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Macy's (M) 1Q Update
Maintain BUY

We are maintaining our BUY recommendation on Macy's (M). The results beat forecasts by $0.10 and the company confirmed guidance. More importantly, many of the growth initiatives are showing positive results. We still believe the best bargain at Macy's is its stock price with a 6.4% yield trading for 7x EPS. Discussions on the call about Chinese tariffs hurt the stock after earnings, which we consider overstated and not a permanent risk.

Market Watch pointed out yesterday that the tariffs being talked about are almost immaterial. There is no discussion of putting tariffs on all Chinese goods at this point, and Market Watch points out that even if 100% of goods had a 25% tariff – it would amount to $135 billion against the US economy of $20.5 trillion. It would amount to a 0.65% increase in prices to consumers. On top of that, Macy's guidance already assumes the first three rounds of tariffs will be in place and the primary area where Macy's has exposure is furniture sales. Clothing would only be impacted if a fourth round comes to fruition – Per CEO Jeff Gennette:

> *"The three tranches of tariffs that were enacted in 2018 have no meaningful impact on our business and were factored into our 2019 guidance. The increase of the Third Tranche from 10% to 25% on May 10 does have some impact, particularly on our furniture business. However, the team anticipates that this can be mitigated. If the potential Fourth Tranche is placed on displays on all Chinese imports, that will have an impact on both our private and our national brands (for apparel).*
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> *We would work with our manufacturing and brand partners to size and minimize the impact to our customers. This potential fourth tranche of tariffs was not contemplated when we provided annual guidance. We are hopeful that trade talks between U.S. and China will continue productively and the trade actions between the two countries will deescalate."*

Later on the call, Mr. Gennette noted that Macy's has been working to move production out of China for years already and that helps its private brands business (about 20% of sales) avoid tariffs. On national brands, Macy's believes it can work with partners to find solutions if the next round of tariffs kicks in.

After seeing the positive trends, we do not believe tariff risk can offset those. Plus, if tariffs are not enacted, it represents another positive catalyst for sentiment on the stock:

- **Another positive sales comp with very strong transaction volume.** This is now six straight quarters of positive sales comps. Transactions were up 5.7%. It appears BackStage is driving volume at a lower price point and people are shopping more frequently but buying fewer products per sale.

- **Gross margin was better than it looks at first glance.** Gross margin was down 80bp y/y. The company guided toward lower margin for 1Q and 2Q of 2019 as it worked off some inventory. Margin was actually flat before higher costs of free shipping.

- **Macy's is working to pull costs out of inventory and shipping.** It is combining shipments to stores to reduce delivery charges on the BOSS (Buy Online Ship to Store) program. It is tinkering with price points and number of units to set thresholds to earn free shipping. In the current 2Q, Macy's is rolling out systems to control inventory markdowns on a per store basis. Vendor Direct is expanding rapidly which gives customers more choices without Macy's owning the inventory.

- **Guidance seems conservative with gross margin down in 1Q and 2Q and calling for sales comps of flat to 1%. This should be the last year of heavy investment in remaking the store base with BackStage and Growth 150 rollouts.** Thus, free cash flow should improve noticeably as new rollouts annualize with higher sales, lower SG&A with the transition declines, and capital spending declines. Macy's has already focused on deleveraging too so stockholders should get more of the attention of rising free cash flow.

Comps Remain Positive with High Transaction Volume

Sales Comps	1Q19	4Q18	3Q18	2Q18	1Q18
Comp Sales	0.7%	2.0%	3.3%	0.5%	4.2%
Transactions	5.7%	6.2%	3.8%	0.5%	1.0%
Units/Trans	-2.2%	-4.9%	-3.1%	-2.6%	-2.0%
Rev/Trans	-2.7%	-0.3%	2.6%	4.6%	5.0%

There are several moving parts here. The roll-out of BackStage stores has continued during this time. The company has seen BackStage add to comps in a meaningful way:

Jeff Gennette:

> "*any time you add BackStage into one of our buildings, <u>it lifts the comp of that store by about five full points.</u> What's really exciting about BackStage is that <u>when you look at it in the second and the third year that the momentum continues.</u> It's not just a one-year episodic issue or opportunity.*
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> *We look at -- the other headline we brought up in the fourth quarter was <u>the cross-sell that goes on for our customer. About 15% of the customers that are in the stores that have BackStage across buying in both areas of the store and their purchases are up about 40% when they do that</u>. So that gave us the confidence to add more BackStage. We've added nine so far of the 50 from 2019, but we're very excited about seeing what's happening with the comps and how the comps of BackStage are driving the comp of the entire store."*

BackStage is bringing in traffic and creating sales. However, BackStage is also a lower price point. The company guided to the first half of 2019 being a period when it would work down some inventories, which depressed prices and faced tough comps on pricing the prior year. Thus, the lower revenue per transaction was expected. The fact that BackStage started as only a few dozen stores, was boosted to about 170 by the end of 2018, and is adding 50 more this year creates some apples-to-oranges issues in the comps.

As this roll-out normalizes, we would expect to see the revenue per transaction level out and begin to rise again.

Adding BackStage and the Growth 150 stores are pulling in traffic and people shop more frequently. Also, the loyalty program brings in people more often and they are buying more.

Paula Price:

> *"Our Star Rewards loyalty program continues to perform very well. Our <u>Platinum customers are shopping with us more frequently. They're spending more with us.</u> They really love the simplicity and value of the new programs, and we had great responses to the exclusive Platinum customer experiences that we can offer them. <u>And so, platinum customers make up about 30% of our sales and their spending behavior is up 10%."</u>*

If the results are showing multiple years of higher traffic and sales from BackStage, but the downside is people make more frequent purchases that encompass fewer units – Macy's will likely take that tradeoff. The only area where more transactions of smaller sales hurts is when there is free shipping involved. We'll discuss below ways Macy's is addressing that.

Gross Margin Was Flat Before Delivery Charges

	1Q19	4Q18	3Q18	2Q18
Gross Margin	38.2%	37.5%	40.3%	39.7%

	1Q18	4Q17	3Q17	2Q17
Gross Margin	39.0%	38.6%	40.3%	39.0%

We noted that 4Q18, the company saw margin pressure from both mark-downs on inventory and shipping costs not leveraging as reasons for 110bp of lower gross margin. In 1Q19, there was a tough margin comp because 1Q18 had few mark-downs and the company guided that it would be working down inventory in 1Q19. Also, more BackStage stores in operation would lower price points.

Despite those pressures, Macy's noted that gross margin would have come in flat for 1Q19 except for shipping costs. We take that as a good sign as the company is working to improve its spending on shipping and inventory overall.

- BOSS (Buy Online Ship to Store) – this program offers free shipping and gets the customer to the store where he/she often buys more goods. Macy's is combining all the BOSS orders to various stores into fewer packages to reduce shipping costs.

- Changing free shipping policies based on customer status and buying habits. Rather than give free shipping to homes at $40, maybe it becomes $75. Other times, maybe it becomes free if another item is added. That should also help leverage the free shipping costs more.

- Inventory levels pressured 1Q19 and are expected to impact 2Q19 as well. Not only because inventory is higher than Macy's wants, but those two quarters have tough comps from 2018 when mark-downs less. That should allow gross margin to recover during the year.

- Hold and Flow Inventory system is rolling out in 2Q. This policy showed a 15% improvement in margin vs. non-test stores. Essentially, it gives each store an allocation of seasonal inventory and holds back more at the distribution center. Stores seeing stronger sales can rapidly be replenished, while the stores with lower sales of particular items have less to mark down.

- Localized inventory mark-downs are rolling out too. This will mark down inventory store by store rather than category across a full region. Essentially, why mark down an item by 50% that is selling in one store simply because it isn't selling in another nearby city.

- Vendor Direct is expanding. This is where vendors ship direct to the store or consumer with online sales. This gives Macy's access to a huge amount of inventory that it does not have buy or risk markdowns on. Plans are to add another 1 million SKUs and boost the number of vendors in the program to 1000 up from 700. Shipping is still a cost here – but there is no incremental SG&A. Jeff Gennette was very excited about this program on the call:

  > *"Vendor Direct has only upside. So, it adds sales. It adds profit. It increases customer consideration of Macy's. It increases traffic to our site. It addresses failed searches. And the profit rate on Vendor Direct is basically -- it's accretive to our overall, when you look at it. Because you really don't have any of the SG&A expenses, the minimal incremental capital, the no inventory investment, it makes for a very high ROIC case. And in Q1, it was about 10% of our online sales, came from Vendor Direct. But we see that penetration increasing as we add more and more content to it."*

There is more work being done on the supply chain as well. We see this as still being in transition, but all of the announced changes point to higher gross margin and more control on costs.

2019 May Be the Final Year of Heavy Transition

We like Macy's because the company has very clear plans on what it is doing and can specify them. Clients know how much we rip companies who continually throw out restructuring plans without showing much in the way of sales or margin gains. The plan is hailed but very little is ever spelled out, "We're going to spend $400 million over three years and will find ways to become more efficient." We always ask, "wasn't that the last plan also, which only cost $80 million?"

In the case of Macy's, they have been remaking the company through a series of large steps including asset sales, remodeling stores, boosting technology, better training of staff, retaining best staff… Through it all, investors have been collecting a dividend of over 6% waiting for the process to be complete and seeing a company set up with considerable upside leverage as better sales and margins meet.

The company has always had well laid out plans for its changes as well. For example, it has done entire presentations on just BackStage and the testing they did with it initially, how it rolled out into weaker stores first so they could tweak it further and still showed significant improvement for the store. How these will enter the comps going forward after 13 months. The cost per unit, the time to implement, the plan for rolling it out to more stores… They can quantify the change; BackStage is adding 5% to store comps and it continues to add after the first year.

In 2018, Macy's rolled out 120 BackStage stores and 50 of the Growth 50 stores. In 2019, another 50 BackStage and 100 Growth stores will be completed. While these heavy remodelings and reconfiguring of stores takes place – a store is likely losing some sales, running up extra SG&A investments, and seeing higher than normal capital spending.
Capital spending in 2018 was $932 million and 2019 should come in at $1 billion. After that, the issue starts to become there simply will not be stores left that have not received upgrading attention. The supply chain and logistics will have been addressed too. The major programs like Vendor Direct and mobile ordering will have been rolled out. We simply

believe Macy's will have a tough time spending $1 billion annually in capital investments plus more in SG&A.

Right now, cash from operations is running about $1.8 billion per year with $1 billion in capital spending and the dividend is $460 million. As the transitions start to annualize, it should boost sales and income driving up cash from operations. We have noted before that closing stores costs Macy's about $1 billion in sales, which it has programs in place to recover. SG&A should largely be flat – so adding back that $1 billion in sales should add $280-$320 million in income to the cash flow statement. It is also $1.00 in EPS. Lower SG&A and lower capital spending will further drive up free cash flow. And, Macy's has already deleveraged that balance sheet too. We think free cash flow could double after 2019 and set up the company for share repurchases or higher dividends.

Guidance remains tame for 2019 too. We think Macy's is likely to beat forecasts calling for 0%-1% comp sales growth, a lower gross margin in Q1 and Q2 that moderates in the second half and EPS without gains on asset sales of $2.80-$3.05. It has some momentum in many areas and will add more of the growth initiatives in 2019 and they are comparing to an EPS in 2018 of $3.26 before gains on asset sales.

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