21 September 2009 | 20 pages

Macys Inc (M)

Upgrade to Buy Rating Based on Increased Conviction in Macy's Topline and Margin Potential

Equity ☑
Rating change ☑
Target price change ☑
Estimate change ☑

- **Our Take** — Following recent proprietary mtgs. with mgmt., we are upgrading M from a Hold (2H) to a Buy (1H) rating based on: 1) M's ability to drive the topline as the My Macy's localization initiative cont. to gain traction; 2) operating margin tailwinds from product cost deflation and Macy's speed to market initiative, and 3) upside fr. current levels based on our $30 price target.
- **Rationale #1: My Macy's to Fuel Topline** — We are encouraged by the consistent, positive early results that Macy's has reported from its 20 pilot markets since 4Q08, and believe that this localization initiative should lead to improved topline (and margin) trends ahead, particularly beginning in 2010.
- **Rationale #2: Margin Tailwinds Abound** — Macy's expects benefits from product cost deflation to be greater in '10 than in '09. Based on our proprietary analysis, cost deflation could boost gross margins by 50 bps next year! Also, Macy's speed to market initiative is underway, and while Macy's is a small step behind the competition, we view this as an investment positive, as a majority of the benefits are ahead of us.
- **Rationale #3: Upward EPS Revisions Warranted** — Our previous EPS estimates and consensus are too low in light of the topline and operating margin drivers discussed above. We also view mgmt's '09 guidance as conservative. As such, we raised our 2009-2011 EPS estimates and target price for M. Lastly, we raised our Sept. SSS estimate to (-4) to (-6)%, up from (-5) to (-7)% previously.

Buy/High Risk	**1H**
from Hold/High Risk	
Price (21 Sep 09)	US$17.79
Target price	US$30.00
from US$15.00	
Expected share price return	68.6%
Expected dividend yield	1.1%
Expected total return	**69.8%**
Market Cap	US$7,481M

Price Performance (RIC: M.N, BB: M US)

EPS	Q1	Q2	Q3	Q4	FY	FC Cons
2009A	0.02A	0.29A	-0.08A	1.06A	1.29A	1.29A
2010E	**-0.16A**	**0.20A**	**-0.06E**	**1.32E**	**1.30E**	**0.91E**
Previous	-0.16A	0.20A	-0.10E	1.03E	0.97E	na
2011E	**0.01E**	**0.37E**	**0.03E**	**1.39E**	**1.80E**	**1.20E**
Previous	-0.05E	0.26E	-0.04E	1.02E	1.19E	na
2012E	**na**	**na**	**na**	**na**	**2.22E**	**1.52E**
Previous	na	na	na	na	1.49E	na

Source: Company Reports and dataCentral, CIR. FC Cons: First Call Consensus.

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See Appendix A-1 for Analyst Certification and important disclosures.

Fiscal year end 31-Jan	2008	2009	2010E	2011E	2012E
Valuation Ratios					
P/E adjusted (x)	8.3	13.8	13.6	9.9	8.0
EV/EBITDA adjusted (x)	4.6	6.0	5.8	4.6	3.7
P/BV (x)	0.8	1.6	0.9	0.9	0.8
Dividend yield (%)	2.9	3.0	1.1	1.6	1.9
Per Share Data (US$)					
EPS adjusted	2.15	1.29	1.30	1.80	2.22
EPS reported	1.90	0.66	0.77	1.80	2.22
BVPS	23.19	11.21	18.90	19.73	21.43
DPS	0.52	0.53	0.20	0.28	0.34
Profit & Loss (US$M)					
Net sales	26,313	24,892	23,283	23,576	23,992
Operating expenses	-24,231	-23,467	-21,874	-21,824	-21,969
EBIT	**2,082**	**1,425**	**1,409**	**1,752**	**2,023**
Net interest expense	-543	-560	-557	-541	-508
Non-operating/exceptionals	0	0	0	0	0
Pre-tax profit	**1,539**	**865**	**852**	**1,211**	**1,515**
Tax	-569	-320	-302	-448	-561
Extraord./Min.Int./Pref.div.	-110	-265	-225	0	0
Reported net income	**860**	**280**	**325**	**763**	**955**
Adjusted earnings	970	545	550	763	955
Adjusted EBITDA	3,386	2,703	2,651	3,069	3,423
Growth Rates (%)					
Sales	-2.4	-5.4	-6.5	1.3	1.8
EBIT adjusted	-8.4	-31.6	-1.2	24.4	15.5
EBITDA adjusted	-4.3	-20.2	-1.9	15.8	11.5
EPS adjusted	-1.2	-39.8	0.9	38.0	23.3
Cash Flow (US$M)					
Operating cash flow	**2,231**	**1,879**	**1,458**	**2,135**	**2,459**
Depreciation/amortization	1,304	1,278	1,242	1,317	1,400
Net working capital	-230	-392	-171	38	58
Investing cash flow	**-789**	**-791**	**-450**	**-550**	**-700**
Capital expenditure	-1,105	-897	-450	-550	-700
Acquisitions/disposals	293	38	0	0	0
Financing cash flow	**-2,069**	**-365**	**-1,050**	**-343**	**-796**
Borrowings	1,301	-16	-966	-226	-650
Dividends paid	-230	-221	-84	-117	-146
Change in cash	**-628**	**723**	**-42**	**1,242**	**963**
Balance Sheet (US$M)					
Total assets	**27,789**	**22,145**	**23,937**	**24,168**	**24,422**
Cash & cash equivalent	583	1,306	1,264	2,505	3,468
Accounts receivable	463	439	411	416	423
Net fixed assets	10,991	10,442	12,328	11,516	10,786
Total liabilities	**17,882**	**17,499**	**16,081**	**15,908**	**15,310**
Accounts payable	4,127	3,910	3,695	3,705	3,696
Total Debt	9,753	9,699	8,733	8,507	7,857
Shareholders' funds	**9,907**	**4,646**	**7,856**	**8,261**	**9,112**
Profitability/Solvency Ratios (%)					
EBITDA margin adjusted	12.9	10.9	11.4	13.0	14.3
ROE adjusted	8.8	7.5	8.8	9.5	11.0
ROIC adjusted	6.7	5.6	6.3	7.2	8.5
Net debt to equity	92.6	180.7	95.1	72.7	48.2
Total debt to capital	49.6	67.6	52.6	50.7	46.3

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Rationale #1: My Macy's to Fuel Topline Growth

On 9/11/09, we hosted meetings with Karen Hoguet (CFO), Jeff Gennette (Chief Merchandising Officer), Julie Greiner (Chief Merchandise Planning Officer), and Ronald Klein (Chief Stores Officer) in NYC to gain a deeper understanding of the My Macy's initiative, which was rolled out nationwide by the end of 1Q09. ***We are encouraged by the consistent, positive early results that Macy's has reported from its 20 pilot My Macy's markets, and believe that this localization initiative should lead to improved topline (as well as margin) trends ahead, particularly beginning in 2010.*** Below are summaries of our key findings:

Background Information

Based on encouraging early results from the company's My Macy's pilot in 20 selected geographic markets since Spring 2008, Macy's management announced that the company would expand this customer-centric localization initiative nationwide in February 2009.

- **Geographic Districts Reduce the Span of Control:** In order to concentrate more management talent in local markets, Macy's stores nationwide were grouped into 69 geographic districts that averaged 10-12 stores each. Of those, 49 were newly-created districts. The other 20 districts (in the Midwest, Upper Midwest, and Pacific Northwest) were created as pilots in Spring 2008. We note that this compares to Macy's previous reporting structure, which relied on Regional Merchandise Managers (RMM's) to serve as the liaisons between buyers and the stores. RMM's often oversaw too broad a number of stores (16-23 stores) and also had mixed lines of reporting (some reported to GMM's while others reported to the stores organization).

- **District Teams are Empowered:** Each district has a team of executives (including a district vice president, district merchant, district planner, and individual store managers) to help central planning and buying executives understand and plan assortments on the needs of local customers.

- **Regional Oversight:** The 69 Macy's districts are grouped into eight regions that are based in the Chicago, Houston, Miami, Los Angeles, New York, Pittsburgh, San Francisco, and Washington, D.C. areas. Each region includes an organization of 35-40 executives who oversee merchandising, planning, and various support operations. Specifically, there is a regional planning manager in each region for each of Macy's five families of business. Lastly, special events and marketing public relations staffs are located regionally around the country.

- **Supported by Communication Tool:** Interestingly, management believes that while technology systems can show merchants what did or did not sell, the My Macy's initiative helps to identify "what would have sold" had the company offered the product. We learned that district teams use a Lotus Notes-based communication tool to submit requests for particular items/sizes/colors. Requests are coded into 13 possible classifications, including: new vendor, delete vendor, look for size, and take markdown, among others. These codes help ensure that the district requests will be routed to the appropriate people within the central organization. Macy's has also implemented response time requirements to ensure that requests are considered and processed in a timely manner. According to management, there have been ~13,000 requests submitted so far, with 95% of them executed.

- **Localization Goal:** Macy's expects that while the company's core merchandise will be consistent across the country, about 10-15% of a store's assortment will be localized. Interestingly, management views size as the biggest My Macy's localization opportunity.

- **Compensation Structure:** Macy's district teams are compensated according to the sales and margins of their group of 10-12 stores. In contrast, previous Regional Merchandise Managers had varying compensation structures, depending if they reported to the stores or to the merchants.

Timeline of Events

Figure 1. M – My Macy's and Consolidation Timeline

Date	Details
February 2008	Macy's began consolidating its Minneapolis-based Macy's North organization into New York-based Macy's East, its St. Louis-based Macy's Midwest organization into Atlanta-based Macy's South, and its Seattle-based Macy's Northwest organization into San Francisco-based Macy's West. The Atlanta-based division was renamed Macy's Central. All current store locations remained in place. The company's Miami-based Macy's Florida and New-York based Bloomingdale's divisions were not affected by this announcement.
February 2008	Macy's launched the My Macy's localization initiative, which is aimed at accelerating sales growth in existing locations by ensuring that core customers surrounding each Macy's store find merchandise assortments, size ranges, marketing programs, and shopping experiences that are custom-tailored to their needs. This initiative was first adopted in the geographic markets that were a part of Macy's North, Macy's Midwest, and Macy's Northwest as they were consolidated into Macy's East, Macy's South, and Macy's West, respectively. If this initiative is successful, Macy's will roll it out to additional divisions.
1Q08	Macy's completed its division consolidations and transitioned to a new regional structure in its former Macy's North, Macy's Midwest, and Macy's Northwest divisions. The division consolidations included systems conversions as well as the building of new organizations.
2Q08	Macy's focused on training its new organizations and visiting stores. Macy's also rolled out a communication tool for use by the districts and the company's central merchandising organization.
February 2009	Macy's began the process of eliminating its Macy's division structure and integrating all functions into a single organization. Macy's central buying, merchandise planning, stores senior management, and marketing functions will be located primarily in New York. Corporate-related business functions such as finance, human resources, law, property development, and purchasing (including those now performed at the division level) will be located primarily in Cincinnati. The NY-based Macy's Home Store and Macy's Corporate Marketing divisions will no longer exist as separate entities. Existing Home Store functions will be integrated into the Macy's national merchandising, merchandise planning, stores, and marketing organizations. Macy's Corporate Marketing will be integrated into the new unified marketing organization. The NY-based Macy's Merchandising Group (MMG) will be refocused solely on the design, development, and marketing of Macy's private brands.
February 2009	Based on encouraging early results from the company's My Macy's pilot in 20 selected geographic markets since Spring 2008, this customer-centric localization initiative will be expanded across the U.S.
1Q09	Macy's completed the unification of its organizational structure, as well as the nationwide rollout of its My Macy's localization initiative. Over 95% of new positions have been filled and almost all of those people are now in their new position.
May 2009	Most of the systems were converted. A comprehensive training schedule has begun for both the new My Macy's districts and regions and the new central organization.
4Q09	Macy's management expects to see an improvement in sales trends from the national rollout of My Macy's beginning in 4Q09.
Spring 2010	Macy's management expects to see large improvements in sales trends from the My Macy's initiative.

Source: Company Reports and Citi Investment Research and Analysis

The Benefits

1) Same-Store Sales

- Same-store sales performance in the 20 pilot districts, which include 238 Macy's stores (~28% of total store base), are outpacing the remainder of the company, and the gap continued to widen in the second quarter to 260 bps (vs. 210 bps in 1Q09 and 150 bps in 4Q08). Also, in the first half of the year, eight of Macy's top ten districts were pilot markets.

- Also, we note that Macy's realized benefits in these test districts sooner than anticipated. While management had expected to realize benefits beginning in Spring 2009, SSS trends actually picked up starting in 4Q08. The earlier-than-expected benefits were likely driven by the increased sense of empowerment and responsibility that Macy's store and district teams had for their localized input, while the Spring 2009 benefits were more driven by the new assortment changes.

- Macy's expects to see some improvement in the new My Macy's districts in 4Q09, with the majority of the benefits coming in Spring 2010 and beyond. *We believe the My Macy's initiative will be a key driver of same-store sales upside for the company ahead.*

2) Lower Clearance Levels

- According to management, the pilot stores have lower overall levels of clearance because of the ability of My Macy's to tailor pricing and the markdown process to a particular market. For instance, while a maxi dress would be marked down in the Fall in the Northeast region, this classification can continue to sell well at full price in warm weather regions such as Florida for several more months. Specifically, Macy's is able to vary start and stop delivery dates based on local needs.

3) Vendor Relationships

- Macy's believes the combination of the My Macy's initiative and centralized organizational structure that it implemented has strengthened its relationships with vendors. Management views being in NYC as a key advantage.

- More specifically, management believes that the improved communications (vendors' points of contact at Macy's are now centralized in NYC vs. regionalized previously) and collaboration with vendors are leading to: 1) the development of more exclusive lines for Macy's; 2) getting product faster as a result of quicker decision-making and reduced cycle times; 3) better pricing given the consolidated volume of orders; and 4) progress on developing unique size packs for Macy's.

4) Higher Customer Satisfaction

- According to management, customer service scores have increased significantly in the My Macy's test districts. We believe this is a result of better customer service and the ability for customers to find more of what they are looking for in-store.

Rationale #2: Operating Margins Supported by Product Cost Deflation & Speed to Market Initiative

On 9/15/09, we hosted meetings with Terry Lundgren (Chairman, President & CEO), Karen Hoguet (CFO), Tim Adams (Chief Private Brand Officer), Leonard Marcus (President of Private Brands), and other members of Macy's Merchandising Group (MMG) in NYC to gain a better understanding of the company's private label strategy and speed to market initiatives. ***We were very encouraged by our findings, which suggest that product cost deflation and Macy's speed to market (S2M) initiative should serve as operating margin tailwinds ahead.*** Below are summaries of our key findings:

A) Product Cost Deflation

Background Information

- **Excess Capacity is Leading to Deflation:** The global economic crisis has spurred a significant decline in orders, which has created excess factory capacity overseas. As a result, factories and suppliers have become quite willing to reduce their pricing in order to try to keep their factories open and operating, which creates gross margin opportunity for retailers.

- **Macy's is a Beneficiary:** We believe that retailers with greater exposures to private label general merchandise (apparel, footwear, home) should benefit more from deflationary product costs, as these companies have the most control over their supply chains and can capture the majority of the pricing benefits. Recall, in 2008, private label product accounted for ~19% of Macy's total sales. Interestingly, certain classifications of business have significantly higher private brand sales at Macy's. For instance, 40% of women's sportswear, 24% of men's sportswear, and 60% of home textiles are driven by private label sales.

- **Deflation Expectations:** While competitor J.C. Penney is expecting deflation of (-5) to (-7)% in 2H09, followed by deflation of (-2) to (-4)% in Spring and continued deflationary trends throughout the remainder of 2010, Macy's management has shared that the company expects product cost deflation to be more pronounced in 2010 than this year.

Proprietary Benefit Analysis

Based on our proprietary analysis for Macy's, we estimate that the company's gross margins will be enhanced by ~15 bps in 2009 and ~50 bps in 2010 as a result of product cost deflation. Recall, ~19% of Macy's sales stem from private label merchandise as of the end of 2008. We assume that the company will keep about half of the anticipated cost savings for margin enhancement and pass the remainder along through higher product quality.

B) Speed to Market (S2M) Initiative

To leverage best industry practices with respect to improving speed to market, Macy's hired consulting firm Kurt Salmon Associates (KSA) for their expertise and continues to work with them today. Macy's is also utilizing technology from Tradestone Software, which is a leading provider of product lifecycle management systems. Finally, Macy's has created a Speed to Market team which works full-time on the S2M initiative.

Notably, Macy's Merchandising Group (MMG) has found that the company's new, centralized organizational structure streamlines decision-making in a meaningful way, as MMG is able to collaborate with their counterparts who are also located in NYC to a greater degree and more efficiently, as they no longer have to negotiate with each division separately. According to management, this has taken weeks out of the normal cycle. *Management noted that the company previously underestimated the magnitude of this benefit when it made the decision to centralize.*

Key Components of the S2M Initiative:

- **End-to-End:** "End-to-end" is Macy's terminology for the entire product cycle, from concept to market. The company's goal is to bring its previous ~42-week average cycle down to ~32 weeks. This will be driven by strategic pre-season planning (which has become easier to do now that buying is centralized), collaboration throughout the development process, collaboration with suppliers to enhance the cost/value equation, identifying specific products that can continue to have long lead times in the interest of cost efficiency (such as basics), and moving fit/color approvals closer to the source. Currently, End-to-End has been rolled out to about half of ready-to-wear. By the end of 2009, all of ready-to-wear will be live (~50% of MMG's volume), and in 2010, men's, intimates, and kids will be added. End-to-end will eventually be rolled out to home, although management does not believe the need is as urgent.

- **Fast Track:** Macy's has selected certain categories for the "Fast Track" initiative, which targets a 10-15 week cycle (not including airing products into the U.S.). The percentage of a brand on the "Fast Track" cycle varies and could be as high as 80-90%, depending on the brand. For instance, almost all INC apparel is on "Fast Track."

- **Product Lifecycle Management (PLM):** As mentioned, Macy's is working with Tradestone Software to launch a fully-integrated product lifestyle management system that encompasses planning, through the creative process, to pre-production, production, and post-production. This PLM system will provide full transparency between MMG, vendors, Macy's Inc., and suppliers; eliminate the use of Excel spreadsheets; and eliminate the use of emails. Macy's is rolling out PLM this year, and expects the entire company to be completed within two years.

Benefits of Shorter Cycle Times

We expect Macy's S2M initiative to reduce cycle times, which will enhance the company's operating margin (topline, gross margin, and expense leverage) as a result of: 1) lower fashion risk; 2) higher product success; 3) lower inventory levels; 4) lower markdown risk; and 5) higher in-stocks. The figure below compares and contrasts the speed to market progress/targets of Macy's with its competitors, J.C. Penney and Kohl's. Decreasing cycle times has been a key area of focus for the department stores under our coverage. As illustrated below, Macy's is a small step behind some of the competition, which we view as an investment positive, as it suggests to us that a majority of the topline and margin benefits are ahead of us.

Figure 2. Speed to Market Comparison Chart (JCP vs. KSS. vs. M)

	Historical Average	2007	2008	2009E	2010E
J.C. Penney	**50-52 weeks**	**40 weeks**	**35 weeks**	**25 weeks**	
Fashion				17 weeks	
Core				25 weeks	
Essentials				Pull Replenishment	
	Historical Average	**2007**	**2008**	**2009E**	**2010E**
Kohl's	**N/A**	**N/A**	**20% of receipts by 1H08**	**100%**	
			50% of receipts by 2H08		
Core Process 1		40 weeks	30 weeks	30 weeks	
Core Process 2			25 weeks	25 weeks	
Fast Track			15 weeks	15 weeks	
	Historical Average	**2007**	**2008**	**2009E**	**2010E**
Macy's	**N/A**	**42 weeks**	**N/A**	**RTW (50% of volume)**	**100%**
Company Average				32 weeks	32 weeks
Fast Track				10-15 weeks	10-15 weeks

Source: Company Reports and Citi Investment Research and Analysis

Rationale #3: Upside From Current Levels

Upside to Street Expectations

We believe our previous earnings estimates and current Street consensus for Macy's are too low, in light of the topline and margin drivers that we previously outlined. We believe some of these fundamental catalysts are underappreciated by the Street and that management's 2009 full-year guidance is conservative.

As such, we are raising our 2009-2011 EPS estimates for Macy's to reflect our:

- More constructive outlook regarding topline and margin benefits from the successful execution of the My Macy's initiative (benefits begin in 4Q09, biggest impact in 2010);
- Margin tailwinds from product cost deflation (M anticipates more of a benefit in 2010 than this year); and
- Improved sales, margins, and inventory turns from the company's speed to market initiative and product lifecycle management technology rollout (benefits begin in 2009 and should continue in out years).

CIRA EPS Estimate Revisions

The figure below summarizes the sales, gross margin, and SG&A adjustments that we have made to our annual EPS estimates for Macy's from 2009-2011. We have included a more detailed discussion below the figure, by year.

Figure 3. M – CIRA EPS Estimate Revisions 2009E-2011E (Before vs. After)

Macy's		**BEFORE**			**AFTER**	
	2009E	**2010E**	**2011E**	**2009E**	**2010E**	**2011E**
Sales (% Growth)						
- Growth	-7.4%	-3.5%	-1.2%	-6.5%	1.3%	1.8%
- Comp Sales	-7.3%	-3.4%	-1.0%	-6.4%	1.5%	2.0%
EBIT Margin (bps improvement)						
Gross Margin	14	94	65	81	122	70
SG&A	(69)	(7)	25	(49)	17	30
Operating Margin	(55)	88	90	33	138	100
Earnings						
Diluted EPS	**$0.97**	**$1.19**	**$1.49**	**$1.30**	**$1.80**	**$2.22**
- Growth	-24.7%	22.7%	24.8%	0.9%	38.0%	23.3%
Consensus EPS						
Mean	**$0.91**	**$1.20**	**$1.52**	**$0.91**	**$1.20**	**$1.52**
High	$1.26	$1.56	$2.13	$1.26	$1.56	$2.13
Low	$0.69	$0.94	$0.97	$0.69	$0.94	$0.97
Guidance	**$0.70 to $0.80**	**N/A**	**N/A**	**$0.70 to $0.80**	**N/A**	**N/A**

Source: Citi Investment Research and Analysis

2009 EPS Outlook

We are raising our 2009 EPS estimate to $1.30 per diluted share, up from $0.97 previously. Our upwardly revised estimate is significantly above Macy's guidance of $0.70 to $0.80, and above current consensus of $0.91 per diluted share. Our 2009 EPS estimate assumes same-store sales decline of (-6.4)% (up from (-7.3)% previously), gross margin expansion of 81 bps (up from 14 bps previously), and SG&A deleverage of (-49) bps (up from (-69) bps previously), for an EBIT margin of 6.0% (up from 5.2% previously). Our 2009 EPS forecast represents 0.9% year-over-year growth.

2009 Quarterly EPS Outlook

- 3Q09E: (-$0.06) vs. (-$0.10) previously

- 4Q09E: $1.32 vs. $1.03 previously

2010 EPS Outlook

We are raising our 2010 EPS estimate to $1.80 per diluted share, up from $1.19 previously and above current consensus of $1.20. Our 2010 EPS estimate assumes same-store sales growth of 1.5% (vs. a decline of (-3.4)% previously), gross margin expansion of 122 bps (up from 94 bps previously), and SG&A leverage of 17 bps (vs. deleverage of (-7) bps previously), for an EBIT margin of 7.4% (up from 6.1% previously). Our 2010 EPS forecast represents 38.0% year-over-year growth over our 2010 EPS forecast.

2010 Quarterly EPS Outlook

- 1Q10E: $0.01 vs. (-$0.05) previously

- 2Q10E: $0.37 vs. $0.26 previously

- 3Q10E: $0.03 vs. (-$0.04) previously

- 4Q10E: $1.39 vs. $1.02 previously

2011 EPS Outlook

We are raising our 2011 EPS estimate to $2.22 per diluted share, up from $1.49 previously and above current consensus of $1.52. Our 2011 EPS estimate assumes same-store sales growth of 2.0% (up from (-1.0)% previously), gross margin expansion of 70 bps (up from 65 bps previously), and SG&A leverage of 30 bps (up from 25 bps previously), for an EBIT margin of 8.4% (up from 7.0% previously). Our 2011 EPS forecast represents 23.3% year-over-year growth over our 2010 EPS forecast.

September SSS Estimate Revision

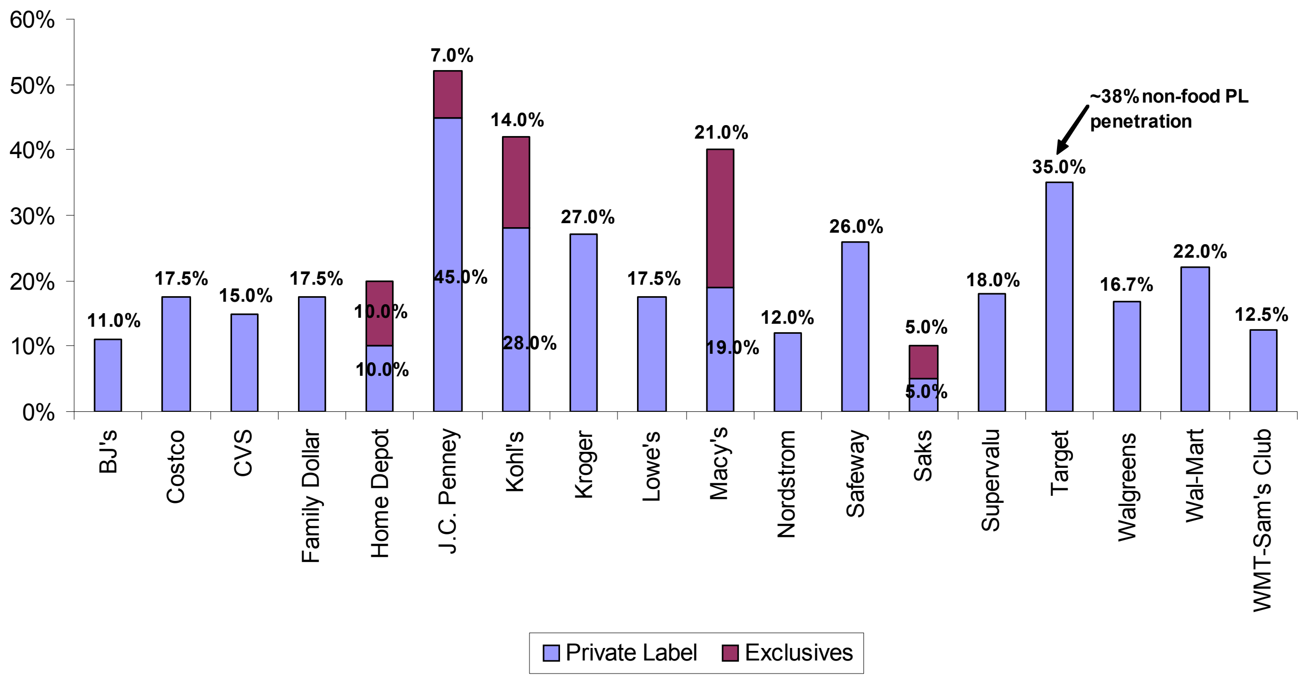
We are also raising our September SSS estimate for Macy's to the range of (-4) to (-6)%, up from (-5) to (-7)% previously, and vs. (-6.6)% last year. Recall, management does not provide monthly SSS guidance, but expects SSS in the back half of 2009 to decline (-5) to (-6)%. We believe that Macy's promotional calendar is a slight positive YOY, as the company's Labor Day Sale shifted from August Week 4 to September Week 1 last year into September Weeks 1-2 this year. We also note that Macy's has slightly higher geographic exposure to the Northeast region (~22% of the store base vs. JCP at 14% and Kohl's at 18%), so that later school start dates this year in many districts was likely more pronounced and favorable for the company this month (shifted sales from August into September).

Raising Our Target Price & Rating

We are raising our target price for Macy's to $30, up from $15 previously, to reflect our updated EV/EBITDA valuation, which incorporates our upward revisions, as we as a shift to 2010 valuation (vs. 2009 basis previously). We apply an ~6x multiple (unchanged) to our 2010 EBITDA assumption (vs. 2009 previously) to derive our new target price for Macy's. Based on upside from current levels, we are upgrading the share of M to a Buy, High Risk (1H) rating, from a Hold, High Risk (2H) rating previously. *Please refer to the Valuation & Risks section for further details.*

Appendix

Figure 4. Broadlines – Private and Exclusive Label Penetration (2008-end)



Source: Company Reports and Citi Investment Research and Analysis

Figure 5. M – New Centralized Executive Team

Terry J. Lundgren	Chairman, President & CEO
Timothy M. Adams	Chief Private Brand Officer
Thomas L. Cole	Chief Administrative Officer
Mark S. Cosby	President-Stores
Jeffrey Gennette	Chief Merchandising Officer
Julie Greiner	Chief Merchandise Planning Officer
Karen M. Hoguet	Chief Financial Officer
Ronald Klein	Chief Stores Officer
Peter Sachse	Chief Marketing Officer
Michael Gould	Chairman & CEO of Bloomingdale's

Source: Company Reports and Citi Investment Research

Macys Inc

Company description

Macy's, Inc. (M) is one of the leading department store retailers in the United States. As of the end of 2Q09, Macy's, Inc. operated 848 department stores and furniture galleries in 45 states, the District of Columbia, Guam, and Puerto Rico, under the names of Macy's and Bloomingdale's. The company also operates macys.com and bloomingdales.com. In 2008, Macy's generated sales of $24.9 billion. Prior to June 1, 2007, Macy's, Inc. was known as Federated Department Stores, Inc.

Investment strategy

We rate the shares of Macy's, Inc. Buy/High Risk (1H). Our rating is supported by: 1) our increased confidence in the ability of the company's centralized organization structure and nationwide My Macy's localization initiative rollout to drive topline growth and margin improvement; 2) margin tailwinds from product cost deflation; 3) topline and margin benefits from Macy's speed to market initiative; and 4) valuation. We are confident in Macy's management team's ability to improve same-store sales and operating margins over the longer-term, particularly when aided by a continued focus on the company's key priorities and customer insights from Macy's partnership with dunnhumby.

Valuation

Our target price for Macy's, Inc. is $30. In our forward EV/EBITDA analysis, our target multiple of ~6x on our 2010 EBITDA estimate is inline with Macy's ten-year median of 6x and at the low-end of its high of 99.9x and low of 3.9x. We view an ~6x EV/EBITDA multiple as reasonable given the company's targeted moderate demographic (which is feeling the pressures from macro headwinds) and limited square footage growth. Our earnings estimates reflect sequential sales improvement driven by the company's My Macy's initiative, as well as margin recovery.

Risks

We rate M shares High Risk based on a number of factors, including stock liquidity, earnings risk, earnings stability, price volatility, balance sheet risk, and financial strength.

We believe that M's price volatility is high and its earnings stability (calculated as the percentage difference between reported EPS and trend EPS) is very low when compared to other stocks in the S&P 500 index, which increases the associated risk.

Our risk rating also reflects industry and company-specific risks. Risks to the stock outperforming our target valuation include: 1) comp trends could pick up faster than expected; 2) M could realize more synergies from the division consolidations than expected; 3) the macro environment could rebound sooner than expected; and 4) LBO speculation could reemerge and drive shares of Macy's up.

Risks to the stock achieving our valuation target include: 1) execution risk; 2) sales disruption risk from the division consolidation; 3) risks relative to the secular trends of the department store industry; and 4) risk of macro headwinds having a greater- or longer-than-expected impact on top line and earnings.

If the impact on the company from any of these factors proves to be greater/less than we anticipate, it may prevent the stock from achieving our target price or could cause our target price to be materially outperformed.

Appendix A-1

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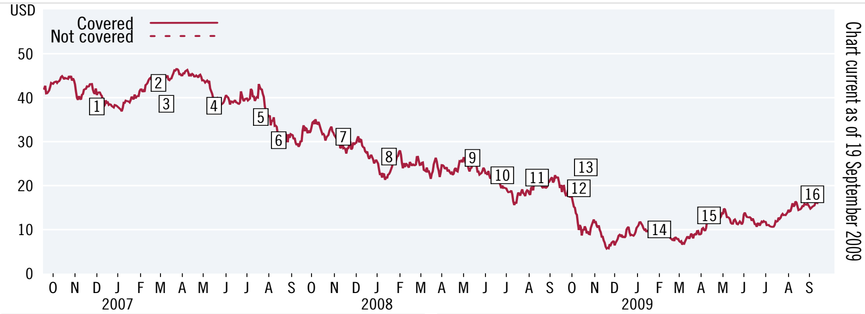
Fundamental Research
Analyst: Deborah L Weinswig



	Date	Rating	Target Price	Closing Price
1	1-Dec-06	*2M	*45.00	40.60
2	27-Feb-07	2M	*47.00	43.35
3	9-Mar-07	2M	*50.00	44.49
4	16-May-07	2M	*45.00	39.65
5	20-Jul-07	2M	*43.00	41.92
6	15-Aug-07	2M	*35.00	31.10
7	14-Nov-07	2M	*31.00	28.47
8	17-Jan-08	*2H	*25.00	22.62
9	14-May-08	2H	*26.00	24.93
10	25-Jun-08	2H	*23.00	20.02
11	13-Aug-08	2H	*22.00	20.66
12	10-Oct-08	2H	*12.00	9.92
13	21-Oct-08	2H	*10.00	10.19
14	2-Feb-09	2H	*9.00	8.59
15	13-Apr-09	2H	*12.00	12.93
16	4-Sep-09	2H	*15.00	15.21

* Indicates change

Rating/target price changes above reflect Eastern Standard Time

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