

Macy's Inc.

Under Promise + Over Deliver = Overweight

Although there wasn't a lot of "new news" in Macy's 4Q earnings, there was a bit more fanfare this morning than we initially expected . . . *and we'd consider it all to be incrementally positive.* **Four points:** First, 4Q EPS results of \$1.06 topped the Street view by ~\$0.05 with the upside solid; relative to our model, EBIT was 70 bps better than we expecting, contributing \$0.08 to EPS. Second, guidance still looks like a "worst case scenario" to us, which we think is the prudent way to approach the year and allows for upside if the macro environment improves. Third, the expected good-will write-down was announced, although the exact amount is not yet determined, but should be in the anticipated \$4.5-\$5.5 billion range, lifting that overhang from the stock. Last, the company quantified the relative performance of My Macy's regions in 4Q, noting a 650 bps improvement from 1H08 (5.0% underperformance vs. the chain pre-implementation) to 4Q08 (1.5% outperformance relative to company average). All in, we believe that the risk/reward balance at Macy's heavily favors the upside as 2009 expectations are low and the company continues to under promise and over deliver, evidenced by a strong 4Q print. We remain Overweight the stock and reaffirm our \$11.00 December 2009 price target.

- 4Q In Review; Solid GPM Gains.** Macy's printed 4Q EPS of \$1.06 (ex. \$0.33 of 1x items) – \$0.055 ahead of our estimate and the Street – as a reminder, M raised its 4Q guidance from \$0.90-\$1.00 to \$1.00-\$1.02 concurrent with its January sales release. As previously reported, Macy's top-line fell 7.7% on a 7.0% SSS decline – the best relative quarterly results among the department stores in our universe. Moving down the P&L, the operating margin contracted 411 bps in the quarter as GPM slid 223 bps to 39.3% on greater promotional activity and discounting and SG&A (as a % of sales) unfavorably increased 188 bps to 28.4% on the sales decline and increased investment in the business. We're excluding \$219 million of 1x merger integration costs and restructuring fees. Net interest and debt expense was flat with 3Q08 at \$143.0 million, the tax rate was 38.5%, and the share count ticked down ~3.0% YOY to 421.4 million.

Overweight

M, M US

Price: \$7.40

Price Target: \$11.00

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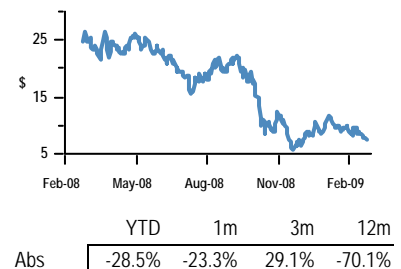
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J.P. Morgan Securities Inc.

Price Performance



Macy's Inc. (M;M US)

	2007A	2008E (Old)	2008A (New)	2009E
EPS (Operating) (\$)				
Q1 (Apr)	0.16	0.02A	0.02A	
Q2 (Jul)	0.29	0.29A	0.29A	
Q3 (Oct)	0.10	(0.08)A	(0.08)A	
Q4 (Jan)	1.65	1.01A	1.06A	
FY	2.14	1.23A	1.29A	0.42
P/E (Operating) FY	3.5	6.0	5.7A	17.7

Source: Company data, Reuters, J.P. Morgan estimates. EPS presented on an operating basis (excluding integration/restructuring charges). 4Q07 also excludes \$0.18 in tax credits.

Company Data

Price (\$)	7.40
Date Of Price	23 Feb 09
52-week Range (\$)	27.08 - 5.07
Mkt Cap (\$ mn)	3,105.78
Fiscal Year End	Jan
Shares O/S (mn)	420
Price Target (\$)	11.00
Price Target End Date	31 Dec 09

See page 5 for analyst certification and important disclosures.

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- **Quality of Beat Solid with \$0.08 of Upside in EBIT.** We'd rate the quality of the 4Q beat as solid as EBIT topped our estimate by ~70 bps, contributing \$0.08 to EPS. Specifically, GPM was 90 bps better than we anticipated (39.3%A vs. 38.5%E), adding \$0.11 to EPS relative to our model, partially offset by a slightly higher SG&A rate (28.4%A vs. 28.2%E) taking \$0.03 from earnings. Below the EBIT line, a modestly higher-than-expected tax rate (38.5%A vs. 37.0%E) negatively impacted EPS by \$0.02 relative to our model, netting the \$0.055 delta between our \$1.01 estimate and the reported \$1.06 result.
- **Maintaining FY09 Estimate of \$0.42, 1Q09 loss of \$0.25.** We weren't surprised that Macy's did not revise its FY09 guidance, which was just set on February 2, 2009 (EPS \$0.40-\$0.55 on a 6%-8% SSS decline) and we remain comfortable with our \$0.42 estimate, about a dime below the Street.
- **Balance Sheet Solid . . . M** maintained clean inventory levels, as total inventory decreased 5.8%, or a 7.5% reduction on a comp store basis, in line with the sales decline. As previously announced, the company put \$686 million of its \$1.3 billion cash to use retiring some of the debt, which matures in 2009 – reducing anticipated 2009 interest expense by \$7 million. Of note, AP/inventory declined to 81.7% from 88.6% a year ago.
- **. . . Even With A Goodwill Write-Down Likely.** As expected (see 1/15 FC note entitled *Macy's: Goodwill Impairment Scenario Analysis, Risk < Reward, Stay OW*), Macy's will likely write down \$4.5-\$5.5 billion of goodwill related to the May acquisition when it releases its 10K in late March/early April, which will impact EPS by \$10.00-\$12.50 per share. Importantly, this will be a non-cash write-down and will have no impact on the company's access to capital or bond indentures.

Macy's Price Target Analysis and Risk To Rating

We rate Macy's Overweight and our \$11.00 December 2009 price target is predicated on a 25/75 weighted, blended P/E and EV/EBITDA multiple build. With the recent pullback in the stock, we believe shares are heavily discounting the fair assessment of current risks. On 2009E EV/EBITDA (75% weighted), Macy's is trading at a multiple of 6.0x, a 20.0% discount to its historical average of 7.5x. On P/E, the valuation is expensive trading at 19.8x our forward earnings forecast, however, we believe EV/EBITDA is a better metric provided the aforementioned significant cash flow generation by the company. In our price target build, we layer in assumptions to include a best, base, and worst case scenario for the stock – trading multiples vary by scenario and are determined based on historical trading ranges and peer valuations. For M, our base case scenario (50%) is based on an absolute P/E of 10.0x and EV/EBITDA multiple of 6.5x. Our best case scenario (30%) is based on an absolute P/E of 12.0x and EV/EBITDA multiple of 9.0x. Conversely, our worst case scenario (20%) is based on a P/E of 8.0x and an EV/EBITDA multiple of 4.0x.

Potential downside risks to our rating and price target include: (1) sales trends continue to decelerate beyond our current assumptions due to either a pro-longed consumer downturn or lost market share, making our estimates too aggressive; (2) on the margin front, our EBIT assumptions could be negatively impacted by more-than-expected markdowns, a more intense promotional environment, and further de-leverage from negative same-store-sales growth; and (3) if Macy's EBITDA continues to deteriorate, the company's bank line of credit covenants could be triggered.

Company Description

Macy's, with corporate offices in Cincinnati and New York City, operates over 840 department stores under the Macy's and Bloomingdale's banners as of February 24, 2009. Macy's has a history of significant mergers, most recently, the acquisition of May Company (487 stores) in August 2005 for roughly \$17 billion. In September 2006, the company renamed over ten regional store banners to Macy's, including Marshall Field's, Famous Barr, Filene's, Foley's, Kaufmann's, and Robinson-May.

In 2007, the company reported revenues totaling \$26.3 billion. The company's merchandise mix in 2007 was 36% accessories, intimate apparel, shoes, and cosmetics, 27% women's apparel, 22% men's & children's, and 15% home and miscellaneous.

Macy's Inc.: Summary of Financials

Income Statement - Annual	FY08A	FY09E	FY10E	Income Statement - Quarterly	1Q09E	2Q09E	3Q09E	4Q09E
Revenues	24,892	22,997	22,205	Revenues	-	-	-	-
COGS	15,009	13,905	13,367	COGS	-	-	-	-
Gross profit	9,883	9,091	8,837	Gross profit	-	-	-	-
SG&A	8,458	8,278	7,955	SG&A	-	-	-	-
Operating income	1,027	413	883	Operating income	-	-	-	-
EBITDA	2,703	2,064	2,158	EBITDA	-	-	-	-
Interest, net	560	530	480	Interest, net	-	-	-	-
Other Income	-	-	-	Other Income	-	-	-	-
Pretax income	467	(117)	403	Pretax income	-	-	-	-
Income taxes	173	(44)	151	Income taxes	-	-	-	-
Tax rate	37.0%	38.0%	37.5%	Tax rate	-	-	-	-
Net income - reported (GAAP)	294	(72)	252	Net income - reported (GAAP)	-	-	-	-
Diluted shares outstanding	421	420	420	Diluted shares outstanding	-	-	-	-
EPS - operating	1.29	0.42	0.60	EPS - operating	-	-	-	-
EPS - reported (GAAP)	0.70	(0.17)	0.60	EPS - reported (GAAP)	-	-	-	-
Balance Sheet and Cash Flow Data	FY08A	FY09E	FY10E	Ratio Analysis	FY08A	FY09E	FY10E	
Cash and cash equivalents	1,306	318	980	Sales growth	(5.4%)	(7.6%)	(3.4%)	
Accounts receivable	439	506	406	Same store sales growth	(4.4%)	(7.0%)	(3.0%)	
Current assets	6,740	5,445	5,867	EBITDA growth	(20.2%)	(23.6%)	4.5%	
PP&E	10,442	9,641	8,866	EBIT growth	4.1%	1.8%	4.0%	
Goodwill	9,125	9,125	9,125	EPS growth - operating	(39.7%)	(67.6%)	43.5%	
Total assets	27,527	25,338	24,946	Gross margin	39.7%	39.5%	39.8%	
Short-term Debt	966	226	650	EBIT margin	5.7%	3.5%	4.0%	
Current liabilities	5,128	4,385	4,683	EBITDA margin	10.9%	9.0%	9.7%	
Long-term Debt	8,733	8,523	7,873	Inventory growth	(5.8%)	(7.5%)	(3.0%)	
Total liabilities	17,798	16,545	16,068	Debt / EBITDA	3.6	4.2	3.9	
Shareholders' equity	9,729	8,998	9,165	D&A	1,278	1,251	1,275	
D&A	1,278	1,251	1,275	Change in working capital	397	632	499	
Change in working capital	397	632	499	Cash flow from operations	1,969	1,235	2,026	
Cash flow from operations	1,969	1,235	2,026	Enterprise value / Revenues	-	-	-	
Capex	(900)	(450)	(500)	Enterprise value / EBITDA	-	-	-	
Free cash flow	1,318	502	1,526	P / E	10.6	NM	12.4	
Free cash flow / share	2.61	0.99	3.43	Dividends	0.52	0.20	0.20	
Dividends	0.52	0.20	0.20					

Source: Company reports and J.P. Morgan estimates.
Note: \$ in millions (except per-share data). Fiscal year ends Jan

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Macy’s Inc. (M) Price Chart



Date	Rating	Share Price (\$)	Price Target (\$)
22-Jan-07	N	40.22	--
16-Apr-08	UW	22.98	--
14-Jul-08	N	16.28	--
17-Oct-08	OW	10.05	--
31-Oct-08	OW	11.66	14.00
08-Jan-09	OW	11.31	13.00
03-Feb-09	OW	8.59	11.00

Source: Reuters and J.P. Morgan; price data adjusted for stock splits and dividends.
 Break in coverage Oct 10, 2005 - Jan 22, 2007. This chart shows J.P. Morgan’s continuing coverage of this stock; the current analyst may or may not have covered it over the entire period.
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