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Retail

## Time for M to Clean Up the Balance Sheet

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*For Rothbort's preview heading into the Macy's conference call, please click here.*

**Macy's (M)** guided to a penny lower for the upcoming quarter. It seems to have mattered little.

I see three issues at Macy's:

1. The company has a truly huge amount of debt, which management needs to aggressively retire.
2. The backlash from the brand consolidation continues to hurt the company, especially in the Midwest.
3. The substitution effect is tightening the reins as consumers trade down to off-price clothiers and discount merchandisers.

On a pure valuation basis, Macy's remains too far oversold. It has bounced and might move higher to the mid-\$20s. Beyond that, the company will have to fix up its balance sheet to provide any real investment value.

Macy's reported second-quarter EPS of 17 cents on net sales of \$5.72 billion. Excluding two "unusual" items, the retailer earned 29 cents per share on a continuing basis during the quarter. These two items were for the consolidation of Macy's brand names (a mistake in my opinion) and impairment charges for private-label brands acquired in the May merger.

Net sales declined 3.0% year over year, and same-store sales declined 2.1%. By geography, sales were strongest in the Northeast and Texas and weakest in the West and Midwest. By brand, Bloomingdale's and the dotcom units of Bloomingdale's and Macy's exhibited strong growth. By product category, sales were strongest in jewelry, cosmetics, shoes, men's furnishings, men's collections, housewares and mattresses. The weaker categories were ready-to-wear, intimate apparel, men's tailored clothing and sportswear, children's, textiles and tablecloths. Macy's was hurt by a lower level of clearance merchandise vs. the prior year.

Gross margins rose 100 basis points year over year, to 41.5%. The company attributes this to inventory management. Inventories ended the quarter 3.7% lower than a year ago.

The company generated \$592 million in net cash flow from operations vs. \$412 million in the year-ago quarter. Macy's ended the quarter with cash and cash equivalents of \$1.293 billion vs. \$249 million a year ago; \$650 million will be used to fund maturing debt in third quarter 2008.

The company guided to results for the rest of the year on the low end of its original guidance range. Comp-store declines are expected to be 1% and EPS (excluding non-recurring items) are expected to be \$1.85 in the third quarter.

On the Q&A:

- An analyst mentioned that the guidance implies margin contraction of 250 basis points in the second half of the year. Management would not comment on those specific numbers but did say that it expects year-over-year improvements in the fall season.
- Auditors will evaluate trade names and goodwill for impairment on an annual basis. (Macy's has plenty of that, and I expect significant impairments in the future to create a problem with its balance ratios and debt ratings; see below.)
- On the credit side, Macy's expects high levels of write-offs and delinquencies to continue in second half 2008.
- Private-label sales have been mixed. The Martha Stewart brands have performed well and Macy's continues to "tweak" the program.
- Rumors that Macy's will close a large number of stores are false, but the company will close underperforming stores as it has in the past.
- When asked if Macy's would consider paying down more debt to keep leverage below 4 times, management responded that it would do what it could to maintain its investment grade rating.

*At the time of publication, Rothbort had no positions in the stocks mentioned, although positions can change at any time.*

*Scott Rothbort has over 20 years of experience in the financial services industry. In 2002, Rothbort founded LakeView Asset Management, LLC, a registered investment advisor based in Millburn, N.J., which offers customized individually managed separate accounts, including proprietary long/short strategies to its high net worth clientele. He also is the founder and manager of the social networking educational Web site [TheFinanceProfessor.com](http://TheFinanceProfessor.com).*

*Immediately prior to that, Rothbort worked at Merrill Lynch for 10 years, where he was instrumental in building the global equity derivative business and managed the global equity swap business from its inception. Rothbort previously held international assignments in Tokyo, Hong Kong and London while working for Morgan Stanley and County NatWest Securities.*

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