

## Neiman Marcus

### Earnings Update

### Neutral

Moody's: Caa3; Outlook,Negative  
S&P: CCC+; Outlook,Negative

Ticker  
**NMG**

**We maintain our Neutral on Neiman Marcus after the company posted in-line results and announced negotiations to replace its existing asset-based revolver.** We believe that Neiman can weather a protracted downturn in the luxury market, but expect results to remain weak near term. Within the context of our Neutral recommendation, we would recommend only hedged trades in the name. Last week we recommended a basis trade – buy senior notes and buy CDS for an estimated pick up of 215bps (bonds @63, CDS at 22 up front). Today may be a better day to put that trade on, given market weakness on no news.

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#### High-Yield Retail

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- The company continues to face consumer headwinds from a shift in the psychology of the shopper. The Neiman Marcus shopper does not really “need” anything so while her PA is down, she is holding off from making frequent large ticket purchases. We believe the luxury shopper will come back fast once confidence returns, but the aspirational customer may not come back for some time (we estimate that sales to this customer may take 2-3 years to come back).
- NMG reported third quarter EBITDA of \$114 million; near our base case estimate of \$120 million (worst case was \$90 million). Gross margin declined 357 bps to 36.5% from the year ago period. Revenues declined 23.7% year-over-year. We calculate rent-adjusted leverage through the senior notes of 6.4x and 7.5x through the total debt. Leverage should peak in 3Q 2010 (April qtr) at 7.1x through the seniors and 8.4x through the subs, before rebounding off the trough EBITDA levels (\$325 million trough estimate in our base case).
- Liquidity remains strong with nothing drawn on the \$600 million revolver (only \$30 million of LCs used) and \$230 million of cash on hand. Management does not anticipate using the revolver for the rest of the year. The company is in talks to renegotiate its revolving credit facility, which we expect gets downsized given that it is not expected to be utilized. Despite ample liquidity, we expect NMG to PIK its senior notes as long as it can (until October 2010).
- We forecast that the company would generate \$361 million of EBITDA in FY09 (ends July), and \$327 million next year. Our worst case estimates peg 2009 at \$324 million and 2010 at \$204 million, which we believe is somewhat unlikely. In our base case, NMB would generate \$68 million of free cash flow in 2009 \$62 million in 2010, but would burn cash in our worst case in the \$50-70 million range.

See page 5 for analyst certification and important disclosures.

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## Liquidity is adequate – expect a new bank deal

We expect NMG to renegotiate its revolver, downsize it, and increase the rate. The current \$600 million facility has no covenants unless there is less than \$60 million of availability. The current rate is L+200, but the facility has not been used since October 2005 (when it was used for the LBO funding). We would expect a new facility will have a similar covenant (triggered if availability falls below a threshold), and would expect the rate to increase considerably (a moot point for modeling purposes since it is undrawn).

Neiman has no other considerable maturities until the term loan comes due in 2013.

Table 1: NMG capitalization and liquidity

\$ in Millions	02-May-09
Revolver (\$600 mn facility, borrowing base)	0.0
Senior Secured Term Loan '13	1,625.0
7.125% Sr Sec Notes due 1 Jun '28	121.2
9.000% Sr Notes due 15 Oct '15 (PIK option through October 2010)	717.1
10.375% Sr Sub Notes due 15 Oct '15	<u>500.0</u>
Total Debt	2,963.3
<b>Liquidity</b>	
Cash	229.4
Revolver Availability	<u>510.0</u>
Total liquidity	739.4
Debt Payments Remaining in 2009	<u>0.0</u>
Net liquidity	739.4

Source: Company reports and J.P. Morgan estimates.

## How bad could it get???

Neiman continues to face consumer headwinds from a shift in the psychology of its customer. The Neiman Marcus shopper does not really “need” anything so while her family’s PA is down, she is holding off from making frequent large ticket purchases. We believe the luxury shopper will come back fast once confidence returns, but will remain more aware of the quality/value relationship than in the past.

The aspirational customer is the real question. We define the aspirational customer as the 25-40 year old consumer that does not shop at Neiman Marcus regularly for all of her needs, but goes there for key items. Over the past 4-5 years, we believe this base has grown from maybe 5-10% of Neiman’s business to potentially 30%; largely focused on hand bags, shoes, and other “statement” items. The aspirational customer may not have the wealth of Neiman’s core customer, so will be more reluctant to return to come back and purchase those “want” items, particularly in an era when “conspicuous consumption” is on the “out” list.

In our base-case model, we assume that 2010 revenue goes back to 2005 levels. This would imply that Neiman’s aspirational customer may return to a 10% of total sales level. In our worst-case model, we assume sales go back to the 2004 level, which we believe is a good barometer of the period before the boom of the aspirational customer. In neither case do we have EBITDA margins returning to 2004/2005 levels because we expect price points (and gross margins) to remain challenged.

Table 2: NMG forecast model - BASE CASE

	01-Nov-08 1Q09	31-Jan-09 2Q09	02-May-09 3Q09	01-Aug-09 4Q09E	01-Aug-09 2009E	31-Oct-09 1Q10E	30-Jan-10 2Q10E	01-May-10 3Q10E	31-Jul-10 4Q10E	31-Jul-10 2010E
<b>Income statement data:</b>										
Revenues	985.8	1,079.4	810.1	970.2	3,845.4	942.7	1,061.8	796.2	969.9	3,770.7
YOY Growth	-12.9%	-21.4%	-23.7%	-6.0%	-16.4%	-4.4%	-1.6%	-1.7%	0.0%	-1.9%
COGS	<u>617.7</u>	<u>821.4</u>	<u>514.8</u>	<u>698.5</u>	<u>2,652.4</u>	<u>590.1</u>	<u>807.0</u>	<u>509.6</u>	<u>698.4</u>	<u>2,605.0</u>
Gross profit	368.0	258.0	295.3	271.6	1,193.0	352.6	254.8	286.6	271.6	1,165.6
Margin	37.3%	23.9%	36.5%	28.0%	31.0%	37.4%	24.0%	36.0%	28.0%	30.9%
SG&A	242.8	243.6	200.5	208.6	895.5	235.7	244.2	199.0	206.6	885.5
Inc/Gain on Credit Card Sale	(13.0)	(10.2)	(10.5)	(13.5)	(47.1)	(13.0)	(10.2)	(10.5)	(13.5)	(47.1)
EBIT	81.6	(592.7)	50.3	20.7	(440.1)	74.0	(34.7)	41.9	21.6	102.8
Nonrecurring items	18.0	586.0	27.2	18.3	649.6	18.3	18.3	18.3	18.3	73.3
<b>EBITDA</b>	<b>138.2</b>	<b>32.4</b>	<b>114.2</b>	<b>76.5</b>	<b>361.3</b>	<b>129.9</b>	<b>20.8</b>	<b>98.1</b>	<b>78.4</b>	<b>327.2</b>
YOY Growth	-34.3%	-82.7%	-43.5%	-11.1%	-47.3%	-6.0%	-35.8%	-14.1%	2.5%	-9.4%
EBITDA/Sales	14.0%	3.0%	14.1%	7.9%	9.4%	13.8%	2.0%	12.3%	8.1%	8.7%
Rent Pmts (Qtly estimates)	24.7	22.0	20.0	19.9	86.6	19.5	21.2	16.2	19.7	76.6
<b>EBITDAR</b>	<b>162.9</b>	<b>54.4</b>	<b>134.2</b>	<b>96.4</b>	<b>447.9</b>	<b>149.4</b>	<b>42.0</b>	<b>114.3</b>	<b>98.2</b>	<b>403.8</b>
Net Interest	57.8	58.6	58.3	59.0	233.7	57.3	56.0	56.0	56.8	226.3
Pre-Tax Income	23.7	(651.3)	(7.9)	(38.3)	(673.8)	16.7	(90.8)	(14.1)	(35.2)	(123.4)
Net Income	12.9	(509.3)	(3.1)	(21.1)	(520.6)	14.2	(77.2)	(12.0)	(30.0)	(104.9)
Cash	115.4	223.2	229.4	306.0	306.0	276.8	344.4	286.9	368.2	368.2
Secured debt	1,746.2	1,746.2	1,746.2	1,746.2	1,746.2	1,746.2	1,746.2	1,746.2	1,746.2	1,746.2
Senior debt	2,446.2	2,446.2	2,463.3	2,480.8	2,480.8	2,498.3	2,515.8	2,533.3	2,550.8	2,550.8
Total debt	2,946.2	2,946.2	2,963.3	2,980.8	2,980.8	2,998.3	3,015.8	3,033.3	3,050.8	3,050.8
EBITDA/Int	2.4x	0.6x	2.0x	1.3x	1.5x	2.3x	0.4x	1.7x	1.4x	1.4x
EBITDAR/Net int. + 1/3 rent	2.5x	0.8x	2.1x	1.5x	1.7x	2.3x	0.7x	1.9x	1.5x	1.6x
Secured debt/EBITDA	2.8x	3.8x	4.7x	4.8x	4.8x	4.9x	5.1x	5.4x	5.3x	5.3x
Debt/EBITDA	4.8x	6.4x	8.0x	8.2x	8.2x	8.5x	8.8x	9.3x	9.3x	9.3x
Net rent adj sr debt/EBITDAR	4.4x	5.4x	6.4x	6.4x	6.4x	6.6x	6.7x	7.1x	6.9x	6.9x
Net rent adj debt/EBITDAR	5.1x	6.3x	7.5x	7.5x	7.5x	7.8x	7.9x	8.4x	8.2x	8.2x
Total Stores	42	42	42	42	42	43	43	43	43	43
Same store sales	-14.5%	-22.8%	-25.1%	-10.0%	-20.0%	-8.0%	-5.0%	-5.0%	-3.0%	-5.3%
<b>Cash Flow Statement</b>										
Net Income	12.9	(509.3)	(3.1)	(21.1)	(520.6)	14.2	(77.2)	(12.0)	(30.0)	(104.9)
Depreciation & Amort	56.6	64.3	47.9	55.8	224.5	55.6	62.4	49.0	56.8	223.8
Deferred taxes	(8.7)	(113.4)	23.8	(17.5)	(115.9)	(4.8)	(15.3)	(7.8)	(9.8)	(37.7)
Loss (Gain) on asset sales/disc ops	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Impairments/Amort of debt issue	3.6	556.6	10.7	3.6	574.5	3.6	3.6	3.6	3.6	14.4
PIK interest			20.5	17.5	38.0	17.9	18.3	18.8	19.2	74.2
Other (inc. non-cash interest)	4.1	4.3	(0.4)	0.0	8.0	0.0	0.0	0.0	0.0	0.0
Inc/(Dec) in Work. Cap	(158.4)	137.2	(76.2)	70.3	(27.1)	(72.1)	102.3	(85.2)	70.6	15.5
Discontinued ops	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<i>Operating Cash Flow (OCF)</i>	<i>(89.9)</i>	<i>139.7</i>	<i>23.1</i>	<i>108.6</i>	<i>181.5</i>	<i>14.3</i>	<i>94.1</i>	<i>(33.6)</i>	<i>110.4</i>	<i>185.3</i>
Capex	(33.5)	(31.1)	(16.7)	(32.0)	(113.3)	(43.6)	(26.5)	(23.9)	(29.1)	(123.1)
<i>Investing cash flow</i>	<i>(33.5)</i>	<i>(31.1)</i>	<i>(16.7)</i>	<i>(32.0)</i>	<i>(113.3)</i>	<i>(43.6)</i>	<i>(26.5)</i>	<i>(23.9)</i>	<i>(29.1)</i>	<i>(123.1)</i>
<b>Free Cash Flow ex Acquisitions</b>	<b>(123.3)</b>	<b>108.6</b>	<b>6.4</b>	<b>76.6</b>	<b>68.2</b>	<b>(29.2)</b>	<b>67.6</b>	<b>(57.5)</b>	<b>81.3</b>	<b>62.2</b>
Change in Debt	(0.5)	(0.7)	(0.2)	0.0	(1.4)	0.0	0.0	0.0	0.0	0.0
<i>Financing cash flow</i>	<i>(0.5)</i>	<i>(0.7)</i>	<i>(0.2)</i>	<i>0.0</i>	<i>(1.4)</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>
Change in Cash	(123.8)	107.8	6.2	76.6	66.8	(29.2)	67.6	(57.5)	81.3	62.2
Beginning cash	239.2	115.4	223.2	229.4	239.2	306.0	276.8	344.4	286.9	306.0
Ending cash	115.4	223.2	229.4	306.0	306.0	276.8	344.4	286.9	368.2	368.2

Source: Company reports and J.P. Morgan estimates.

Table 3: NMG forecast model - WORST CASE

	01-Nov-08 1Q09	31-Jan-09 2Q09	02-May-09 3Q09	01-Aug-09 4Q09E	01-Aug-09 2009E	31-Oct-09 1Q10E	30-Jan-10 2Q10E	01-May-10 3Q10E	31-Jul-10 4Q10E	31-Jul-10 2010E
<b>Income statement data:</b>										
Revenues	985.8	1,079.4	810.1	881.9	3,757.1	883.4	1,017.2	762.1	867.8	3,530.6
YOY Growth	-12.9%	-21.4%	-23.7%	-14.6%	-18.3%	-10.4%	-5.8%	-5.9%	-1.6%	-6.0%
COGS	617.7	821.4	514.8	648.2	2,602.1	565.4	783.3	503.0	637.9	2,489.5
Gross profit	368.0	258.0	295.3	233.7	1,155.0	318.0	234.0	259.1	230.0	1,041.1
Margin	37.3%	23.9%	36.5%	26.5%	30.7%	36.0%	23.0%	34.0%	26.5%	29.5%
SG&A	242.8	243.6	200.5	208.1	895.1	238.5	240.1	200.4	204.8	883.8
Inc/Gain on Credit Card Sale	(13.0)	(10.2)	(10.5)	(13.5)	(47.1)	(13.0)	(10.2)	(10.5)	(13.5)	(47.1)
EBIT	81.6	(592.7)	50.3	(16.7)	(477.5)	36.7	(51.3)	13.2	(18.0)	(19.3)
Nonrecurring items	18.0	586.0	27.2	18.3	649.6	18.3	18.3	18.3	18.3	73.3
<b>EBITDA</b>	<b>138.2</b>	<b>32.4</b>	<b>114.2</b>	<b>39.0</b>	<b>323.8</b>	<b>92.5</b>	<b>4.1</b>	<b>69.2</b>	<b>38.6</b>	<b>204.4</b>
YOY Growth	-34.3%	-82.7%	-43.5%	-54.7%	-52.8%	-33.1%	-87.4%	-39.4%	-1.0%	-36.9%
EBITDA/Sales	14.0%	3.0%	14.1%	4.4%	8.6%	10.5%	0.4%	9.1%	4.5%	5.8%
Rent Pmts (Qtly estimates)	24.7	22.0	20.0	17.7	84.4	18.0	20.1	15.3	17.2	70.6
<b>EBITDAR</b>	<b>162.9</b>	<b>54.4</b>	<b>134.2</b>	<b>56.7</b>	<b>408.2</b>	<b>110.5</b>	<b>24.1</b>	<b>84.5</b>	<b>55.8</b>	<b>275.0</b>
Net Interest	57.8	58.6	58.3	59.0	233.7	57.3	56.6	56.8	57.4	228.1
Pre-Tax Income	23.7	(651.3)	(7.9)	(75.7)	(711.2)	(20.6)	(107.9)	(43.5)	(75.4)	(247.4)
Net Income	12.9	(509.3)	(3.1)	(41.6)	(541.2)	(17.5)	(91.7)	(37.0)	(64.1)	(210.3)
Cash	115.4	223.2	229.4	180.5	180.5	190.6	231.8	194.9	172.6	172.6
Secured debt	1,746.2	1,746.2	1,746.2	1,746.2	1,746.2	1,746.2	1,746.2	1,746.2	1,746.2	1,746.2
Senior debt	2,446.2	2,446.2	2,463.3	2,480.8	2,480.8	2,498.3	2,515.8	2,533.3	2,550.8	2,550.8
Total debt	2,946.2	2,946.2	2,963.3	2,980.8	2,980.8	2,998.3	3,015.8	3,033.3	3,050.8	3,050.8
EBITDA/Int	2.4x	0.6x	2.0x	0.7x	1.4x	1.6x	0.1x	1.2x	0.7x	0.9x
EBITDAR/Net int. + 1/3 rent	2.5x	0.8x	2.1x	0.9x	1.6x	1.7x	0.4x	1.4x	0.9x	1.1x
Secured debt/EBITDA	2.8x	3.8x	4.7x	5.4x	5.4x	6.3x	7.0x	8.5x	8.5x	8.5x
Debt/EBITDA	4.8x	6.4x	8.0x	9.2x	9.2x	10.8x	12.1x	14.8x	14.9x	14.9x
Net rent adj sr debt/EBITDAR	4.4x	5.4x	6.4x	7.3x	7.3x	8.2x	8.9x	10.5x	10.7x	10.7x
Net rent adj debt/EBITDAR	5.1x	6.3x	7.5x	8.5x	8.5x	9.6x	10.4x	12.4x	12.5x	12.5x
Total Stores	42	42	42	42	42	43	43	43	43	43
Same store sales	-14.5%	-22.8%	-25.1%	-20.0%	-22.3%	-15.0%	-10.0%	-10.0%	-5.0%	-10.2%
<b>Cash Flow Statement</b>										
Net Income	12.9	(509.3)	(3.1)	(41.6)	(541.2)	(17.5)	(91.7)	(37.0)	(64.1)	(210.3)
Depreciation & Amort	56.6	64.3	47.9	55.7	224.5	55.5	62.2	48.9	56.6	223.2
Deferred taxes	(8.7)	(113.4)	23.8	(28.4)	(126.8)	(8.4)	(16.9)	(10.7)	(13.8)	(49.8)
Loss (Gain) on asset sales/disc ops	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Impairments /Amort of debt issue	3.6	556.6	10.7	3.6	574.5	3.6	3.6	3.6	3.6	14.4
PIK interest			20.5	17.5	38.0	17.9	18.3	18.8	19.2	74.2
Other (inc. non-cash interest)	4.1	4.3	(0.4)	0.0	8.0	0.0	0.0	0.0	0.0	0.0
Inc/(Dec) in Work. Cap	(158.4)	137.2	(76.2)	(26.6)	(123.9)	1.1	91.2	(37.6)	2.3	56.9
Discontinued ops	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<i>Operating Cash Flow (OCF)</i>	<i>(89.9)</i>	<i>139.7</i>	<i>23.1</i>	<i>(19.9)</i>	<i>53.0</i>	<i>52.2</i>	<i>66.7</i>	<i>(14.1)</i>	<i>3.8</i>	<i>108.6</i>
Capex	(33.5)	(31.1)	(16.7)	(29.1)	(110.4)	(42.1)	(25.4)	(22.9)	(26.0)	(116.4)
<i>Investing cash flow</i>	<i>(33.5)</i>	<i>(31.1)</i>	<i>(16.7)</i>	<i>(29.1)</i>	<i>(110.4)</i>	<i>(42.1)</i>	<i>(25.4)</i>	<i>(22.9)</i>	<i>(26.0)</i>	<i>(116.4)</i>
<b>Free Cash Flow ex Acquisitions</b>	<b>(123.3)</b>	<b>108.6</b>	<b>6.4</b>	<b>(49.0)</b>	<b>(57.3)</b>	<b>10.1</b>	<b>41.3</b>	<b>(37.0)</b>	<b>(22.2)</b>	<b>(7.8)</b>
Change in Debt	(0.5)	(0.7)	(0.2)	0.0	(1.4)	0.0	0.0	0.0	0.0	0.0
<i>Financing cash flow</i>	<i>(0.5)</i>	<i>(0.7)</i>	<i>(0.2)</i>	<i>0.0</i>	<i>(1.4)</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>	<i>0.0</i>
Change in Cash	(123.8)	107.8	6.2	(49.0)	(58.7)	10.1	41.3	(37.0)	(22.2)	(7.8)
Beginning cash	239.2	115.4	223.2	229.4	239.2	180.5	190.6	231.8	194.9	180.5
Ending cash	115.4	223.2	229.4	180.5	180.5	190.6	231.8	194.9	172.6	172.6

Source: Company reports and J.P. Morgan estimates.

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