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EARNINGS QUALITY & DIVIDEND SUSTAINABILITY RESEARCH

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Macy's (M) Update
Maintain BUY

Macy's held a presentation at the Goldman Sachs Global Retailing Conference last week. It gave more details on forecasts with numbers for its plans that we've talked about in several of our reports on M. One of the reasons we think Macy's is a BUY is that in addition to the valuation of under 6x EPS of essentially $3.00, there is also the potential for earnings growth. We are amazed that people look at actual results and say – "Oh that cannot happen" after it has already occurred for two straight years. The company has been very good at rebuilding the business and posting 7-quarters in a row of positive sales comps. Here are some of the items the company highlighted last week:

- They are taking market share in some new products such as furniture to help drive sales. Its comp sales are being fueled by more transactions by customers tied to Macy's via credit cards, marketing, and reward points. It is further fueling sales gains with Vendor Direct where it boosts the total amount of inventory that is available to customers but held by the vendor until it is purchased. Wider selection and lower inventory investment are the results, and this is already being seen.

- The Backstage and Growth 150 stores are both comping at mid-single digits. More of those stores will be in place for 4Q19 and going forward. Offering free shipping to the store also creates what Amazon cannot match – customers making incremental purchases at the store driven by an online order. All of that should help drive sales and comps.

- The last 6-quarters of comp sales have been 0.3%, 0.7%, 2.0%, 3.3%, 0.5%, and 4.2%. As we noted after 2Q19 results, the 0.3% comp last quarter was hurt by mark-downs that have been rare at Macys over several years. Without the mark-down, the comp would have been 1.4%-1.5%. These comps do not bring extra SG&A, rent, wages, etc. The gross margin is historically about 40%. Every annual 1% comp gain at a 35% gross margin is worth 20-cents in annual EPS growth.

- Lower mark-downs can also help comps as well as margins. The company has outlined several areas where it has programs rolling out that will lower the risk of mark-downs. They believe they can add $275-$375 million to gross profit over 2-4 years. That is 110-150bp in gross margin. They see $200 million by the end of 2020 and $300 million by the end of 2021. Every $100 million in improvement is worth 24-cents in annual EPS.

- These gross margin programs include Hold and Flow – where they distribute a smaller volume of seasonal items to each store and then add additional volumes to the stores that sell out. This can include taking merchandise from stores that are not selling that merchandise. The testing has shown 3%-4% higher sales and $2/unit higher margin. That is expected to reduce total inventory investment, risk of mark-down and deliver $80-$100 million of the gross margin benefits.

- Another program will pull merchandise from the store most likely to see a mark-down (say a winter coat in Florida) and transfer it to the store that needs it more. Results of testing have shown a net $0.60 boost/unit in margin - $0.70 offset by $0.10 in shipping. This will have 100% roll-out in 4Q19.

- Switching to a store-by-store mark-down process from a 6-region computer process has also already shown improvements. Sales of tested products have posted 1.6% higher sales and 110bp of gross margin improvements. This will be rolling out too.

- Macy's knows it has headwinds from offering shipping and higher wages. It believes that as it continues to work with vendors on the Vendor Direct program and increases the size – it can get help on reducing shipping costs by sharing some of it, shipping more orders in bulk and trading inventory among stores. They plan to expand self-checkout and in-store tablets to help customers shop as well. The SG&A is expected to be a smaller part of the equation, but still produce about $70-$80 million in savings in 2020 – that is 17-19 cents in EPS and is expected to double by 2023.

We continue to see Macy's as a company that has laid the groundwork for considerable success and much of it is already visible. As JC Penny and Sears, among others, are failing – Macy's is already posting growing sales and creating higher numbers of frequent customers. Many of the systems intended to drive improvement are already in place. It has already rationalized its footprint and unlocked billions of dollars in cash that helped the balance sheet improve and the actual operations of the company modernize. EPS forecasts are basically $3 a share and the dividend yields 8.8% that it can comfortably afford and free cash flow should grow with sales, margins, and capital spending should decline.

Let's assume they can achieve $200 million of their gross margin gains – that would push EPS to basically $3.50. Let's assume all the SG&A savings are recycled against shipping costs and other fulfillment costs and net to zero – other than they help drive sales. The sales comps grow at 1%-2% which adds 20-40 cents to annual EPS. On top of that, they free up $100 million from working capital with these programs. That retires more debt and saves interest expense. In addition, these programs do not require additional capital spending and the years of hefty capital spending for remodeling are essentially past the company after 2019.

In our view, it simply isn't much of a stretch to see a company growing EPS at 13-20% for the next few years that is trading for less than 6x EPS right now, with one of the strongest balance sheets in the industry.

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