WESTPEAK RESEARCH ASSOCIATION

# Abercrombie & Fitch Co. (NYSE:ANF)

**Consumer Goods – Clothing and Accessories**

## Fitch is the Name, Comps is the Game

March 11, 2019

*Abercrombie and Fitch Co. ("Abercrombie") is a global clothing retailer focused on providing premium offerings of fashion apparel, accessories, and personal care products through its brands: Abercrombie & Fitch, Hollister, Gilly Hicks, and Abercrombie kids. Abercrombie currently operates 861 stores across over 20 countries worldwide, with a majority of its operations situated domestically within the US.*

### Thesis – Return to Growth in Deteriorating Retail Backdrop

Abercrombie is in the midst of restructuring its organizational strategy – taking on certain key initiatives that we believe have potential to stimulate global growth and re-establish stability within its current stores. Despite its abysmal performance of the past, the turnaround story here is supported by management's recent performance. Growing revenues amidst store shutdowns in the near term while setting high targets for its EBIT margins seem overly optimistic given the current industry landscape and macro environment. However, we suspect heavier than expected comps will continue to drive Abercrombie forward into FY19.

### Drivers – Global Expansion and Positive Comps

Moving forward, Abercrombie's success will be dependent on its leadership in domestic excellence and its ability to capture international market share in the face of a slowing global economy. With clear headwinds ahead, Abercrombie will need to consistently sustain positive comparable store sales (comps) to signal stable growth in an otherwise cyclical sector.

### Valuation

Given Abercrombie's current share price of $26.64, we believe that Abercrombie is being undervalued by the market. Using discounted cash flow and comparable company analyses, both weighted equally at 50%, we arrived at a price target of **$33.00**, implying a **total return of 26.9%.** We initiate a **BUY** rating on Abercrombie and Fitch Co.

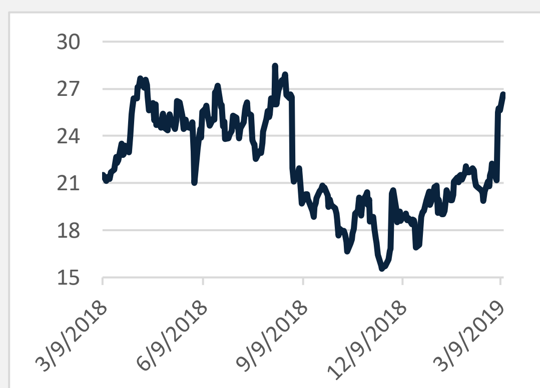
**Analyst:** Ricky Guan, BCom. '21
contact@westpeakresearch.com

| Equity Research | U.S. |
|---|---|
| **Price Target** | **USD$ 33.00** |
| **Rating** | Buy |
| **Share Price (Mar. 11 Close)** | USD$ 26.64 |
| **Total Return** | 26.9% |

| Key Statistics | |
|---|---|
| **52 Week H/L** | $29.69/$15.28 |
| **Market Capitalization** | $1.76B |
| **Average Daily Trading Volume** | 2.76M |
| **Net Debt** | N/A |
| **Enterprise Value** | $1.40B |
| **Net Debt/EBITDA** | N/A |
| **Diluted Shares Outstanding** | 68.1M |
| **Free Float** | 98.86% |
| **Dividend Yield** | 3.00% |

| WestPeak's Forecast | 2019E | 2020E | 2021E |
|---|---|---|---|
| **Revenue** | $3.67B | $3.74B | $3.79B |
| **EBITDA** | $324M | $336M | $379M |
| **Net Income** | $88M | $97M | $122M |
| **EPS** | $1.24 | $1.37 | $1.73 |
| **P/E** | 21.5x | 19.5x | 15.4x |
| **EV/EBITDA** | 4.3x | 4.0x | 3.4x |

**1-Year Price Performance**



# Business Overview/Fundamentals

## Company Overview

Abercrombie and Fitch is an American-based, multinational clothing retailer specializing in casual apparel, swimwear, accessories, and personal-care products. Abercrombie currently reports its revenue through two main segments: Abercrombie & Fitch and Hollister, the company's two major brands. Alongside its two major brands, the company also operates two other secondary brands: abercrombie kids, and Gilly Hicks. Each sub-brand provides a different customer experience specific to the sub-brand's target demographic, with stores designed to deliver consistency across its 861 global locations.

**Hollister & Gilly Hicks**

Hollister bases its product lines and store designs off the "SoCal" lifestyle, a balance between luxury and leisure. Hollister, as a brand, targets a more youthful demographic of teenagers, with premium offerings of California-inspired casual apparel and swimwear. Under the Hollister umbrella lies Gilly Hicks, a sub-brand which mainly focuses on female sleepwear and lingerie.

**Abercrombie and Fitch & abercrombie kids**

Heralded as the flagship brand, Abercrombie and Fitch promotes itself as a casual luxury to its consumers and charges a premium to its counterpart, Hollister. The company currently maintains over 300 Abercrombie & Fitch locations and designs its stores and products with emphasis on its rooted heritage. Abercrombie's product line features a wide assortment of sweaters, shirts, jeans, outerwear and other apparel that cater towards mid-market consumers. In recent years, Abercrombie merchandise and branding have undergone significant redesign to offer more minimalistic and timeless styles that consumers have favored.

**Exhibit 1: Company Brands and Store Concepts**

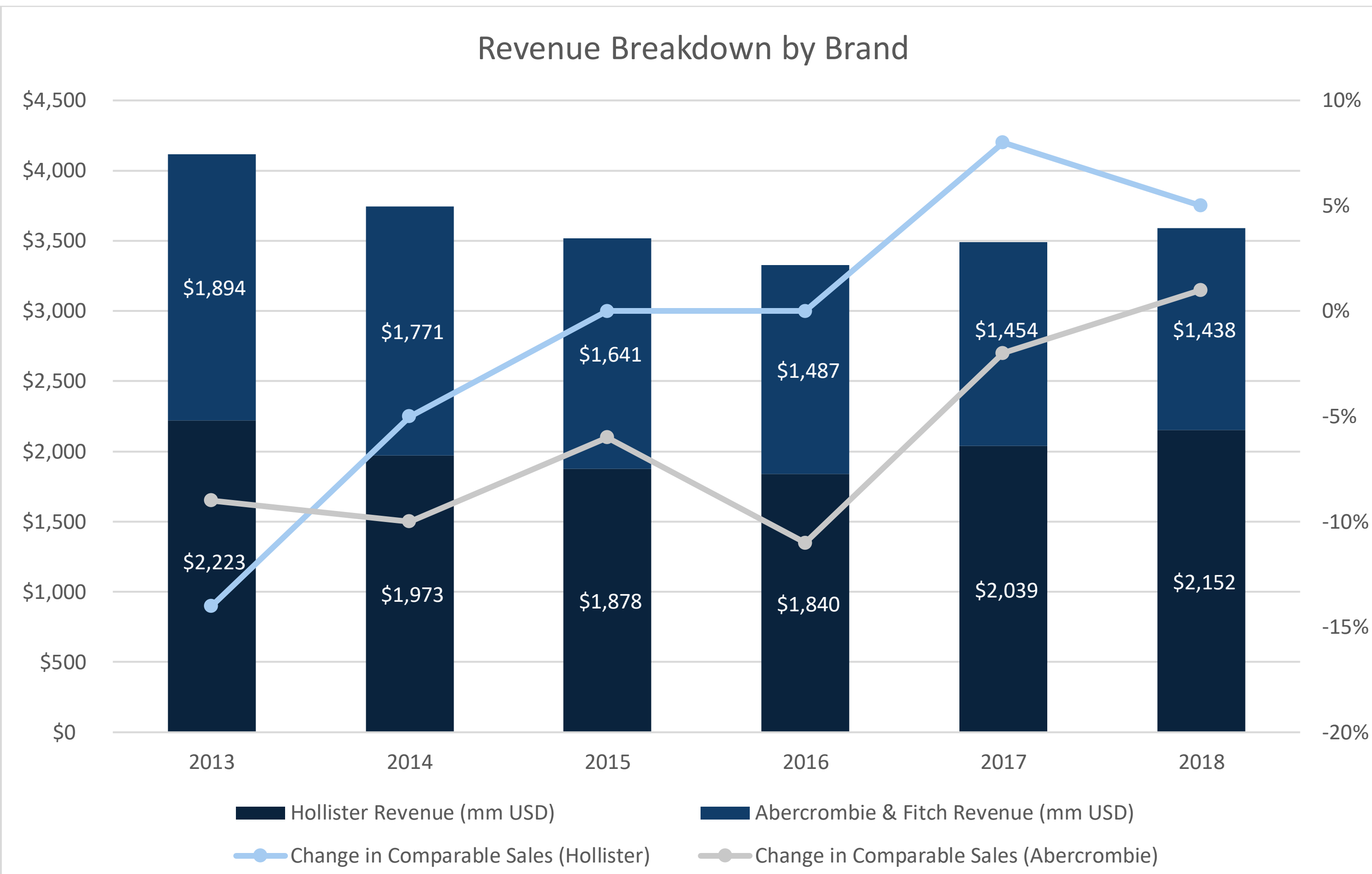

*Source: Investor Presentations & WD Partners*

## Revenue Breakdown

**Brand Basis**

Historically, Hollister has generated a majority portion of the company's revenue. During FY18 60% of the company's revenue was realized within the Hollister brand, due in part to the greater number of operating locations that Hollister currently has. Even in its the sheer volume, the company also realizes greater revenue per square feet basis with Hollister, generating an average of $525.3/sq. ft vs Abercrombie's $514.0/sq. ft in FY17. While the breakdown for sales/sq. ft by brand has yet to be disclosed, we expect similar outcomes to arise once the 10-K has been released, with Hollister performing relatively better on a per square footage basis. On a comparable basis, both brands have started to experience top line stability. After 5 consecutive years of negative comps across both brands, Abercrombie had finally established positive same store sales in FY17 and has stabilized for the time being. Keeping with the uptrend, momentum was carried into FY18, posting yet another year of positive comps growth across both brands (5% for Hollister, and 1% for Abercrombie & Fitch).

**Exhibit 1: Revenue Segments (Brand)**

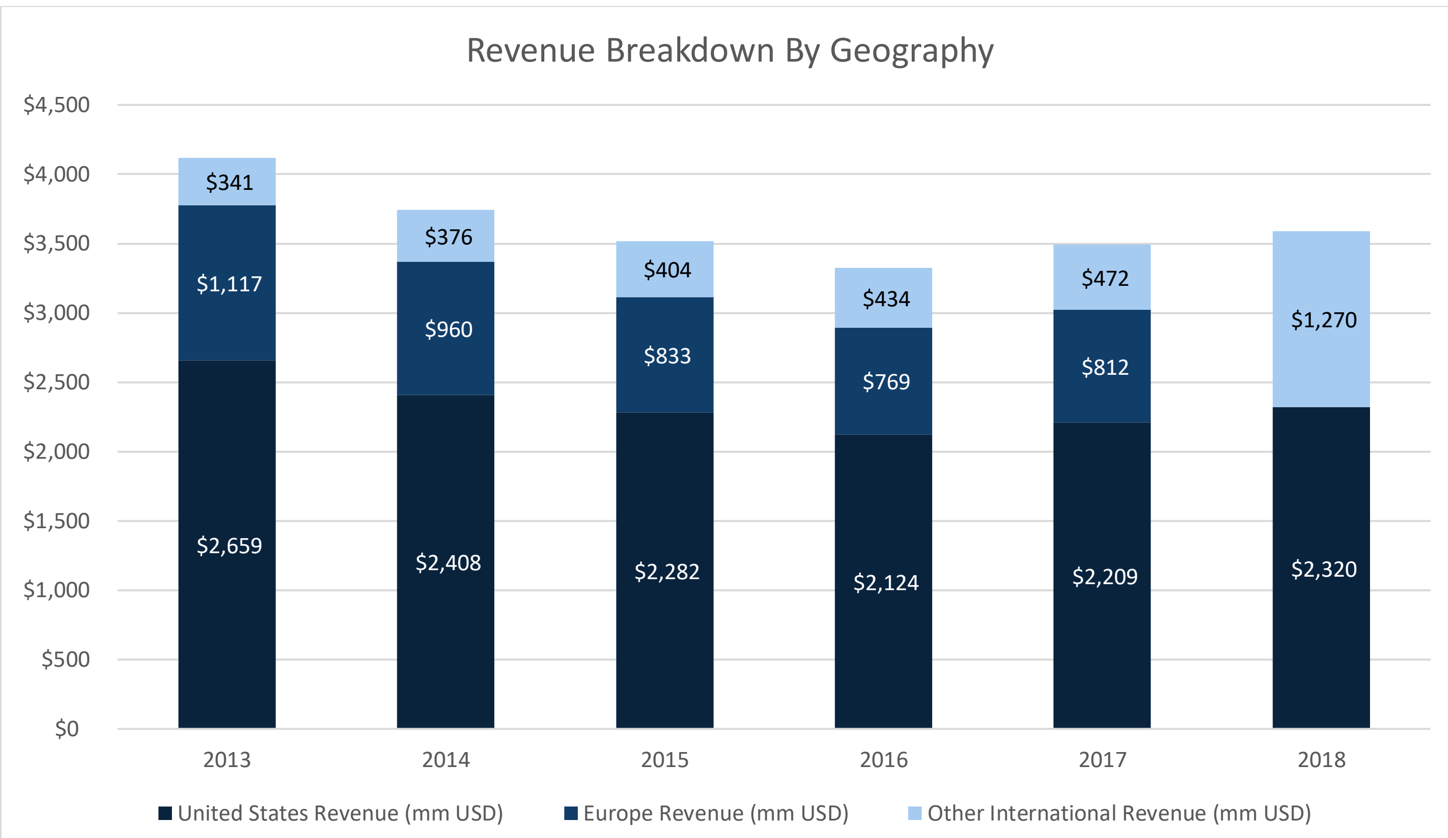



*Source: Company Filings*

**Geographic Basis**

Geographically speaking, the company realizes most of its sales domestically within the US, with its second largest market being Europe. Sales across both markets have seen mid-single to low-double digit revenue contraction from FY13-FY16. In its recent turnaround, Abercrombie has been able to return to a state of modest growth. For FY17, Abercrombie grew US and European sales by 4% and 5.6%, respectively. FY18, however, showed slight hiccups for Abercrombie's international operations as aggregated international sales regressed -1% from FY17. But despite this, the company has been steadily capturing market share within Asia and has seen regional revenues increase at 8.5% CAGR from FY13-FY17. Much of this performance has been attributed to its operations in China, capitalizing on mobile pop-up shops and e-commerce platforms such as T-Mall and Alibaba to deliver top line growth. Growth in this geographical area is seen to be more lucrative due to wider margins, driven by price premiums which foreign consumers are willing to accept. Execution of strategic expansion in more underdeveloped Asian markets, as well as in its European markets, remains a key determinant in management's plan to sustain low single digit CAGR in global sales heading into FY19.

**Exhibit 2: Revenue Segments (Geography)**




**2018 10-K has not been released at date of publishing. EU revenue figures are aggregated with Int'l/Asia revenue*

*Source: Company Filings*

## Company Strategy - Operational Shift and Improving Productivity

Outlined by management as a key determinant for future success, one of Abercrombie's core objectives is to increase operating margins. More specifically, management is expecting the company to double its 2017 adjusted-EBIT margins (2.9%) by FY2020. Realistically, there remains considerable challenges ahead for Abercrombie in fully realizing its omnichannel investments, counteracting deleveraging effects, and preserving brand value. Despite these challenges, we believe that the company's reinvestments into capital infrastructure and reduction in its retail footprint show promise in steering the brand around. Potential to increase operating margins will rely heavily on the effectiveness of these strategies initiated by management.

**Consolidation of Store Locations**

With the rise of e-commerce, comes the slow death of retail malls. Under the current retail landscape, Abercrombie has begun to re-evaluate its distribution channels. As of 2019, over 50% of the company's leasehold agreements have an expiry date of 2 years or under. Such leases are expected to provide the company with an opportunity to focus on leaning out its operations through reassessing its retail portfolio.

As a result, Abercrombie is expected to close as many as 40 stores by the end of FY19, most of which will be domestic, negative contribution stores. While closures may have an adverse effect on short-term sales performance, we believe the shift away from an oversaturated US retail space will prove favorable in the long term. Terminating unfavorable lease agreements for underperforming stores would enable the company to strategically plan out its future entries into more lucrative spaces. Such opportunities could involve growing Abercrombie's international presence. Re-evaluating its global positioning to discover attractive opportunities in less competitive markets could lead to heavier cash flows from higher margin areas.


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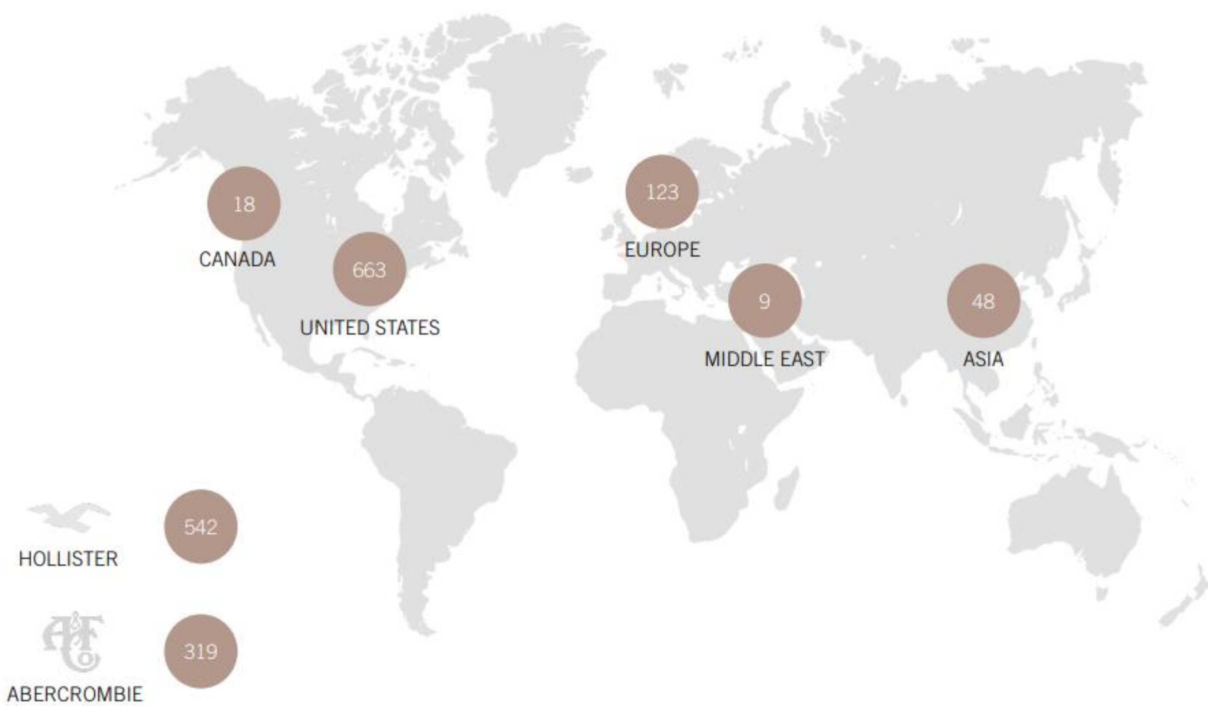
**Exhibit 3: Worldwide Map of Current Store Locations**




*Source: Investor Presentations*

**Emphasis on Right Sizing and Remodelling**

In order to concentrate its operations and bolster productivity across the company, Abercrombie has been in the midst of redesigning a majority of its retail locations. By the end of FY19, the company is expected to complete a total of 85 renovations and right-sizing of existing stores. Facelifts and the subsequent shift away from expensive, flagship locations are expected to give Abercrombie more flexibility in attracting consumers during times of sluggish mall traffic. Plans of modernizing its current retail locations will cost the company ~120mm USD for FY18 (a ~33% YoY increase in renovation-related expenditures). In the short term, we believe that these remodels can be adequately funded with the company's healthy cash balance and a 400mm USD revolving line of credit intended for capital expenditures.

To better align with consumer values, Abercrombie has also opened two collegiate concept stores to experiment with its various initiatives in a sample environment. Piloting products, campaigns, and operational best practices in the collegiate setting will indefinitely provide framework and insight into the successes and downfalls of management's execution plan. We believe this will be crucial in understanding the collegiate audience's demands before scaling up and rolling-out any capital-intensive campaigns.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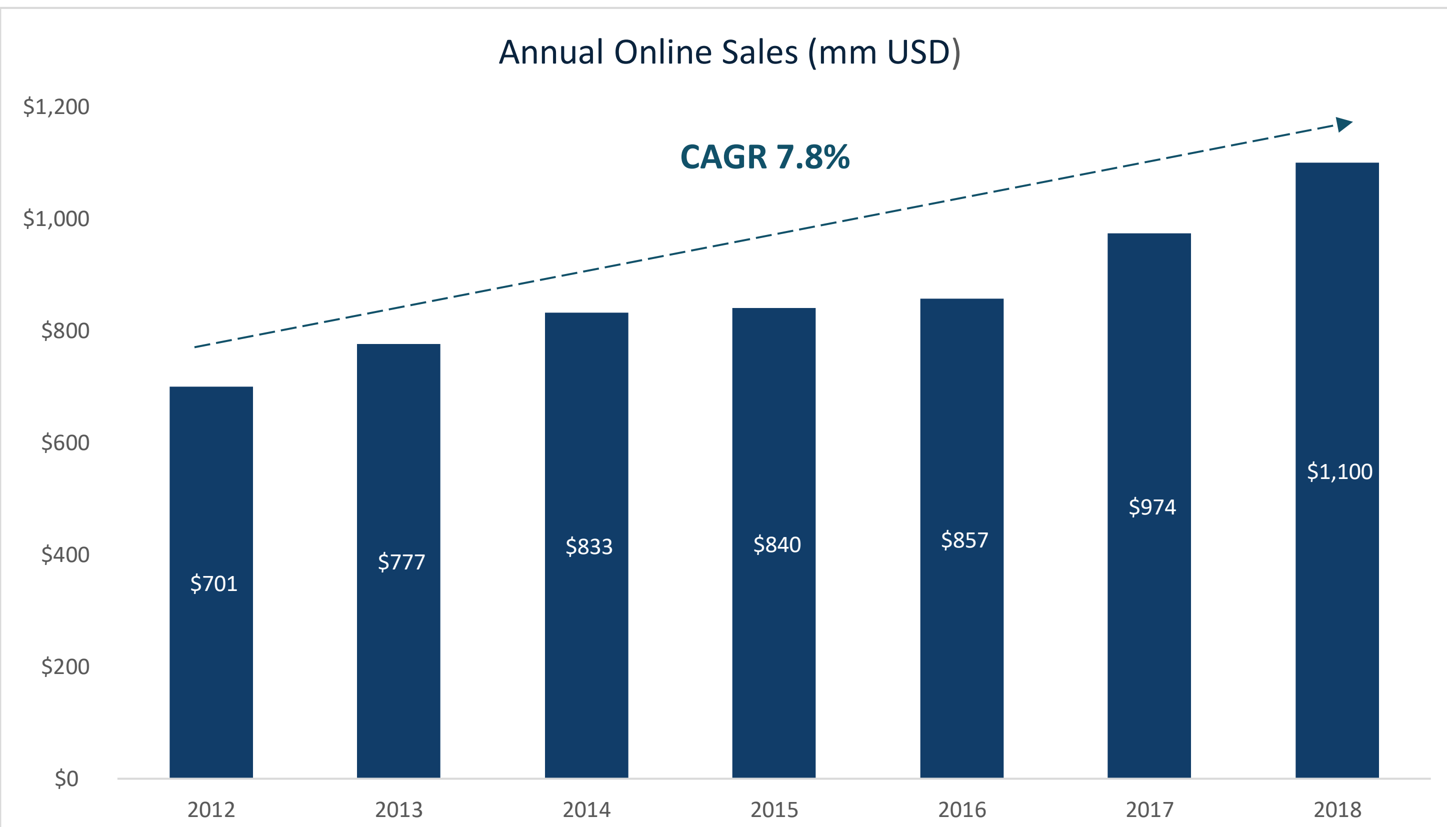
**Development of Omnichannel Infrastructure**

As E-commerce continues to dominate consumer spending on a global scale, Abercrombie has responded by allocating the necessary resources towards developing its IT framework. Extensive capital has been poured into growing its direct-to-consumer capabilities as well as its omnichannel infrastructure. Emphasis on optimizing online/mobile storefronts and creating a consistent online-to-store experience are priorities for Abercrombie in delivering a frictionless experience to consumers. To meet this objective, management is projecting to invest an approximated 80mm USD in FY19 (~45% YoY increase) for further development of CRM software, customer loyalty programs and other IT related investments.

Undoubtedly, expanding its online presence will better connect the company with its customers. However, as we see further allocation of resources towards its online platforms, we believe there remains significant concerns in Abercrombie's operational leverage. Shifting volumes across channels could prove margin dilutive as the company deleverages its fixed, existing real estate. While online sales growth has shown a healthy uptrend (7.8% CAGR over past 7 fiscal years), margin contraction may occur given incremental shipping and distribution costs associated with online retailing.

**Exhibit 4: Online Sales Trends**




*Source: Company Filings*

## Company Strategy – Pricing

**Excessive Promotional Pricing**

The emergence of fast fashion has forced retailers to exercise retail agility to deliver end products at a much faster pace than previously before. Not only does store merchandising need to be quicker and more dynamic - clothing retailers are increasingly expected to compete more vigorously on price. Abercrombie's frequent use of promotional pricing has helped top line performance in recent quarters, however, there remains significant concern in the abuse of continual discounts. Excessive, recurring discounts have implications of eroding brand value and setting new base price expectations that remain hardwired to consumer perceptions.

We believe establishing new expectations and changing consumer behavior will remain a challenge for future quarters if pricing strategies remain similar. Margins may constrict if Abercrombie faces rising input costs, flat average unit retail (AUR) trends, and stagnant demand. Management is adamant in their analysis of the promotional environment, suggesting that Abercrombie remains in line with industry standards. Their strategy on juggling competitive pricing and retaining brand value lacks clarity as we have yet to receive specific details about increasing AUR. Inability to increase AUR in the current macro environment could point to further troubles in a bear economy. In the event of a potential economic downturn, Abercrombie may be expected to further discount merchandise from current levels in order to attract consumers with tighter wallets.

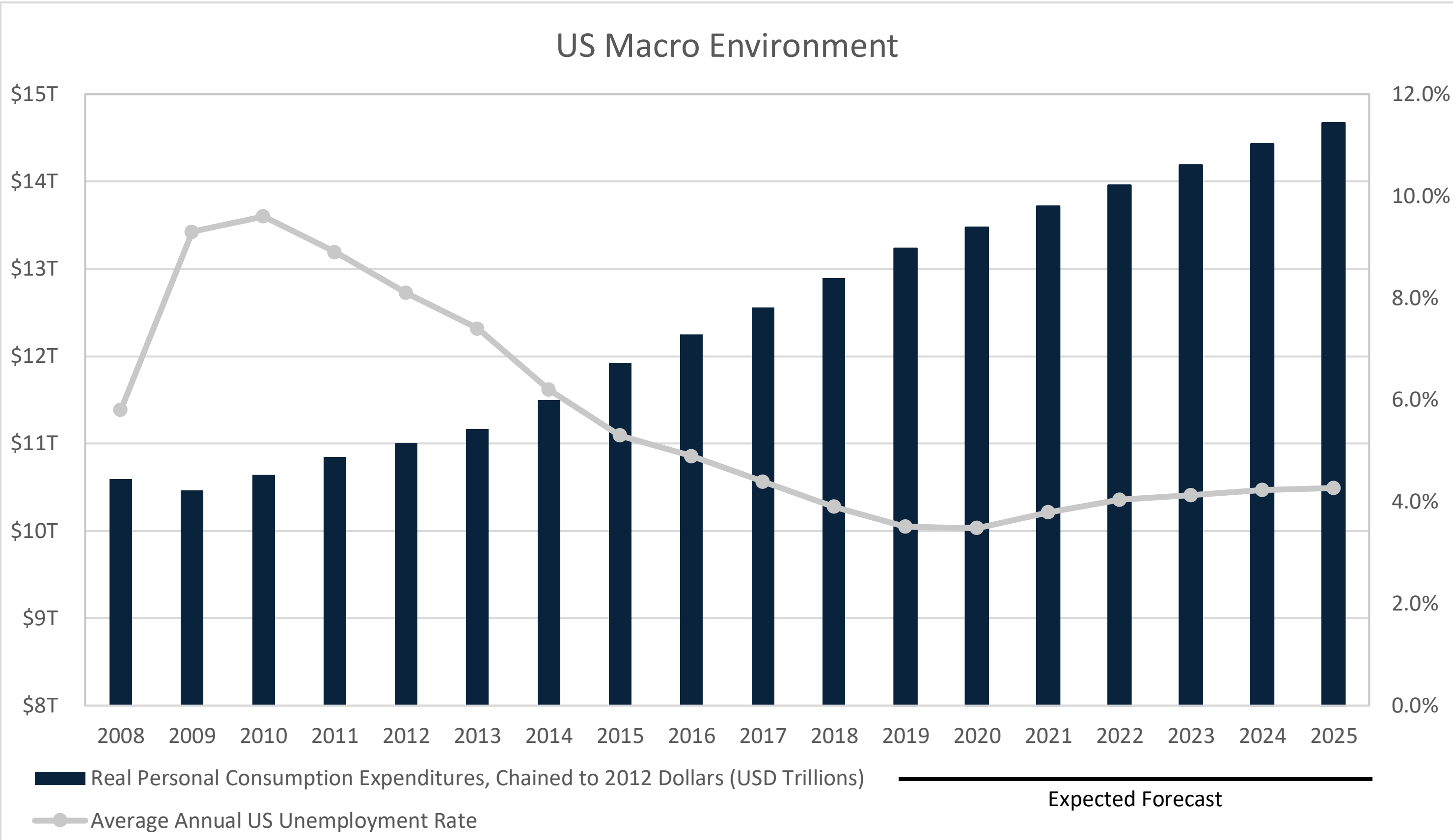
# Industry Analysis

## The Good: Healthy Macro Drivers and Upward Momentum in Consumer Spending

Abercrombie primarily operates in mature economies such as the United States, where the nation is currently experiencing record lows in unemployment, rising levels of disposable income and steady job growth – all of which support an environment for greater discretionary spending. With respect to consumer spending, data from the U.S. Bureau of Economic indicates that aggregate consumption has steadily grown in the past 5 years under these favorable conditions. Similarly, US consumption on fashion apparel has also ticked upwards in recent years with consumers amassing greater wealth.

Economic conditions in Abercrombie's secondary markets are also experiencing similar conditions. Two of Abercrombie's largest European markets – Germany and Great Britain, are maintaining similarly tight labour markets with recent estimated unemployment rates reported at 3.7% and 4.0%, respectively. In China, economic growth has given rise to a boom in household wealth that has shaped the world's largest middle class. Overall, conditions in the global ecosystem have fostered an environment where consumer demand for the latest trends and hottest styles have coincided with rising global prosperity.

**Exhibit 5: US Real Personal Consumption & Unemployment Forecast**




*Source: IBISWorld & US Bureau of Economic Analysis*

## The Ugly: Margin Squeeze, Protectionist Policies, and Global Uncertainty

While consumption for fashion goods has seen a steady climb, the industry as a whole has underperformed in recent years. Immense competition and the proliferation of merger activity within this industry has culled many, leaving only a select few players. Those who remain require demonstrated brand value in order to maintain a long-term sustainable position.

Exacerbated by competition, many fashion retailers are also experiencing increased pressures to provide more competitive pricing at greater cost structures arising from several macro factors. Worldwide wage pressures affect the entire industry landscape, from altering a firm's global supply chain to how firms develop cost strategies. In the US, labour movements have gained traction as inflation has eroded significant real wage growth for many minimum wage workers. Heading into 2019, current legislation expects 22 states to increase their minimum wage above the $7.25/hr federal threshold. We believe that such increases to SG&A expenses throughout the industry will continue to negatively impact profitability for the players in the space by further erosion of margins.


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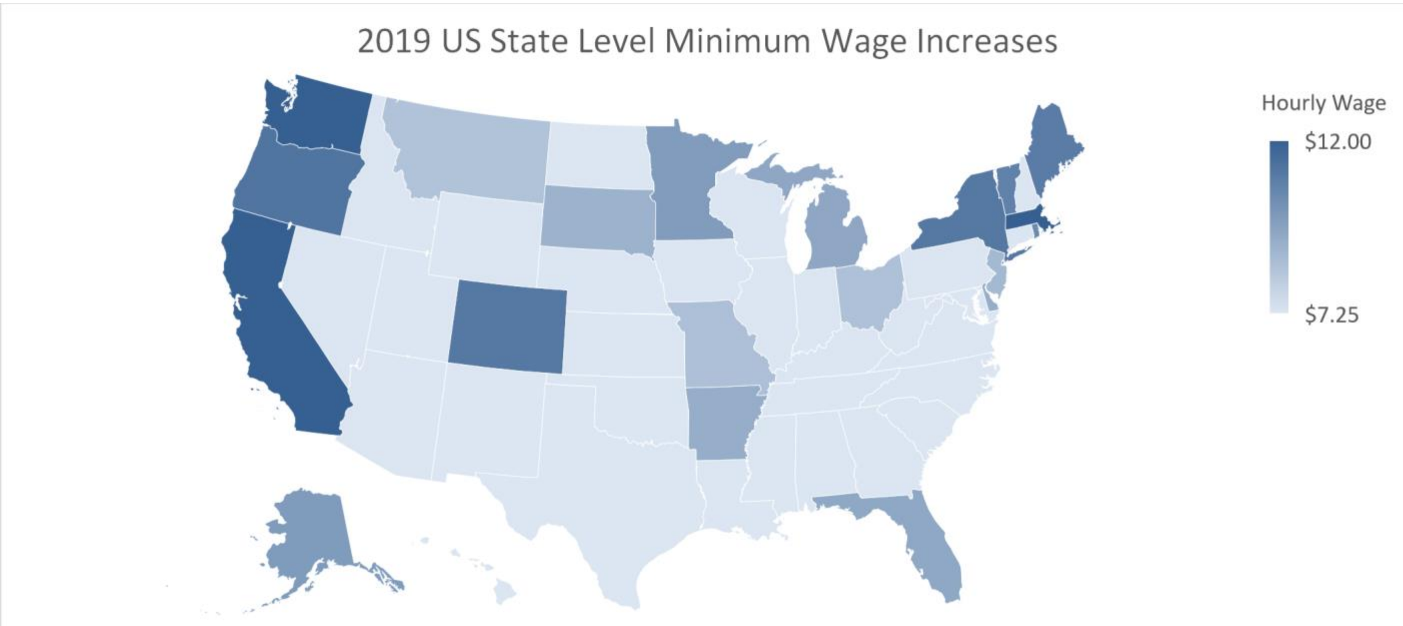
**Exhibit 6: US Map of Expected Minimum Wage Increase**




*Source: National Employment Law Project*

In the context of our current geopolitical landscape, we expect significant market volatility across several sectors in the near term, especially those which rely heavily on international trade, such as the apparel industry. In Europe, economic uncertainty regarding Brexit continues to linger as governments work to clarify and give color to Brexit negotiations. Failure to reach future trade agreements could prove detrimental to a $23B market of finished clothing goods currently being traded between the EU and the UK. In China, escalating US-China trade tensions continue to dampen economic prospects as retailers begin to experience the effects of protectionist tariffs moving up the value chain. Lagging growth from the global leader in exports has also seen economic slowdown through deceleration of consumer spending and cooling GDP growth. Economic turbulence and current trends from China could foreshadow material concerns about feasible expansion into emerging markets and into the lucrative Chinese retail space for Abercrombie.

# Catalysts

## 2019 Comps Delivery and Abercrombie Turnaround

Abercrombie's latest Q4FY18 earnings release surprised analysts' expectations by beating street estimates for both sales growth, and EPS. Highlights included an overall +3% increase in full year comps, primarily driven by outperformance in domestic markets with +6% comps within its American division. Tacked onto impressive online sales growth (+13% YoY), share prices surged as much as 25% the next trading day. Despite the positive reception from the market, concerns about its flagship brand continue to linger as Q4 same store sales figures were lighter than expected (-2% vs. -0.9% street est.). Weakness during the holiday season was attributed to excess channel inventory in categories for Abercrombie and Fitch's women's dresses and tops. Management has stated that the "product missteps" were isolated incidents and have been addressed moving forward into the new fiscal year. To remain close to its customer core, Abercrombie's inventory management and ability to correctly identify style trends will be crucial in revamping the company's flagship brand. Future execution of the Abercrombie brand will rely heavily on its ability to replicate Hollister's success and apply similar strategies in brand repositioning.

From the perspective of the whole company, investors can expect similar volatility as the market examines whether or not Abercrombie can sustain its recent performance for the next fiscal year amidst a bearish industry. Investors can look for management's delivery on revenue forecasts (+2-4% for the year) and execution of comps while mitigating the effects of tariffs for the next fiscal year.

## Strategic Expansion into New Markets

With ~50% of US leases coming up for renegotiation by the end of FY20, Abercrombie is at a pivotal crossroad in determining how the company wants to navigate around its portfolio of real estate. Focusing on a currently stronger performing, more competitive domestic market could prove beneficial to sales in a near term. However, tapping into emerging markets could be more accretive to the firm in the long term. Comps on the international front last quarter dipped -2% YoY but remains an important battleground for Abercrombie to establish a greater foothold in higher margin regions.

8.5% CAGR in international sales over the last four years (primarily within Asia and specifically China) have shown signs of brand accretion in these regions. However, with slower consumer spending in China, growth opportunities are beginning to narrow as preluded by weak comps figures. Further investments into building its brand and a shift in management's focus could re-steer international operations back into positive comps. Despite the setbacks, we believe further penetration into the mainstream Chinese markets will be critical in developing brand value and forming a foundation for global growth. Management's plans for expansion currently lack form as they have focused most of their efforts on domestic excellence. However, leveraging its international franchising model, Abercrombie could enter into emerging markets where the company currently lacks presence in. In using franchise system, markets may be tested with small entries that could reveal opportunities for new cash flow streams. While this is a possibility, much of it would rely on the success of their operations in China. Success in the Chinese markets would ideally provide gateways into other underserved, neighbouring regions such as India, or in proven markets such as Australia.

Entries into these markets will undoubtedly be affected by the global political state. As market conditions change and geopolitical tensions flesh out, investors should be more reassured about Abercrombie's international growth prospects with political stability. Current protectionist attitudes affect most global retailers in their manufacturing and distribution of goods through the added costs of tariffs. Any signals or talks towards free markets and resolution of global political discord could lower cost barriers for Abercrombie within key growth areas like China.

### Reduction in Expected Store Closures

Abercrombie's top line performance has dwarfed since its pinnacle with over 160 store closures over the past 5 years. Online sales channels show promise, however, we believe that a retail presence is still relevant and essential in driving sales. Return to an expansionary state driven by greater renewals of strategic locations in a shorter time horizon than we anticipate could suggest revenue growth beyond our estimates. Such growth could justify a higher valuation, all else equal.

## Management Team

At the time of this report's publishing date, Abercrombie and Fitch's FY18 compensation for executive management has yet to be released.

### Fran Horowitz – Chief Executive Officer

In 2014, the departure of her predecessor, Mike Jeffries, left Abercrombie without a designated CEO to carry out the company's vision moving forward. After 3 years of searching for an Executive Officer, Fran Horowitz was internally promoted to the Chief Executive Officer position in February 2017. Prior to the promotion, Ms. Horowitz held several executive roles within Abercrombie, with the most notable of them being the Brand President of Hollister. In addition to her leadership capabilities, Ms. Horowitz's previous merchandising experience at various luxury department stores is believed to be an important asset in helping Abercrombie revitalize its in-house brands. In terms of compensation, we believe Ms. Horowitz's objectives seamlessly coincide with those of the firm's. Ms. Horowitz's 10.3mm compensation for FY17 was primarily comprised of performance-based stock awards. From her 10.3mm USD compensation package, only 1.2mm was guaranteed through base salary pay.

### Kristin Scott – President, Global Brands

Abercrombie has recently merged the two positions of Brand Presidents into a consolidated role in its Q3FY18 press release, with Kristin Scott taking helm. Prior to the promotion, Ms. Scott overlooked merchandising and back-end operations for the company as Brand President of Hollister, a position she has held since 2016. In her new role, Ms. Scott will continue to streamline planning and merchandising across both brands with her industry experience in previous leaderships roles at Victoria's Secret, Target and Gap. In terms of organizational alignment with respect to compensation, we believe Ms. Scott has significant interests vested in the performance of Abercrombie. In FY17, the majority (75%) of Ms. Scott's $3mm USD compensation was linked to the performance of the company.

### Scott Lipesky – Senior VP & Chief Financial Officer

Starting as an Assistant Treasurer back in November of 2007, Scott Lipesky has internally climbed the ranks throughout his years with the company. He currently acts as CFO of Abercrombie & Fitch and has held his position since October 2017. As a Chartered Professional Accountant, Mr. Lipesky started his early career with PricewaterhouseCoopers and has had extensive work experience in corporate finance, financial accounting, and financial consulting. In FY17, Mr. Lipesky received 774k USD of total compensation with only 169k USD of that guaranteed through base salary. Considering Mr. Lipesky's variable compensation structure and his tenure with the firm, we believe Mr. Lipesky is in line with the firm's long-term operational vision and goals.

## Shareholder Base, Liquidity, Market Depth

### Shareholder Base

Abercrombie has 66.2mm basic shares outstanding with insignificant insider ownership. Aggregated equity ownership amongst all of management only accounts for a total of 1.14% shares outstanding. Shareholder base lacks concentration and is mainly comprised of institutional holders, with 158% of the free float being held by institutional investors (86.13mm shares). Institutional investors are able to hold over 100% of the free float due to the relatively high short interest Abercrombie is currently experiencing. Abercrombie is one of NYSE's most shorted stocks in terms of percentage of free float with short interest currently sitting at around 21.6%. The following table outlines the largest shareholders of Abercrombie.

**Exhibit 7: Top 10 Largest Shareholders**

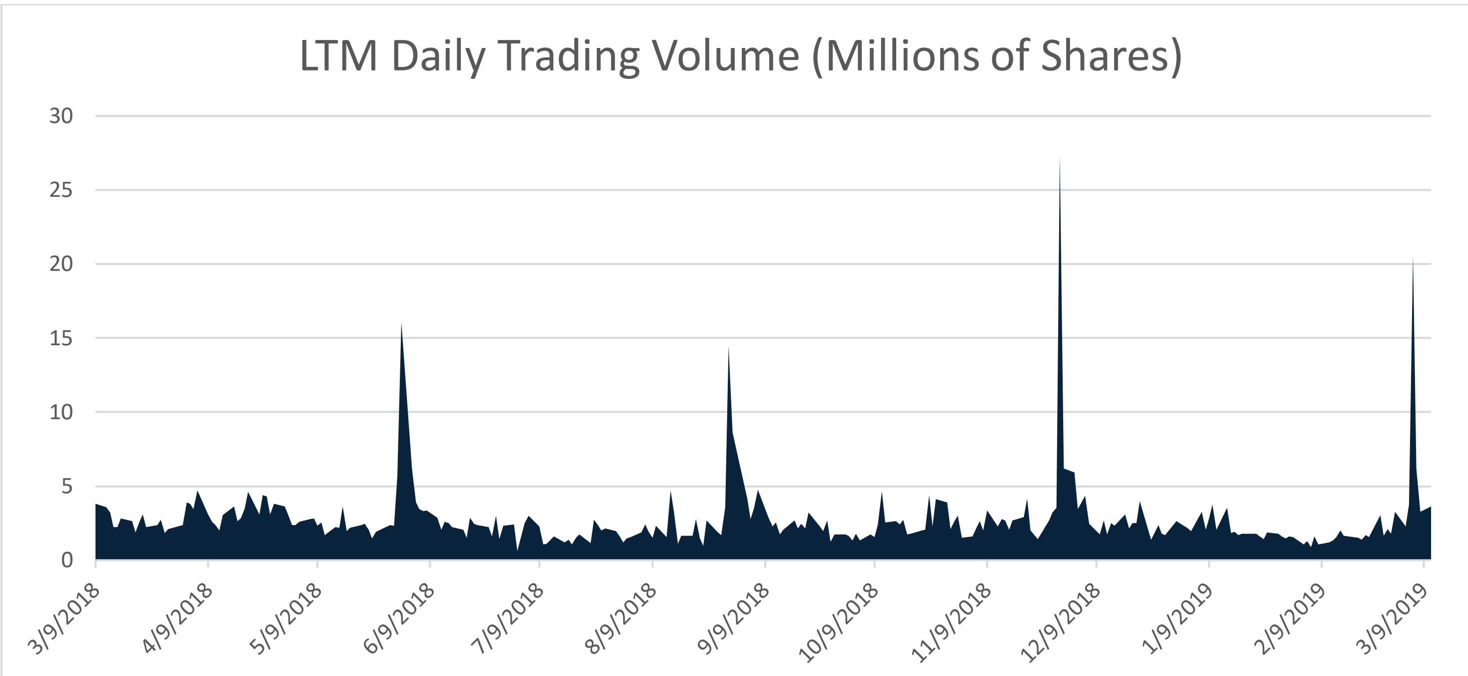
| Shareholder | Shares Held | Shares Outstanding | Latest Filing Date | Insider? |
|---|---|---|---|---|
| (name) | mm | % | (Date) | (Y/N) |
| Vanguard Group Inc. | 11.77 | 17.88% | Dec-31-2018 | N |
| BlackRock Inc. | 9.75 | 14.72% | Dec-31-2018 | N |
| Dimensional Fund Advisors LP | 5.69 | 8.60% | Dec-31-2018 | N |
| Contrarius Investment Management Ltd. | 2.89 | 4.36% | Dec-31-2018 | N |
| Paradice Investment Management Pty Ltd. | 2.71 | 4.09% | Dec-31-2018 | N |
| Bank of New York Mellon Corporation | 2.38 | 3.59% | Dec-31-2018 | N |
| JPMorgan Chase & Co | 2.30 | 3.47% | Dec-31-2018 | N |
| State Street Corp. | 2.22 | 3.35% | Dec-31-2018 | N |
| Arrowstreet Capital LP | 1.61 | 2.43% | Dec-31-2018 | N |
| FMR LLC | 1.52 | 2.30% | Aug-31-2018 | N |
| Top 10 Identified Shareholders | 42.84 | 64.79% | | |

*Source: Bloomberg*

## Liquidity

Abercrombie's daily average trading volume from the LTM (March 11th 2018-2019) sits around ~2.76mm shares/day. The elevated levels of trading volume depicted on the graph are attributed to quarterly earnings releases.

**Exhibit 8: Year to Date Daily Trading Volume**




*Source: Yahoo Finance*

# Valuation

In our valuation method, we incorporated a discounted cash flow (DCF) with a five year exit multiple (5.0x) and a FY19 EV/EBITDA median-based comparable company analysis (CCA) approach, equally weighted at 50%. Through our analysis and projections, our DCF and CCA indicates **a share price upside of 23.9**%. Including dividends, **total return is expected to be 26.9%.**

## Discounted Cash Flow Assumptions

**Revenue Forecasts**

Our five-year sales forecast is primarily based on management's guidance of low single digit CAGR top line growth heading into 2020. Driving top line projections from a revenue-per-store basis, we remain cautious of the Abercrombie's ability to grow substantially in the near term during this transformational phase of downsizing. We are expecting the company to continue with its consolidation and have forecasted for no net change in stores spread across both brands heading into FY19.

On a sales basis, we stand to remain conservative with the current retail backdrop and capacity of the industry. Our revenue projections factor in Hollister's continued strength for the brand and management's guidance for a 2-4% increase in sales for FY19. We expect modest growth being fueled by increases in average store sales and return to fleet expansion from FY20 onwards. Across the board, we expect to see a 2.08% CAGR in revenues over the next 5 years. Management's target and our expectations will remain heavily reliant on the carryover momentum of digital sales, and Abercrombie's ability to maintain positive same store sales within our time horizon.

**Cost Assumptions and Margin Analysis**

Abercrombie's recent efforts to control costs have picked up steam but the effectiveness of such measures remain unclear. We expect to see COGS percentages to slightly increase in the near term, before leveling back out at 39.5% in our forecasts for expansion. This assumes Abercrombie's purchasing power will diminish as a result of its consolidation of store locations and inventory. As unit costs increases, we anticipate that Abercrombie will minimize such effects by leveraging its global supply chain, shifting production to lower cost regions in response to input cost pressures. On the distribution end, we expect a push-pull effect with S&D expenses. Improvements to productivity will dial back costs, however, incremental freight costs associated with increased direct-to-consumer shipping could neutralize said savings. As a result, we expect S&D to improve slightly/remain flat in our projections.

In the bigger picture, we remain unsure about management's ability to double FY17 EBIT margins (2.9%) by FY20. We project margin expansion to be a bit more be conservative. Factoring in Abercrombie's cost saving measures, prudent revenue growth, and fierce competition within this space, we arrived at more modest numbers. Our estimates and assumptions lead us to believe that EBITDA margins will gradually increase before hitting a plateau at around 11%. Additionally, our estimates for Abercrombie's FY20 operating margins fall short of management's goal of 5.8% by around ~160 bps. Nonetheless, management's target remains a possibility with the appropriate OpEx leverage driving margin expansion beyond our assumptions.

**Capital Expenditures and D&A**

To effectively roll out management's optimization strategy of updating its existing store fleet, management has guided for 200mm USD of capex for FY19. We expect these capital investments to slowly taper off with our estimates for capex softening out in future years as the number of remodels and renovations slow down. Our estimates for P&E useful life remain in line with historicals - flat at 4.0 years throughout.

**Tax Rate**

While the statutory corporate tax rate in the US remains at 21%, Abercrombie's historic effective tax rate has been astronomically higher due to payment of deferred taxes and other charges. We incorporated a 28% effective tax rate in our model to reflect a mandatory one-time repatriation tax payment of 10.8mm USD that the company will be paying over 8 years on top of any deferred payments.

**Dividend Policy**

Historically, Abercrombie has provided shareholders with a quarterly dividend of $0.20 per share and we assume that this will remain unchanged. For the last 20 quarters, Abercrombie has held dividend payments constant with yields fluctuating between 1.6%-6.4%. Abercrombie's current dividend yield is 3.00%.

**Weighted Average Cost of Capital (WACC)**

Using CAPM, we determined our cost of equity to be 10.9%, derived from a 10.0% expected market return (25-year annualized return on the S&P500), a 2.44% risk free rate (5-year US T-Bill rate) and a beta of 1.12 from Bloomberg. We determined our pre-tax cost of debt to be 4.18% (from Aswath Damodaran) and reused our aforementioned effective tax rate of 28% to arrive at a WACC of 9.8%.

## Comparable Companies Analysis Set

In order to create a relevant portfolio of comparable companies for relative valuation, we considered the following fashion retailers. The set is comprised of companies which operate under similar business models and are focused on providing similar offerings through omnichannel capabilities. All companies, except for The Gap Inc. are within $2B USD of Abercrombie's market cap. Within our selected set, Abercrombie trades at a slightly lower multiple relative to its peers (4.2x vs. industry median of 5.5x 2019 EV/EBITDA multiple). In our analysis, we have decided to value Abercrombie with our industry 2019E EV/EBITDA multiple (5.5x), implying that Abercrombie is trading a discount to its peers. We believe that similarities in growth prospects open to both Abercrombie and its competitors justify its valuation to be at the very least, at an industry average.

**American Eagle Outfitters (NYSE:AEO)**

American Eagle is a global fashion retailer popularized by its offerings of jeans and its sub-brand "aerie", a growing leader in the lingerie and nightwear space.

**Chico's FAS (NYSE:CHS)**

Chico's is a US based female apparel company that features a wide assortment of clothing and accessories targeted towards an older demographic of women.

**Express (NYSE:EXPR)**

Express is a clothing apparel store that is focused on contemporary and formal styles for both men and women at competitive prices.

**Guess? (NYSE:GES)**

Guess is a mid-market global retailer that focuses on forward trend clothing, accessories, and bags through its multiple store concepts such as MARCIANO and Guess Accessories.

**The Gap Inc. (NYSE:GPS)**

The Gap Inc. is one of the largest clothing retailers within the US market and operates four distinct brands for various consumer profiles: Banana Republic, GAP, Old Navy, and Athleta.

**Urban Outfitters (NASDAQ:URBN)**

Retailing items beyond the typical fashion apparel store, Urban Outfitters is a one-stop-shop that caters to trendy millennials and young adults through its sale of pop-culture related merchandise, personal care items and fashion apparel.

## Recommendation – Buy

Given our assumptions and understanding of the company's fundamentals, we arrived at a **target price of $33.00**, representing an **implied upside of 26.9%** (inclusive of dividend yield) from the current share price of $26.64.

Undoubtedly, we've witnessed the beginning to a turnaround story arising from respectable quarterly performances as of late. Compelling company strategy laid out by management presents an organizational revamp and long-term growth opportunity driven by:

1. Bolstering productivity and optimizing existing real estate,
2. A return to positive comps (in both brick and mortar and in e-commerce), and
3. Growing presence in online retailing.

Evident from its recent performance, we believe that Abercrombie has been heavily discounted by the market despite being a top performer within the competitive retail vertical. While we remain cautious of the current macro ecosystem that could mute Abercrombie's international growth, we see great potential for the company to exceed market expectations in both top and bottom line performance. Industry headwinds lead us to believe that Abercrombie will have slight difficulties meeting its targets of doubling operating margins by FY20 given the fierce competition in this space. Regardless, investors should recognize management's recent efforts in margin expansion through mitigating macro risk in its diversification of distribution channels. As Abercrombie continues to execute on their playbook initiatives, investors will soon begin to appreciate the revitalization of the brand, and its ability to generate wealth for its shareholders.

# Risks

## Foreign Exchange Effects

As a side effect of conducting business in various regions of the globe, Abercrombie transacts with customers and pays its suppliers in local currencies which may be exposed to undesirable fluctuations. Key currencies which have illustrated significant weakness to the USD in the current macro environment have been the Chinese Yuan and to a lesser extent, the British Pound and Euro. Unpredictable movements in these currencies have measurable and material impact to Abercrombie's bottom line. To hedge the volatility of such FX effects, the company actively engages in FX forwards contracts, derivatives and other hedging instruments that mitigate fluctuations in the Euro, British Pound, Canadian Dollar, and Japanese Yen.

## Shifts in Consumer Preferences

Ability to connect with customers and capitalize on current trends by designing favoured merchandise at competitive prices has long been a challenge for the clothing industry. As consumer tastes evolve and develop over time, so must fashion retailers. Failure to identify and understand preferences for styles will affect the company's ability to grow revenues and increase brand awareness.

## Supply Chain Risk

Without moving upstream, firms rely on third-party manufacturers to produce and manufacture their products for redistribution or merchandising. Added layers in the value chain pose risks to disruption in production and could prevent the flow of goods to the end consumer. In terms of production, Abercrombie remains diversified. It currently sources its manufacturing out to various third-party vendors across Asia and Central America. Leveraging its global supply chain and network of established relationships, Abercrombie has been able to mitigate disruptions in its supply chain and has not relied on a single entity for more than 10% of its merchandise production.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# Appendix 1: Model Summary

| | Feb-14 | Feb-15 | Feb-16 | Feb-17 | Feb-18 | Feb-19 | Feb-20 | Feb-21 | Feb-22 | Feb-23 | Feb-24 |
|---|---|---|---|---|---|---|---|---|---|---|---|
| *(Figures in mm USD)* | FY2013 | FY2014 | FY2015 | FY2016 | FY2017 | FY2018 | FY2019 | FY2020 | FY2021 | FY2022 | FY2023 |
| **Income Statement** | | | | | | | | | | | |
| **Revenue** | 4,116.9 | 3,744.0 | 3,518.7 | 3,326.7 | 3,492.7 | 3,590.1 | 3,672.0 | 3,737.4 | 3,794.3 | 3,875.9 | 3,980.1 |
| **EBITDA** | 421.2 | 378.1 | 296.7 | 192.3 | 264.1 | 311.0 | 324.0 | 336.4 | 379.4 | 426.3 | 437.8 |
| **Net Income** | 54.6 | 51.8 | 38.6 | 7.7 | 10.5 | 78.8 | 87.7 | 96.2 | 120.7 | 151.7 | 161.4 |
| **Earnings Per Share** | $ 0.69 | $ 0.71 | $ 0.51 | $ 0.06 | $ 0.10 | $ 1.09 | $ 1.23 | $ 1.35 | $ 1.71 | $ 2.17 | $ 2.31 |
| **Cash Flow Statement** | | | | | | | | | | | |
| **Capital Expenditures** | (163.9) | (174.6) | (132.1) | (136.7) | (106.8) | (146.8) | (204.1) | (216.9) | (205.0) | (185.9) | (168.7) |
| **Acquisitions** | - | - | - | - | - | - | - | - | - | - | - |
| **Divestitures** | - | - | - | - | - | - | - | - | - | - | - |
| **Dividend Payment** | (61.9) | (57.4) | (55.1) | (54.1) | (54.4) | (53.9) | (52.9) | (52.9) | (52.9) | (52.9) | (52.9) |
| **Dividend Per Share** | $ 0.80 | $ 0.80 | $ 0.80 | $ 0.80 | $ 0.80 | $ 0.80 | $ 0.80 | $ 0.80 | $ 0.80 | $ 0.80 | $ 0.80 |
| **Dividend Payout to Earnings** | 113.4% | 110.7% | 143.0% | 700.5% | 516.8% | 68.4% | 60.3% | 55.0% | 43.8% | 34.8% | 32.8% |
| **Dividend Payout to Core FCF** | 11.9% | 11.7% | 13.1% | 15.8% | 14.7% | 12.8% | 11.3% | 10.7% | 10.3% | 10.0% | 10.1% |
| **Dividend Yield** | 1.9% | 2.3% | 3.7% | 3.6% | 4.9% | 3.6% | 3.0% | 3.0% | 3.0% | 3.0% | 3.0% |
| **Balance Sheet** | | | | | | | | | | | |
| Current Assets | 1,320.6 | 1,165.0 | 1,179.0 | 1,139.3 | 1,264.5 | 1,336.0 | 1,380.7 | 1,347.3 | 1,405.6 | 1,521.1 | 1,667.0 |
| Non-Current Assets | 1,530.4 | 1,340.2 | 1,254.1 | 1,156.5 | 1,061.2 | 1,049.6 | 1,077.8 | 1,114.0 | 1,129.2 | 1,121.4 | 1,098.4 |
| **Assets** | 2,851.0 | 2,505.2 | 2,433.0 | 2,295.8 | 2,325.7 | 2,385.6 | 2,458.5 | 2,461.3 | 2,534.7 | 2,642.6 | 2,765.4 |
| Current Liabilities | 568.2 | 486.0 | 534.7 | 486.0 | 507.5 | 558.9 | 597.0 | 556.5 | 562.1 | 571.0 | 585.3 |
| Non-Current Liabilities | 553.3 | 629.5 | 602.6 | 557.7 | 565.7 | 608.1 | 608.1 | 608.1 | 608.1 | 608.1 | 608.1 |
| **Liabilities** | 1,121.5 | 1,115.5 | 1,137.3 | 1,043.7 | 1,073.2 | 1,167.0 | 1,205.1 | 1,164.5 | 1,170.1 | 1,179.1 | 1,193.4 |
| **Shareholders' Equity** | 1,729.5 | 1,389.7 | 1,291.1 | 1,243.4 | 1,242.4 | 1,208.9 | 1,243.7 | 1,287.1 | 1,354.9 | 1,453.8 | 1,562.3 |
| **Cash** | 600.1 | 520.7 | 588.6 | 547.2 | 675.6 | 723.1 | 755.5 | 759.6 | 810.5 | 915.4 | 1,047.7 |
| **Debt** | 195.7 | 343.9 | 333.7 | 309.4 | 300.3 | 296.8 | 296.8 | 296.8 | 296.8 | 296.8 | 296.8 |
| **Net Debt** | (404.4) | (176.8) | (254.9) | (237.8) | (375.2) | (426.4) | (458.7) | (462.8) | (513.7) | (618.7) | (750.9) |
| **Minority Interests** | - | - | 4.7 | 8.6 | 10.1 | 9.7 | 9.7 | 9.7 | 9.7 | 9.7 | 9.7 |
| **Debt/EBITDA** | n/a | n/a | n/a | n/a | n/a | n/a | n/a | n/a | n/a | n/a | n/a |
| **Operating Metrics** | | | | | | | | | | | |
| **Return on Equity (ROE)** | 3.2% | 3.7% | 3.0% | 0.6% | 0.8% | 6.5% | 7.1% | 7.5% | 8.9% | 10.4% | 10.3% |
| **Return on Assets (ROA)** | 1.9% | 2.1% | 1.6% | 0.3% | 0.5% | 3.3% | 3.6% | 3.9% | 4.8% | 5.7% | 5.8% |
| **Return on Invested Capital (ROIC)** | 10.5% | 6.5% | 5.6% | 0.7% | 1.5% | 11.4% | 13.2% | 13.4% | 16.0% | 19.8% | 21.6% |
| **Valuation Metrics** | | | | | | | | | | | |
| Stock Price (High) | $ 54.41 | $ 44.32 | $ 28.21 | $ 32.83 | $ 23.53 | $ 29.69 | $ 26.64 | $ 26.64 | $ 26.64 | $ 26.64 | $ 26.64 |
| Stock Price (Low) | $ 31.72 | $ 25.52 | $ 15.42 | $ 11.29 | $ 9.03 | $ 15.28 | $ 26.64 | $ 26.64 | $ 26.64 | $ 26.64 | $ 26.64 |
| Stock Price (Average) | $ 43.07 | $ 34.92 | $ 21.82 | $ 22.06 | $ 16.28 | $ 22.49 | $ 26.64 | $ 26.64 | $ 26.64 | $ 26.64 | $ 26.64 |
| Diluted Shares Outstanding (Average) | 78.7 | 72.9 | 69.4 | 68.3 | 69.4 | 68.2 | 68.1 | 68.1 | 68.1 | 68.1 | 68.1 |
| Market Capitalization (Average) | 3,387.8 | 2,547.0 | 1,514.3 | 1,506.3 | 1,129.9 | 1,534.0 | 1,813.4 | 1,813.4 | 1,813.4 | 1,813.4 | 1,813.4 |
| Enterprise Value (Average) | 2,983.4 | 2,370.2 | 1,264.1 | 1,277.1 | 764.8 | 1,117.3 | 1,364.4 | 1,360.3 | 1,309.4 | 1,204.5 | 1,072.2 |
| **P/E** | 62.0 x | 49.1 x | 42.6 x | 380.8 x | 159.3 x | 20.6 x | 21.7 x | 19.7 x | 15.5 x | 12.3 x | 11.5 x |
| **EV/EBITDA** | 7.1 x | 6.3 x | 4.3 x | 6.6 x | 2.9 x | 3.6 x | 4.2 x | 4.0 x | 3.5 x | 2.8 x | 2.4 x |
| **FCF Yield to Market Capitalization** | 1.7% | 5.9% | 11.2% | 3.1% | 11.9% | 12.5% | 5.7% | 4.0% | 6.6% | 9.6% | 11.1% |
| **FCF Yield to Enterprise Value** | 1.9% | 6.4% | 13.4% | 3.7% | 17.5% | 17.2% | 7.6% | 5.4% | 9.1% | 14.4% | 18.7% |
| **Free Cash Flow** | | | | | | | | | | | |
| EBIT | 186.0 | 151.7 | 83.0 | (3.1) | 69.5 | 133.0 | 148.1 | 155.6 | 189.6 | 232.7 | 246.1 |
| Tax Expense | (18.6) | (47.3) | (16.0) | 11.2 | (44.6) | (37.6) | (41.5) | (43.6) | (53.1) | (65.2) | (68.9) |
| D&A | 235.2 | 226.4 | 213.7 | 195.4 | 194.5 | 178.0 | 175.9 | 180.8 | 189.8 | 193.6 | 191.7 |
| Capital Expenditures | (163.9) | (174.6) | (132.1) | (136.7) | (106.8) | (146.8) | (204.1) | (216.9) | (205.0) | (185.9) | (168.7) |
| Changes in NWC | (182.3) | (4.9) | 21.2 | (20.0) | 21.3 | 65.4 | 25.7 | (3.1) | (1.8) | (1.7) | 0.8 |
| **Unlevered Free Cash Flow** | 56.3 | 151.3 | 169.8 | 46.8 | 134.0 | 192.1 | 104.2 | 72.8 | 119.6 | 173.6 | 201.0 |

# Appendix 2: Discounted Cash Flow Analysis

| | Feb-14 | Feb-15 | Feb-16 | Feb-17 | Feb-18 | Feb-19 | May-19 | Aug-19 | Nov-19 | Feb-20 | Feb-20 | Feb-21 | Feb-22 | Feb-23 | Feb-24 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| *(Figures in mm USD)* | **FY2013** | **FY2014** | **FY2015** | **FY2016** | **FY2017** | **FY2018** | **Q1-2019** | **Q2-2019** | **Q3-2019** | **Q4-2019** | **FY2019** | **FY2020** | **FY2021** | **FY2022** | **FY2023** |
| **WACC Calculations** | | | | | | | | | | | | | | | |
| **Free Cash Flow** | | | | | | | | | | | | | | | |
| EBIT | 186.0 | 151.7 | 83.0 | (3.1) | 69.5 | 133.0 | (43.4) | (0.6) | 40.5 | 151.6 | 148.1 | 155.6 | 189.6 | 232.7 | 246.1 |
| Less: Tax expense | (18.6) | (47.3) | (16.0) | 11.2 | (44.6) | (37.6) | 12.2 | 0.2 | (11.3) | (42.5) | (41.5) | (43.6) | (53.1) | (65.2) | (68.9) |
| Add: Depreciation and amortization | 235.2 | 226.4 | 213.7 | 195.4 | 194.5 | 178.0 | 43.4 | 43.8 | 44.1 | 44.6 | 175.9 | 180.8 | 189.8 | 193.6 | 191.7 |
| Less: Capital expenditures | (163.9) | (174.6) | (132.1) | (136.7) | (106.8) | (146.8) | (48.6) | (49.0) | (52.9) | (53.6) | (204.1) | (216.9) | (205.0) | (185.9) | (168.7) |
| Less: Change in net working capital | (182.3) | (4.9) | 21.2 | (20.0) | 21.3 | 65.4 | (108.6) | (4.5) | 64.4 | 74.4 | 25.7 | (3.1) | (1.8) | (1.7) | 0.8 |
| **Unlevered Free Cash Flow** | **56.3** | **151.3** | **169.8** | **46.8** | **134.0** | **192.1** | **(145.0)** | **(10.2)** | **84.8** | **174.6** | **104.2** | **72.8** | **119.6** | **173.6** | **201.0** |
| Discount factor | | | | | | | 0.25 | 0.50 | 0.75 | 1.00 | 1.00 | 2.00 | 3.00 | 4.00 | 5.00 |
| **Present Value of Unlevered Free Cash Flow** | | | | | | **-** | **(141.7)** | **(9.7)** | **79.0** | **159.1** | **86.7** | **60.4** | **90.3** | **119.5** | **126.0** |

**WACC Calculations**

| **Cost of Equity** | |
|---|---|
| Risk-free rate | 2.4% |
| Expected market return | 10.0% |
| **Market Risk Premium** | **7.6%** |
| Beta | 1.12 |
| **Cost of Equity** | **10.9%** |

| **Cost of Debt** | |
|---|---|
| Pre-tax cost of debt | 4.2% |
| Effective tax rate | 28.0% |
| **Cost of Debt** | **3.0%** |

| **WACC** | |
|---|---|
| Market value of equity | 1,813.4 |
| Market value of debt | 296.8 |
| **Total Capitalization** | 2,110.2 |
| Cost of equity | 10.9% |
| Cost of debt | 3.0% |
| **WACC** | **9.8%** |

| **Exit Multiple Method** | | |
|---|---|---|
| **Terminal EV/EBITDA Multiple** | | 5.0 x |
| PV sum of unlevered FCF | | 482.9 |
| Terminal value | | 1,371.9 |
| **Enterprise Value** | | **1,854.7** |
| Add: Cash | | 723.1 |
| Less: Debt | | 296.8 |
| Less: Other EV adjustments | | 9.7 |
| **Equity Value** | | **2,271.4** |
| Shares outstanding | | 68.1 |
| **Implied Share Price** | $ | **33.37** |

| | | |
|---|---|---|
| Current Price | $ | 26.64 |
| **Implied Price** | $ | **33.37** |
| **Total Return** | | **25.3%** |

| Terminal EV/EBITDA Multiple | WACC 10.80% | 10.30% | 9.80% | 9.30% | 8.80% |
|---|---|---|---|---|---|
| **3.0 x** | $ 24.45 | $ 24.82 | $ 25.21 | $ 25.61 | $ 26.01 |
| **4.0 x** | $ 28.30 | $ 28.76 | $ 29.24 | $ 29.73 | $ 30.23 |
| **5.0 x** | $ 32.15 | $ 32.70 | $ 33.27 | $ 33.85 | $ 34.45 |
| **6.0 x** | $ 36.00 | $ 36.64 | $ 37.30 | $ 37.98 | $ 38.67 |
| **7.0 x** | $ 39.85 | $ 40.58 | $ 41.33 | $ 42.10 | $ 42.89 |



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# Appendix 3: Comparable Company Analysis

*(Figures in mm USD)*

| Company | Ticker | Equity Value | Enterprise Value | EV/EBITDA Multiple<br>2017A EV/EBITDA | 2018A EV/EBITDA | 2019E EV/EBITDA | P/E Multiple<br>2017A P/E | 2018A P/E | 2019E P/E |
|---|---|---|---|---|---|---|---|---|---|
| American Eagle Outfitters | (NYSE: AEO) | 3,723.4 | 3,297.9 | 6.7 x | 6.4 x | 6.1 x | 18.6 x | 14.3 x | 13.1 x |
| Chico's FAS | (NYSE: CHS) | 641.1 | 512.5 | 2.1 x | 3.5 x | 4.6 x | 6.5 x | 18.2 x | 19.6 x |
| Express | (NYSE: EXPR) | 366.0 | 270.3 | 1.9 x | 2.3 x | 2.5 x | 19.9 x | 17.2 x | 18.4 x |
| Guess? | (NYSE: GES) | 1,838.2 | 1,757.6 | 10.8 x | 9.4 x | 8.0 x | (205.5 x) | 22.0 x | 16.4 x |
| The Gap Inc. | (NYSE: GPS) | 9,954.6 | 9,834.6 | 4.9 x | 5.2 x | 5.3 x | 12.3 x | 10.2 x | 10.6 x |
| Urban Outfitters | (NASDAQ: URBN) | 3,159.6 | 2,522.1 | 6.4 x | 5.0 x | 5.6 x | 31.2 x | 11.0 x | 11.5 x |
| **ANF** | **(NYSE: ANF)** | **1,814.2** | **1,397.5** | **4.8 x** | **4.3 x** | **4.2 x** | **266.4 x** | **24.7 x** | **18.0 x** |
| **Median** | | | | | **5.1 x** | **5.5 x** | | **15.7 x** | **14.7 x** |
| **Mean** | | | | | **5.3 x** | **5.4 x** | | **15.5 x** | **14.9 x** |
| **High** | | | | | **9.4 x** | **8.0 x** | | **22.0 x** | **19.6 x** |
| **Low** | | | | | **2.3 x** | **2.5 x** | | **10.2 x** | **10.6 x** |

| | EV/EBITDA Implied Price | | P/E Implied Price | |
|---|---|---|---|---|
| Median | $ 30.50 | $ 32.92 | $ 17.01 | $ 21.80 |
| **Mean** | **$ 31.34** | **$ 32.32** | **$ 16.71** | **$ 22.11** |
| High | $ 50.82 | $ 45.23 | $ 23.71 | $ 29.03 |
| Low | $ 16.87 | $ 18.39 | $ 10.97 | $ 15.76 |


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