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Macy's (M) 2Q19 Update
Maintain BUY

We are maintaining our BUY recommendation on Macy's after 2Q19 results that literally saw one issue set off a wave of panic – marking down warm-weather seasonal inventory that was not selling in the first month of the 2nd quarter with temperatures below normal and rain nationwide. One thing Macy's has been rolling out is the ability to move slower-moving inventory within season to other stores where sell-through is better to reduce mark-downs and carry less inventory. Normally, it's warm somewhere when it's cold elsewhere – but that doesn't work as well when everywhere has the same issue. **The mark-down amounted to a 100bp hit to gross margin.** Because the cost of merchandise didn't change, it lowered the selling price. **That means, it also reduced the sales figure. We estimate that sales would have risen 1.2% without this mark-down and comp sales of 0.3% growth would likely have been up about 1.5%.**

Even with the mark-down of seasonal clothes, Macy's did in fact post it's 7th positive comp sales growth figure in a row. Transactions were up 5.3% in the quarter too, so traffic and purchases are not a glaring issue. **We estimate that the mark-down cost Macy's about 23-cents in EPS and the company reduced annual guidance by 20-cents**. With the company increasing its customer totals, enjoying higher sales, reducing leverage and posting earnings and positive free cash flow – it's time to stop lumping this in with Sears as the press does hourly. At under 6x EPS, a 9% yield, with a growing on-line business that can produce same-day delivery, and cheap real estate to drive incremental sales – this business model is actually innovating and working.

Macy's was asked several times about the tariff issues. They pointed out the first two tranches had "no significant impact." The 10% third tranche had very limited impact. When tranche 3 went to 25%, they had to make adjustments with vendors. Tranche 4 for Macy's will not require price increases and in **total Macy's believes they may have no more than $0.05 of annual EPS at risk from tariffs – against essentially $3.00 in EPS.** This is another overblown issue in our view that probably cut $1.5 billion off the market cap before the 2Q results.

Guidance is for a very strong 4Q (against an easy comp) where Macy's does 35% of its revenues and routinely produces an incremental $1 billion in gross profit dollars vs the other quarters. Let's focus on the bad parts and the good parts of 2Q going into 3Q and 4Q:

- **Working through the miss in 2Q19, we see that markdowns coming in below forecast has been a more frequent positive or non-event at Macy's helping gross margin.** 2015 and now this quarter are the times this has been called out as a negative in 8-years. We do not view this as way-of-life for Macy's and many changes they have made to the business such as Vendor Direct and Hold and Flow are specifically designed to reduce markdowns going forward.

- **Basic retail stats all look positive. The company is seeing customers buy more frequently but spending less per transaction.** New store features are driving up comps and Vendor Direct should continue to add to digital sales with minimal investment. It also noted that international tourist shopping was down 9% in the quarter. This may be an area where Macy's outperforms in the next two quarters.

- **Guidance calls for flat 3Q and strong 4Q. Who wouldn't take that trade off?** A strong 4Q with several easy comp factors would produce much more sales and earnings leverage than if guidance called for the reverse.

- **Comps at smaller stores that are not getting all the new make-overs still struggle.** The market is focused on "maybe Macy's should just close every laggard store." What is being missed is some of the lost sales at these stores is due to transforming their operations into a higher percentage of logistics, fulfillment, and warehouses for online sales and reducing their selling space footprint. Macy's real estate is largely in Class A malls with good locations and they either own the building or lease it for about $4-$6/sq. foot. We actually applaud the effort to use some of the existing cheap real estate in this manner. Macy's model reduces shipping costs, increases traffic to stores, and leads to incremental online and physical store sales. The result is total sales are rising and being allocated away from a store comp into the digital or vendor direct bucket. However, the store played a big role.

- **Cash flow and the balance sheet should continue to improve after 2019 completes another year of heavy investment.** Logistics build out, BackStage, Growth 150 stores will be largely completed this year. There will always be capital spending but it should start to decline from $1 billion to perhaps as low as $600 million. The new changes are boosting sales faster than the company as a whole as well. We expect free cash flow to increase and further support the capital goals of a reinvesting in the business, a low leverage situation, paying dividends, and repurchasing shares. The $465 million dividend consumes about 50% of free cash flow now, adding $300-$400 million via less capital spending should only enhance that picture.

Retail Stats Still Look Strong – the Markdown is Being Given too Much Weight:

Sales Comps	2Q19	1Q19	4Q18	3Q18	2Q18	1Q18
Store Comps	0.3%	0.7%	2.0%	3.3%	0.5%	4.2%
Transactions	5.3%	5.7%	6.2%	3.8%	0.5%	1.0%
Units/Trans	-1.8%	-2.2%	-4.9%	-3.1%	-2.6%	-2.0%
Rev/Trans	-3.0%	-2.7%	-0.3%	2.6%	4.6%	5.0%

First, let's look at the store comp of 0.3% for the 2Q19. The company reported sales of $5.55 billion vs. $5.57 billion in 2Q18 (down 0.5%). The market has focused on the mark-down of warm-weather apparel hurting gross margin by 100bp according to management. That's not really the place to start. We know that the cost of merchandise didn't change with the mark-down and we know the units were sold. The variable is the change in selling prices and the impact on sales and gross margin.

Cost of goods sold was $3.395 billion and the gross margin was 38.8%. First, let's take $236 million of depreciation and amortization of software out of COGS to get a merchandise cost figure. That gives COGS of $3.159 billion and dividing that by the $5.546 billion in sales is a margin of 43.0%. Without the mark-down, it should have been 44.0% which is 100bp higher. For $3.159 in COGS to make a 44% margin – sales would be $5.641 billion – which is $95 million higher. (Macy's mentioned nearly 100bp so if you want to make a range of 90-100bp – at 90bp, sales would have been $85 million higher).

First of all, $85-$95 million would have made total sales rise by 1.1-1.2%. Given that store comps rose 0.3%, that probably would roughly translate to a 1.4%-1.5% same-store sales comp for 2Q. Actually, we think the market would loudly cheer that. Also, a gross margin of 39.8% would not have looked out of the ordinary:

	2Q19	1Q19	4Q18	3Q18
Gross Margin	38.8%	38.2%	37.5%	40.3%

	2Q18	1Q18	4Q17	3Q17
Gross Margin	39.7%	39.0%	38.6%	40.3%

We already know that the ramp up of shipping costs for online sales, vendor direct, and promotions to ship to the store are pressuring margins and that happened again in 2Q19. Without the mark-down, gross margin would have been flat despite the other headwinds from changing the business model.

Let's not stop there. That $85-$95 million would have dropped to the pretax line – they already paid the staff, transport, and vendors. The company sees a 23% tax rate for the year – so they lost 21-23 cents in EPS here. The company cut guidance by only 20-cents. Also, mark-downs are a normal risk for a retailer. Is there evidence that Macy's gets hit with this often? No! We went back and saw that the company mentioned fewer mark-downs helped 2018 and 2016. In the years of 2017, 2014, 2013, 2012 – markdowns were not called out at all. Only in 2015 was there a year of markdowns and much of what Macy's has focused on with its new logistics systems within the company is targeted at preventing markdowns.

So, in our view, this company had an inventory problem that negatively impacted about 1.7% of inventory in one quarter. It's definitely a strike/foul ball/black eye – whatever term you want to use. The company probably should have pre-announced this issue. But it also is a rare event historically and the transaction figures show that people are still coming. We're not as certain this $95 million one-time mistake is worth $1.4 billion in market cap disappearing and see the sell-off as a major over-reaction.

What Other Data is Helping/Hurting the Retail Stats?

We know that BackStage is a lower price point business and as that drives comps at mid-single digits for stores where it operates – it helps on transactions but reduces the revenue per transaction. That should cycle through in 2019 as the largest roll-outs of BackStage are now complete. Macy's has also seen strong numbers with its most frequent shoppers. They are buying more often – but are buying fewer units per sale. That figure is starting to improve too. Again, Macy's is being viewed as Sears or JCPenney but no one is looking to see that total sales are actually rising, comp sales are rising, people are visiting more often, and making more purchases. Those are big differences between Macy's and the others.

Macy's singled out International tourists as a problem area on revenues. This is likely more of a strong dollar issue than Macy's issue, but they did see a -9% y/y change in international tourism business and they shop at the larger stores. They are also very profitable as they don't return anything as well as paying full price. The company's guidance assumes the -9% figure continues in 3Q and 4Q. However, it is worth noting that they have now completed four straight negative comps for international. The -9% in 2Q came against a positive figure the year before. Thus, guidance may be too conservative in this area. Despite it occurring over the last four quarters, Macy's has had 7-straight quarters of positive comps.

More Backstage and Bluemercury.com continues to enter the comps going forward along with the $1 billion of spending this year to transform more stores to design into a Growth 150 model or add Backstage or more digital capabilities.

Also, the company is very comfortable with inventories which hurt the comp last quarter with the mark-downs. Vendor Direct where the vendors hold the inventory and Macy's does not have to deal with markdowns is becoming a larger part of total inventory. The investment is minimal so it is a higher ROI transaction. Also Hold and Flow is now rolling out on a bigger scale. This is where seasonal inventory is bought in smaller quantities and allocated to stores at the start of the season and then moved among stores during the season. Essentially this redesigns the older method of buying 200 units and giving each store 20, and at the end of the season – marking down the remaining 1-3 units per store. They avoided fewer out of stocks that way, but still ended up with surplus merchandise. Hold and Flow would buy 100 units and give each store 10, some will sell out and others will sell few – the new system will rapidly take units from slower selling stores and move it to the others. Total mark-downs should decrease while minimizing out of stocks. Both situations should help on margin and sales going forward.

Macy's Has a Tough Comp for 3Q and an Easy Comp for 4Q

Last year Macy's had a strong 3Q with an early start for winter clothes. Comps were very strong as a result and the company is expecting weaker sales results than 2018 as result. It is even saying 3Q could come in below its full year forecast of flat sales. The positives for 3Q are that inventories are in better shape than the spring, more of the investments will be in place so overhead costs should be lower than in the spring, and there will more of their growth drivers in place – more Vendor Direct SKUs, more BackStage stores, more Growth 150 makeovers.

However, they are forecasting the comp for 4Q to be much stronger than 3Q. Last year they had missteps in releasing promotions to only platinum customers rather than all customers. They also had a warehouse fire that damaged inventory in 4Q and cost the company sales. More investment in growth areas will be in place as well.

The main issue to us is higher sales leverage quickly at Macy's against many fixed parts of SG&A. We'd much rather hear they are confident in a strong 4Q. Historically Qs 1-2 are 22%-23% of sales, Q3 is the weakest at 20%-21% with 35% in 4Q. That translates into about $1 billion in additional gross profit and leveraged overhead costs vs. the other periods.

2018 margins	4Q	3Q	2Q	1Q
Sales	$8,455	$5,404	$5,572	$5,541
Gross Margin	37.5%	40.3%	39.7%	39.0%
Gross Profit	$3,167	$2,178	$2,252	$2,159
SG&A	$2,538	$2,255	$2,164	$2,083
SG&A %	30.0%	41.7%	38.8%	37.6%

This leaves out credit card income and asset sale income. We actually took guidance on the call as very positive. If sales growth is going to be strongest in 4Q when the most operating leverage and operating profits are generated then that's a good situation.

Negative Comps on Some Stores Are Not Being Viewed in Full Context

There are articles out after the call focusing on whether Macy's needs to close hundreds of additional stores. On the call, the CEO noted that sales come from several segments: Online/digital, Flagship, Magnet, the Growth 150 (which are many of the Flagship/Magnet), BackStage stores all posting good comps while other neighborhood stores without the new makeovers do not see the same results and post negative comps.

Immediately analysts started talking about the death of brick and mortar again and just get rid of everything physical. The example that I always remember from years ago was an article about "Just think how profitable AMR would be with just Sabre and they got rid of this money losing American Airlines." Lost in the basic theme of "they should just run the accounting system as a profit center" was a huge flaw in the thought process – How would

Sabre do all this profitable accounting without being able to bill the airline that generated 100% of its volume?

There are several points to make here. The first is Macy's does close stores. They closed five more this year so far which is after closing about 100 in recent years as part of the transformation that has been going on. Others have been transformed into outlet stores and BackStage. The company is not afraid to change its real estate footprint. Also, these smaller stores have lower sales totals to begin with. 50% of Macy's bricks and mortar sales come from its largest 150 stores. The smaller stores have a smaller impact on the total comp. The press makes this sound as though all stores are equal.

At the same time the company rolls out more digital/online sales, programs to move inventory between stores, have customers pick-up shipments at stores – including many direct from vendors where Macy's did not have inventory risk – Macy's needs a large amount of square footage devoted to logistics. The company essentially owns half its stores and leases the rest for about $4-$6 per square foot. So, if the company has real estate with poor sales that is cheap – why not transform to fit a growing logistical need? They can have units from Vendor Direct shipped in bulk to stores and reduce shipping costs. They have a location that is easy to find and people already visit the mall – why go out and lease more real estate for some of these logistical needs? When you think about total sales and costs vs. Amazon – Macy's is paying less for real estate, Macy's can get more bulk shipping from vendors and reduce delivery costs, with a physical store Macy's has proven people picking up an online sale come in and buy more stuff at the physical store – that offsets free shipping cost – Amazon cannot do that, Macy's can also show that the physical store becomes a showroom and generates more online sales – Amazon cannot do that either.

The result is some of these stores becoming more focused on logistics and losing selling square footage which hurts their sales – and thus a negative comp. However, having the physical retail location does many things. People who pick up an on-line order at the store frequently make another purchase while at the store. Maybe free shipping at $50 of purchases, gets the first $50 in revenue and then they buy something for $10 at the store. In the past, the person not worrying about shipping deals may have bought $20 of things at the store. So, the store reports a drop in sales from $20 to $10. However, Macy's saw sales rise from $20 to $60. They pushed the total from $20 to $50 by giving away $6 in free shipping and the $6 in free shipping generated another $10 in sales at a physical store. Vendor Direct and Hold and Flow also allows Macy's to increase the total inventory available to the customer at any store – without increasing its inventory purchases. They can lower the sales staff in that store too.

Look at BackStage – which allows more orderly close-out sales and brings traffic into the store. Those are posting strong comps and its bricks and mortar! Maybe Macy's should close all the rest of the store and just operate the BackStage – that would be thinking being offered by many today. That would ignore that BackStage generates traffic and sales throughout the store. Also, people buy online in the store to match what they found in the store at the moment – have it shipped there and thus return the physical store again. It would also ignore that much of the BackStage inventory and sales process works in conjunction with the Macy's store. The BackStage sale generates a regular Macy's sale or the BackStage brings a person into the Macy's 10x per year instead of 3x and on those 10 visits, two additional online/mobile orders are made. Analysts are going to say the online is growing, the BackStage is growing and Macy's is not – but all the extra orders happened due to or with sizeable help from having a physical Macy's store.

Also, where did Macy's try and test all these new ideas? Did they tinker with pricing, shipping, BackStage, new product lines at their strongest Flagship stores and just accept that some things won't work? No – they test all this stuff in smaller stores on smaller scales, then roll it to a few more and ensure it works, the ROI is positive and then bring to the larger traffic stores. They then roll it back down to the lower stores. That's how the Flagships saw lots of transformation, then the Growth 50 stores, then that became the Growth 150. It's how BackStage went from a small number of stores to over 200 now.

Thus, when Jeff Gennette continued – he pointed some of this out too:

> *"So, we really have a line of sight on what growth looks like for Magnets and Flagships. The growth strategy really led by our Growth50 gave us all the confidence in getting growth out of those buildings.* ***We talked about how those Growth50 stores had outperformed other stores in the Growth 100 by 3 full points.*** *Those stores are positive campaign, this -- customer engagement in those particular stores is much higher than our other store fleet.* ***So, what we've done is we've applied all of those learnings to the next 100 stores, which is what we call the Growth 100 and what you're quoting that Growth 150 which will be complete by the end of October touches about 50% of all of our brick and mortar sales.*** *Separate from that is what you have -- many of our flagships that are classified differently that add to that 50%, clear line of sight about what we need to do to make those better. So, we've got a lot of initiatives with what we're doing with new experiences like b8ta and Market and STORY, trying new concepts like thredUP that are all adding new opportunities in these stores, many of these stores are touched by Backstage.*

The neighborhood stores, I would expect those to continue to negatively comp, but they're becoming more profitable because we're operating them more efficiently with less square footage. The customers are really using them big for fulfillment, a higher percentage of their sales are moving through fulfillment. *So, we're handling their expectations in those particular stores. We're always looking at our portfolio to look at, does it make sense? We're never going to say, we're done, but we do believe this national footprint that we have, we're servicing a national customer. We know that when we close the store, we're firing customers, we lose their business online, we'll make all those decisions very carefully.* ***So, this segment's dictation strategy really serves a customer that shops between our stores satisfying her needs, it also satisfies how we're building the omnichannel business through Digital and Mobile****, and so we'll be very careful about any accidents that we do in -- in future store closures."*

Cash flow Should Improve after 2019

Based on Guidance for $3 in EPS with asset sales, there is about $1.9 billion of cash flow here assuming no working capital changes:

2019 guidance	4Q
EPS * 312	$936
Dep/Amt	$944
Cash Ops	$1,880
CapX	$1,000
FCF pre WC	$880
Dividend	$466
Dividend %	53%

Capital spending has been elevated for several years with the various store investments and new technologies. We believe those should drive earnings higher and push up cash from operations. Some of the inventory changes may free up working capital too. At the same time, the level of investment should decrease. They have been in this transformation for several years and still 2019 is expected to be one of the highest levels of investment at $1 billion. In 2017, it was $760 million. Having the investment level fall by $300-$400 million may be possible. That makes the dividend 35%-38% of the free cash flow without earnings growth.

Macy's also wants to reduce its debt ratio to 2.5-2.8x EBITDA The adjusted debt includes lease liabilities. Right now, the ratio is at 2.7x ($8045/$2962). However, that EBITDA includes gains on real estate sales and they would like the ratio in the 2.5-2.8x band without asset sales. Given some modest EBITDA gains and asset sales retiring more of the debt, Macy's would probably like to retire $500-$800 million in debt from internally generated cash flow over the next few years. That seems like an easy plan to accomplish given that free cash flow should increase.

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