2.8x. The company's guidance for 2019 is essentially $1b in income and $975 million depreciation and amortization. Adding back taxes and interest would produce EBITDA of about just under $2.5 billion. The company expects $100 million in asset sale gains so take those out but add back about $340 million in rent expense to reach an adjusted EBITDA just over $2.7 billion.

To reach 2.8x on the adjusted ratio, Macy's would need to reduce debt by about $400 million more during 2019. That should also be more than doable. As noted above $1.975 billion is Macy's forecast cash from operations and if it wants to reduce inventory – then working capital should have a minimal risk of reducing that figure. The $100 million in asset sale gains would reduce cash from operations but cash from the sale would flow back in investing activities. The company predicts $1 billion in capital spending with the heavy build out in 2019. So free cash flow should be between $900 million to $1 billion.

From that free cash flow, Macy's dividend is $465 million, so it's covered 2 to 1. Paying down an additional $400 million looks certainly doable to meet the company's goal of getting leverage down to 2.8x without asset sale gains boosting EBITDA. And, that is in a year when investment spending pushing up SG&A is high and capital spending is inflated.

Going forward, we would expect the heavy spending on Growth 50 and roll-out of more logistics to reduce capital spending and SG&A. The company will likely still focus some attention on debt, but the EBITDA figure would be higher via lower SG&A and continue pushing debt ratio lower. Some lower capital spending would combine to drive free cash flow up. Even assuming no growth at Macy's simply lower SG&A spending of about $200 million and $200 million in lower capital spending would boost free cash flow about $350 million. Even the CFO says it would turn attention to returning more cash to shareholders after hitting its leverage goal:

"In terms of power using our excess cash in 2019, again we're planning to use the excess cash to get closer to our target leverage range of 2.5 times to 2.8 times when looking at it without asset sale gains, so that will be our first priority. And then beyond that, we'll then see how the cash position develops. And if warranted, we will evaluate share repurchases next. That something that we'll have to discuss with our board for 2019, but we're just going to have to wait and see, how the cash develops over the course of the year, Kimberly."

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