

Retail Geeks

Weekly Spin Cycle November 21, 2011

Welcome to our inaugural issue of the *Weekly Spin Cycle*. Each week, we'll deliver some news and commentary about the retail industry. Whether you're an industry insider, investor, or outside observer, the articles/commentary you read here are designed to enhance your understanding of the retail sector and the issues facing it.

In addition, we'll pay close attention to the "managerial spin" and will on occasion offer a contrarian view. You are encouraged to provide any feedback to info@RetailGeeks.com.

ANF Management Loses Credibility with Investor Community

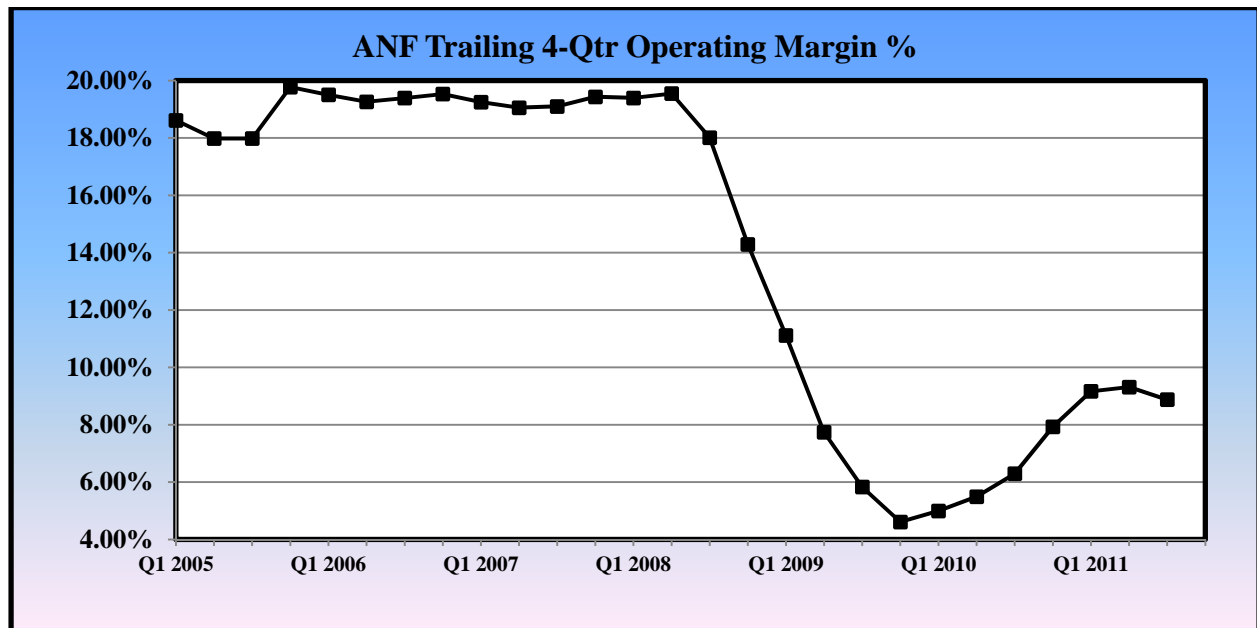
Jonathan Ramsden, EVP & CFO at **Abercrombie & Fitch (ANF - \$47.30)**, maintained the company's FY 2012 EPS target of \$4.75... despite reporting disastrous financial results for Q3 2011. A reasonable EPS estimate for this year is \$2.64 with an implied EBIT margin of 8.4% (only +50 Bps versus LY).

To reach \$4.75 next year, ANF needs to deliver at least +MSD comps and an estimated 12.0% EBIT margin.

This week, by maintaining next year's EPS target, Mr. Ramsden just lost any and all credibility he had with the investment community.

ANF management has been "hoping" for a less promotional environment here in the U.S. for some time. Simply, "hope" is not a strategy or even a reasonable expectation in light of today's macroeconomic environment.

Finally, it's worth noting that even **Urban Outfitters (URBN - \$25.96)** management suggested that its sales in Europe were relatively strong as comparable sales there "improved sequentially throughout the quarter." Not so at ANF. Is ANF experiencing worse troubles in Europe than of a simple macroeconomic variety?



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GPS CEO Murphy ALWAYS Promises Improved Product is Right Around the Corner

The Gap (GPS - \$18.76) continues to materially underperform versus its peer group. But, we chuckle when listening to the quarterly conference calls because CEO Glenn Murphy always seems eager to suggest that improved product is right around the corner. An example from this week's conference call:

"I'd like to think that when people go to stores in December, they will start seeing the beginning of some changes to the business when it comes to its aesthetic, in terms of quality of the product, in terms of acceptance of color."

Good luck with that prognostication. While his expense management and strategic vision has been stellar and kept the company's financials from imploding, Mr. Murphy's track record on predicting improved top-line performance is near zero.

Just How Profitable is China for Retailers? Maybe Not As Much As We're Being Led to Believe

That said, there was one other interesting topic that was discussed during this week's conference call. Many investors are assuming that most retailers are having a tremendous amount of success in China. But, take a look at the following quotes from GPS CEO Mr. Murphy that suggests 'profitability' in China may be more elusive than many investors have contemplated to this juncture:

"Our China store performance, from a sales perspective, has been very positive."

"But, you have to invest in China. It's a busy market and there's lots of brands coming in. You have got to put marketing money into that business in order to make sure that long-term you have a sustainable, healthy profitable brand."

"We knew that China would take the longest to become accretive. Definitely dilutive this year, likely dilutive next year as well."

"It's taking more headcount. It's more burdensome administratively. So, those costs are heavier than initially envisioned. We're also putting a lot of money into marketing."

It's time for investors to stop being so enamored by the top-line metrics for China being bandied about by retail management teams and to instead begin to better understand a retailer's profitability in the country. It may be that other retailers are having similar bottom-line problems in China as GPS is having today.

Free Shipping May Not Be the Margin Robber that Many Retailers Are Claiming

Target (TGT - \$53.00) management disclosed that the impact of free shipping on GPM% is "not one of the larger items" when looking at the company's GPM% decline versus LY.

Why interesting to us? We suspect that many other retailers are using free shipping (in addition to the higher product cost environment) as excuses for GPM% degradation versus LY. It's much easier to lay the blame elsewhere... as opposed to your own merchandising missteps and/or strategic failures.

TGT delivered fairly impressive EBIT margin expansion in its *U.S. Division* in Q3 2011 and we believe that there is further EPS upside versus the consensus estimate in Q4 2011.

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Don't Want to Issue Downside Forward EPS Guidance – Do What JCP Did This Week

In our view, **J.C. Penney (JCP - \$31.57)** management came up with a novel approach on how to avoid the issuance of EPS guidance that is materially below consensus.

In what may have been one of the more ridiculous disclosures we've seen in our career, this week, JCP management stated the following in their quarterly earnings press release:

“This guidance does not include the financial impact that is expected to be incurred in the fourth quarter as the Company executes changes to its pricing strategy in preparation for the Spring 2012 season. The Company expects to disclose the financial impact of these changes with its fourth quarter results.”

Simply, the above disclosure is unprecedented. Why is this unusual and of the non-recurring variety? It sounds more like a heavy markdown quarter or possibly that the markdowns reserve for Q3 was light.

Also, it's odd given that if the company convinces investors to view the above as a non-recurring item, next year's fiscal Q4 results will be tougher to compare against (the incoming CEO's problem).

When pressed during this week's conference call, JCP management gave no additional color on this topic.

DTC Sales Higher at URBN – What About Catalog/Internet Advertising Spend?

We love how **Urban Outfitters (URBN - \$25.96)** CEO Glen Senk suggested that the core brand's DTC sales in Q3 2011 “improved sequentially versus the second quarter.”

Why important? There was no discussion of the brand's increased level of catalog circulation (materially higher over the past 12 months versus the prior year... per 10-Q filings) and/or possibility of an increased level of Internet advertising spend versus LY.

Also, Mr. Senk suggested that the better performance by the DTC channel is a function of the ability to “adjust the web site much more quickly” than the retail stores.

It'll be interesting to see the company's catalog circulation disclosures when the 10-Q is filed. The sequential improvement in the core brand's DTC channel may have much more to do with the increased level of catalog circulation/Internet marketing than anything else.

The same holds for any retailer reporting DTC/Internet sales growth. Investors should ask management teams how much incremental dollars they're investing to drive this particular channel's top-line growth.

That said, we'll give Mr. Senk credit for admitting his ability to predict an improved trend in the business has been miserable of late. During his prepared remarks, Mr. Senk finally admitted he's no Nostradamus:

“As a merchant at heart, I realize that I am an eternal optimist, so I ask that you not misconstrue my enthusiasm as an indication of our performance. This is a cyclical business and I cannot tell you when our trend will improve.”

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WMT Takes a Margin Hit & Makes a Heavy Inventory Investment – Yet, Sales Still Lag Peer Group

In Q3 2011, Wal-Mart (WMT - \$57.23) was facing a materially easier 2-year GPM% comparison. Yet, GPM% imploded in Q3 2011 versus LY (-52 Bps versus LY). All 3 operating segments reported a GPM% decline versus LY.

On the earnings recording, the head of the *U.S. Division* made the following statement:

“Cost increases in numerous categories were not passed on to our customers in the form of increased prices.”

It's worth noting that the company suggested that its grocery inflation (*U.S. Division*) increased +4.0% in Q3 2011 versus LY. This compares to the +3.5% inflation that was disclosed in Q2 2011.

Inventory growth eclipsed sales growth at the *U.S. Division* for the 6th consecutive quarter. The company talks about an “investment in price” as a primary reason for GPM% degradation versus LY. But, the “investment in inventory” should be having a material impact on comp store sales growth (via higher fill rates). That, coupled with food inflation, should be driving greater top-line improvement than the company has reported of late.

In addition, we find it odd that WMT made essentially no mention of its e-commerce business in Q3 2011. Historically, the company's *U.S. Division* would report the total sales growth of its e-commerce business. But, in Q2 2011 and Q3 2011, there has been only a limited qualitative disclosure.

For example, in Q3 2011, WMT's *U.S. Division* made the following statement:

“The sales trends I've outlined here are also reflected in our dotcom sales, with stronger performance in electronics, home and toy categories.”

Why no disclosure of sales growth for the company's Internet business? Hmmmm.

When Was the Last Time NWY Product Resonated with Anyone?

We have to chuckle when reading the New York & Company (NWY - \$2.42) quarterly earnings press release. The company suggested the following when discussing the poor top-line performance:

“We believe our product continues to resonate with our customers as evidenced by our improved retail inventory turns.”

Question... when did NWY's product ‘resonate’ with customers? 10 years ago? 15 years ago?

CEO Gregory Scott should be embarrassed to make a statement like that on his press release. The fact is that comp store sales declined -5.2% in Q3 2011 and merchandise margins declined -200 Bps versus LY in the quarter.

Given those metrics, to suggest the product “continues to resonate” is beyond the pale for a retailer that will likely report a -2% to -3% annual EBIT margin this year.

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