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Graduate Business School

Group 22

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| Assessment Title: | Valuation Report - Bath & Body Works Inc. | |
| Module Code: | FIN42030 | |
| Module Title: | Financial Analysis 2024/25 | |

Declaration of Authorship: We declare that all materials included in this assessment is the end result of our own work and that due acknowledgement has been given in the bibliography and references to ALL sources, be they printed, electronic or personal.

Signed:

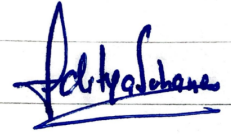



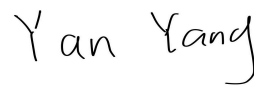

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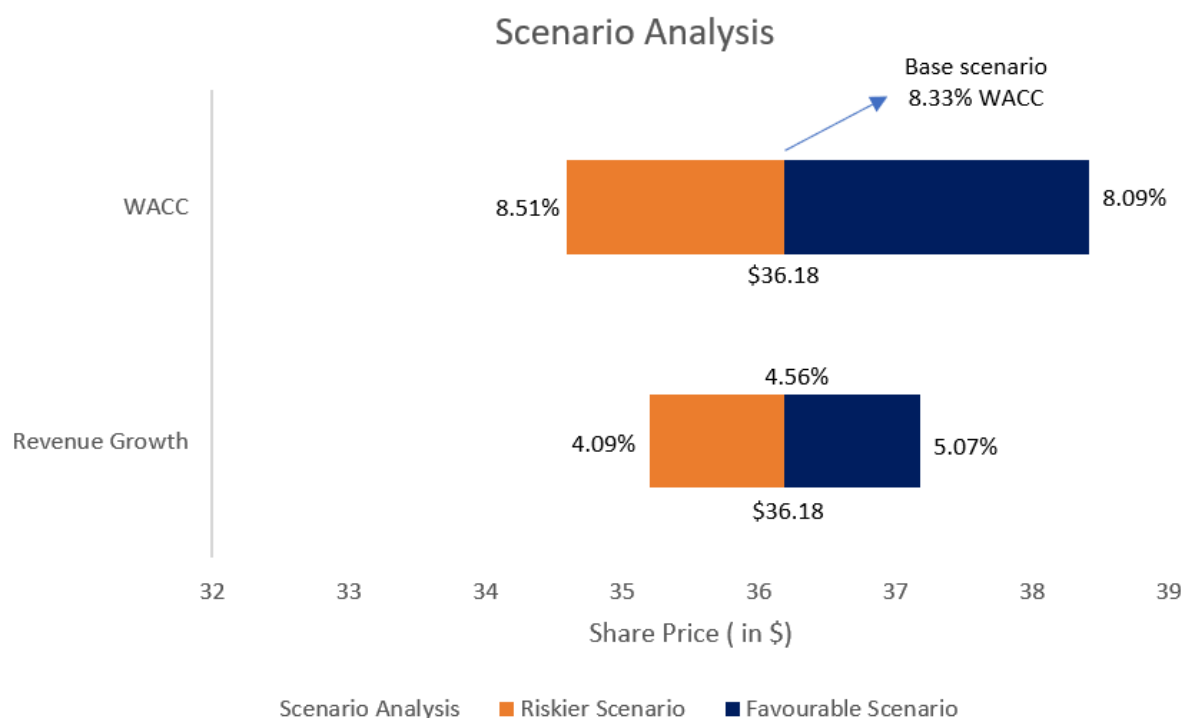
Bath & Body Works, Inc. Valuation Report

Recommendation: BUY

Basis for Conclusions

Bath & Body Works, Inc. (BBWI) was trading at \$33.2 as of 5th August, 2024 (last trading day of the financial quarter 2, 2024). Our analysis computed the fair value of the stock, in the base scenario, to be \$36.18 using the FCFF Valuation Model, and \$39.31 using the FCFE Valuation Model. The stock thus offers an upside potential of **8.6% as per the FCFF model and 16.89% as per the FCFE model**. Both models indicate that the share price is undervalued as of this date and hence, our recommendation is to buy the stock.

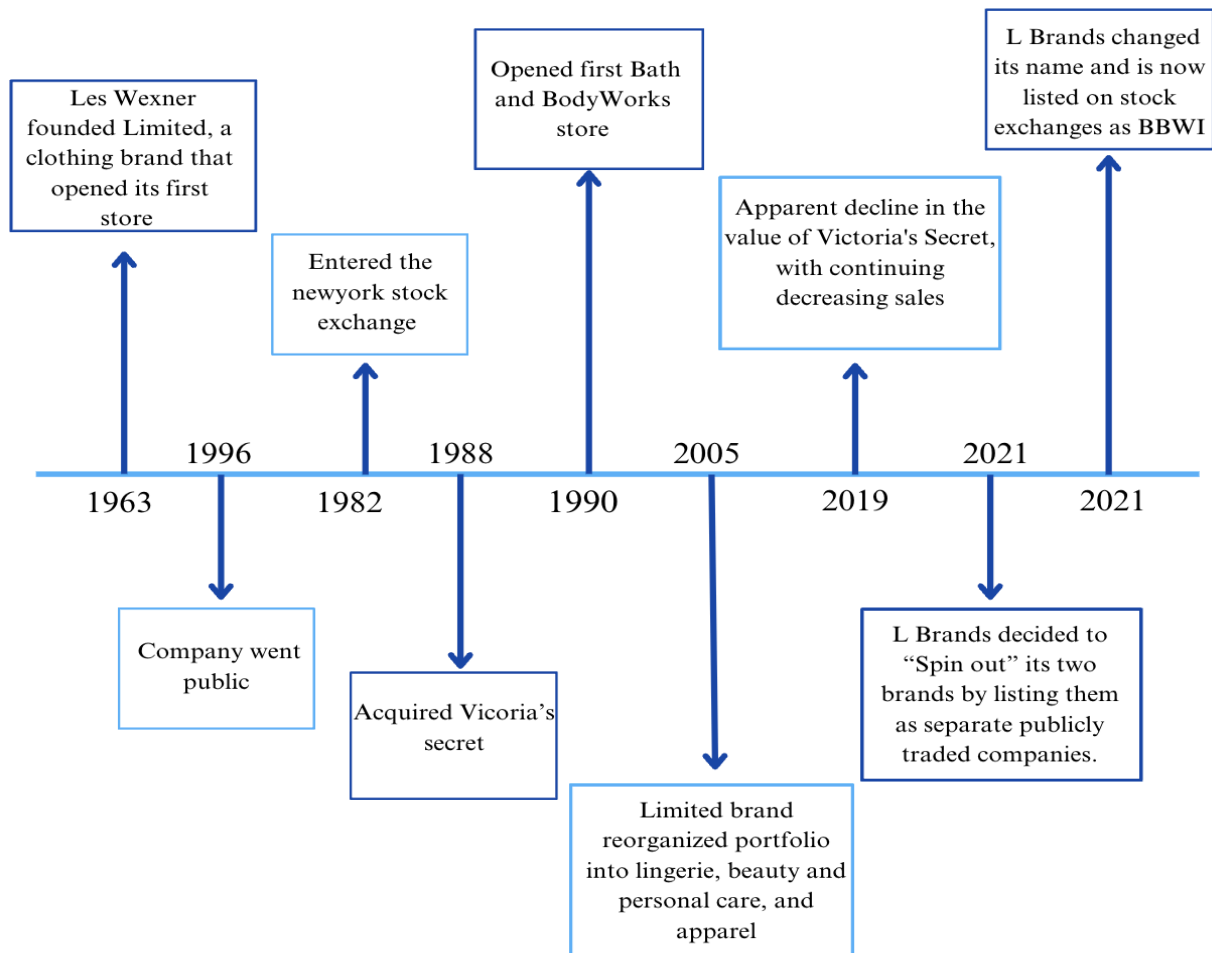
We performed a Scenario Analysis - to determine the sensitivity of the stock price to the change in Revenue Growth rate and WACC. This has been explained in detail in the upcoming section.



Source: Own elaboration

ABOUT THE COMPANY

Timeline of the Company



Source : Own elaboration

Business Segments, Global Presence and Operational Focus

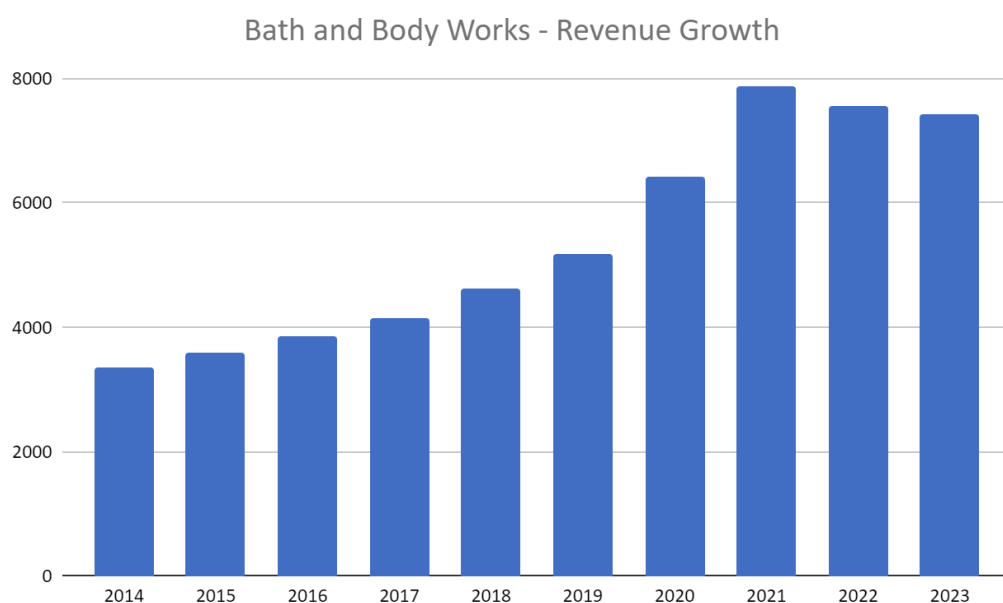
BBWI operates in specialty retail and is a sector leader in fragrance and body care products. Its main segments include home fragrances, soaps and sanitisers, and body care. The company has a significant physical presence within North America, operating 1850 stores. It has a global presence with a growing number of retail stores outside North America, in the Middle East and Asia, and also operates through licensing and merchandising agreements (Bath & Body Works, 2023). BBWI also currently operates 28 e-commerce sites (Weiker, 2021).

Stock Split and Internal Management Changes

As part of the separation of Bath and Body Works Inc. from Victoria's Secret, as a standalone company, there was a 1:3 stock split, meaning each BBWI shareholder received one share of Victoria's Secret (Bath & Body Works, 2021). Additionally, there have been internal management issues, such as the stepping down of the current president (Bath & Body Works, 2024), with all responsibilities being handed over to the CEO. In the last meeting, when BBWI was performing well, the CEO attributed the success to the company's loyalty program (Bath & Body Works, 2024). Regarding employment, BBWI has also hired a significant number of people for the holiday season.

GROWTH STRATEGIES

- BBWI is focusing on **product innovation** aligned with consumer trends, with the launch of new product lines and categories. (SeekingAlpha.com, 2024). In 2024, it reevaluated all of its formulas to remove sulphates and parabens from its products (Bath & Body Works, 2024).
- The company launched a popular **loyalty program** in 2022. (www.sec.gov, n.d., Yahoo Finance, 2023). Recent theme-based collaborations and members-only events have been successful strategies. (Adams, 2024)
- The company is **exploring more off-mall realty to address leasing issues**. One key strategic focus of the company is its continued global expansion through e-commerce and increased store presence. (Adams, 2024)
- BBWI has invested in a **multi-year IT transformation project** in 2023, including a collaboration with Accenture to scale its digital and data analytics capabilities and leverage generative AI technologies. (Accenture.com, 2024)



Source : Revenue data from BBW annual reports and Bloomberg.

POTENTIAL RISKS:

We categorised the risks into two areas:

- **Industry - Specific Risk - Inflation and geo-political risk** As a consumer cyclical speciality retailer, BBWI is exposed to the risks of this sector. Consumer demand is seasonal and can decline in unfavourable economic conditions like higher inflation rates, as seen in 2022 and 2023. BBWI has relied heavily on their in-store experience. Net sales are dependent on the customer footfall in physical stores, and the sustainability of their leased spaces poses a potential area for losses. As an international business, the company is exposed to foreign exchange risk, geopolitical situations and global supply chain issues. Crucially, the competitive nature of the retail industry indicates fierce price competition and necessitates investment in product innovation, branding and marketing.
- **High level of Debt leverage:** The recent trend of turnovers in the company's key leadership positions and instances of shareholder activism could extend into the future. Given the high level of leverage, debt repayment and refinancing are ongoing challenges for BBWI.

ACCOUNTING STANDARDS

The company follows the U.S. GAAP accounting principles and publishes annual reports, quarterly results and SEC filings. Their fiscal year ends on the Saturday closest to January 31st (BBWI Form 10-K 2024).

INDUSTRY OVERVIEW:

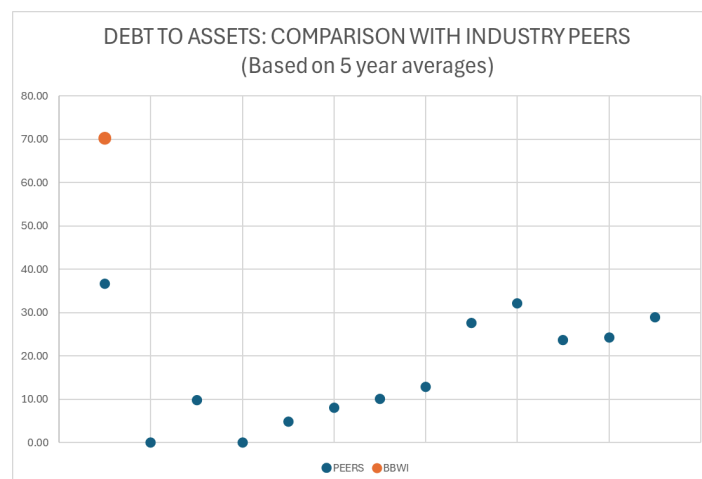


Source : Own elaboration per Yahoo Finance

In the graph above, we have compared the past ten years of returns of BBWI with the S&P 500 index and the SPDR S&P Retail ETF, which tracks the performance of the retail segment of the total market index. (Graph created on Yahoo!Finance.com). As of 1 October 2024, BBWI moved out of the S&P 500 index to the S&P SmallCap 600 (News Release Archive, 2024)

COMPETITIVE POSITIONING

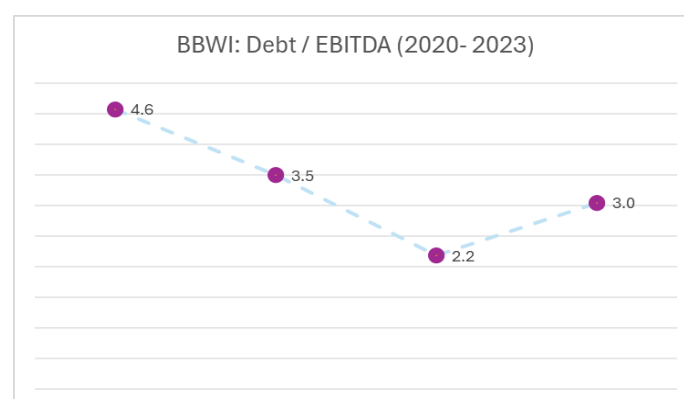
In our peer analysis, we focused on Bath & Body Works' leverage relative to its competitors. While the company's profit margins align with those of its peers and the industry, it exhibits an anomaly in terms of leverage. Comparing average key metrics over 2019- 2024, **the abnormal leverage ratios of BBWI, due to high level of indebtedness and negative equity, are highlighted.** ("Peer Metrics" tab in Group_22_Valuation_BBW.xlsx, Data Source: Yahoo!Finance.com, Eikon.Refinitiv.com).



Source : Own elaboration

Our analysis of the annual SEC filings showed that, post the Victoria's Secret spinoff, BBWI has had several strategy shifts (such as more off- mall retail spaces) and investments (such as the IT Transformation Project), which have required capital expenditure, resulting in high accumulated levels of long-term debt. This can be interpreted as a leveraged growth strategy by BBWI to recapture their position in specialty retail.

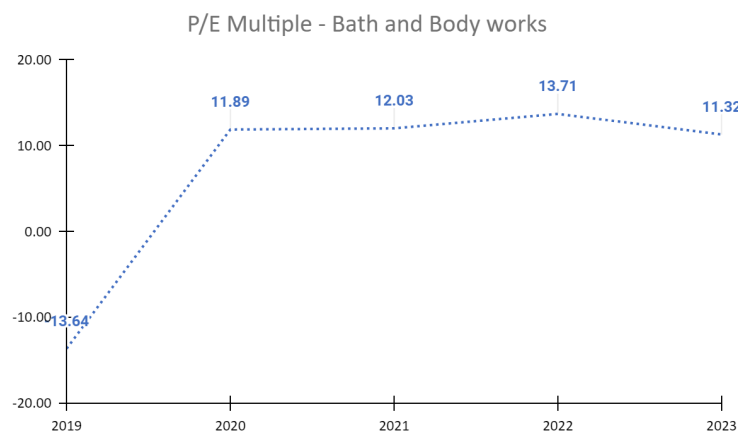
Reducing Leverage : The company repaid 447 million USD worth of long-term debt in 2023- 24 and their Debt/ EBITDA level has reduced from 2020 (www.sec.gov, n.d.). Through analysis of their annual reports - we can reasonably expect the company to continue to lower its debt to reach industry normative levels.



Source : Own elaboration

FINANCIAL ANALYSIS

- **Revenue** grew from \$3.3 billion in 2014 to \$7.4 billion in 2023, with an average annual increase of 5.66%. The pandemic years of 2020 and 2021 were outliers, with a 24% revenue surge driven by increased consumer focus on skincare and personal care products as self-care gained importance
- **Segment-wise revenue** - The surge in revenue in 2020 and 2021 for hand-sanitisers has started to reduce post pandemic, but the growth in men's skincare has increased thereby leading to overall increase in Net Sales.
- **P/E Multiple** : The company has demonstrated stable, moderate growth, with its P/E multiple ranging between 11 and 14. However, there was a drop in the P/E multiple from 2022 to 2023 due to a decline in profits driven by inflation, which increased the costs of raw materials, transportation, and labour.



Source : Own elaboration

- **Capital Expenditure- IT Systems** : Company spent \$164 million on **capital expenditure** to build new IT systems that would separate it from the IT system of Victoria's secret , thereby supporting distribution and logistics capabilities that would result in long term-growth.
- **Favourable Current Ratio** : The company has been consistently maintaining a favourable current ratio (above 1). It was increased from 1.37 in 2019 to 1.64 in 2024. This is in-line with the industry and its peers.
- **Reduction in Net Profit Margin** : Due to an increase in debt and rising costs from inflation, the company's net profit margin has **decreased from 17% to 12%**.
- **Focus on increasing profitability and shareholder Value** : Amid the transition to a standalone company, the company has maintained a consistent dividend payout ratio of 20%. The company is currently focusing on reducing its debt in the capital structure, building IT systems to enhance its online presence and develop a separate infrastructure from Victoria's Secret, **increasing its focus on profitability and shareholder value**.

VALUATION

For the valuation of BBW free cash flows are projected over 10 years and discounted to their present values. Beyond this explicit projection period, a terminal value is used to account for future and long term cash flows. The weighted average cost of capital (WACC), incorporates cost of debt and cost of equity, used as the discount rate. WACC reflects the company's capital structure and includes the tax benefits of debt in the discount rate rather than the cash flows. WACC is the rate at which a company's total free cash flows are discounted to determine its overall value (Damodaran, 2002).

FORECASTING:

1. Revenue Growth

Bath & Body Works (BBW) separated from Victoria's Secret as a standalone company post-2021. To forecast its revenue, we analysed the company's annual reports from 2014 for BBW specific revenues. Revenue spiked in 2020 and 2021 due to increased demand for skincare products during the pandemic. To ensure accuracy, we excluded these outlier years. The average historical YoY growth rate calculated was 5.66%, while the specialty retail industry grew at 2.38%. Given rising consumption trends and BBW's Capex growth, we forecasted revenue using a blend of historical and industry growth rates:

| | |
|------------------|---|
| 2024 to 2028 | $r_g = \frac{2}{3} \cdot r_{\text{Historical Growth}} + \frac{1}{3} \cdot r_{\text{Industry Growth}}$ $r_g = \frac{2}{3} \cdot 5,66\% + \frac{1}{3} \cdot 2,38\%$ $r_g = \mathbf{4.56\%}$ |
| 2029 to 2033 | Projected as a decreasing average between the forecasted revenue until 2029 and the continuing value. |
| Continuing Value | Given the GDP is expected to grow at an average of 1.8% (published by cbo.gov.in), the continuing value has been at 1.5% for the company's growth. |

Revenue growth - Sensitivity Analysis

We further used the **1/9th sensitivity adjustment rule**, to predict the best case and worst case growth rates.

| | 2024 to 2028 | 2029 | 2030 | 2031 | 2032 | 2033 | Continuing Value |
|-------------------|--------------|-------|-------|-------|-------|-------|------------------|
| Best Case | 5.07% | 4.36% | 3.64% | 2.93% | 2.21% | 1.50% | 1.50% |
| Base Case | 4.56% | 3.95% | 3.34% | 2.73% | 2.11% | 1.50% | 1.50% |
| Worst Case | 4.06% | 3.55% | 3.04% | 2.52% | 2.01% | 1.50% | 1.50% |

Source : Own elaboration

2. WACC - Weighted Average Cost of Capital

A WACC of 8.33% was calculated for August 2nd, 2024 (please refer to tabs 4.1 WACC and 4.2 Beta BBW in the Excel file).

Formula:

$$WACC = r_{kb} \cdot (1 - T) \cdot \frac{Debt}{(Debt+Equity)} + r_{kp} \cdot \frac{Equity}{(Debt+Equity)}$$

Components of WACC calculation:

To arrive at the WACC figure of 8.33%, we calculated the below data:

| | Forecast | Calculation |
|-----------------------------|------------------------------|--|
| Target Debt-to-Equity ratio | 31.66% Debt 68.34% Equity | The target debt-to-equity ratio of 46.34% reflects the company's target debt-to-equity ratio and complies with the firm's capital policy as described in the annual report. The assumption is that they will keep reducing their debt until 2029 (FY28). |
| Cost of Debt | 6.6% | This is the YTM of the latest bond that BBW issued. The 6.625% fixed interest rate notes due October 2030 issued by Bath & Body Works is a bullet bond For the fiscal year ending February 2024, the company reported a debt leverage ratio of 2.8, down from 3.1 the previous year. This debt leverage ratio has been influenced |

| | | |
|-------------------------|-------|--|
| | | by BBWI retaining Victoria Secret's debt following the split of the companies. As per the annual report, BBWI plans to repay this debt. Accordingly, the debt ratio of the company will be drastically reduced within the next 5 years, with a slight increase for the following 4 years. |
| Beta of debt | 0.53 | <p>This was calculated based on the following formula (please refer to Excel tab 4.1). The current risk-free rate of a US 10Y Treasury Bond on the 2nd of August is 3.76%, and the market risk premium per Statista for 2024 in the US is 5.5%.</p> $K_b = R_f + \beta_d \cdot MRP$ $\beta_d = \frac{K_b - R_f}{MRP}$ |
| Adjusted Beta of equity | 1.2 | <p>Using OLS regression, and the stock prices of S&P 500 index and Bath and Body works over the last 2 years, this was calculated. (502 observations in total and R-square at 20%)</p> $\beta_{adjusted} = (\frac{1}{3}) + \beta * (\frac{2}{3})$ |
| Unlevered Equity Beta | 0.94 | <p>Using a corporate tax rate of 21% for the US (Federal tax rate) and the average debt-to-equity ratio of the past 4 years:</p> $\beta_p^{\frac{c}{d}} = \beta_p^{\frac{s}{d}} \cdot \left[1 + (1 - t_c) \cdot \frac{B}{P} \right] - \beta_d \cdot (1 - t_c) \cdot \frac{B}{P}$ $\beta_p^{\frac{s}{d}} = \frac{\beta_p^{\frac{c}{d}} + \beta_d \cdot (1 - t_c) \cdot \frac{B}{P}}{1 + (1 - t_c) \cdot \frac{B}{P}}$ |
| Cost of Equity | 9.74% | <p>Calculated using the CAPM formula:</p> $K_P = R_f + \beta_p^{\frac{c}{d}} \cdot MRP$ |

However, if the target capital structure changes, we get a different WACC, as shown in the table below:

| Calculation of Cost of Capital for Bath and Body Works. | | | | | | | | |
|---|--------------|-------|----------------|--------------|------------|--------------|----------------|-------|
| | Cost of Debt | Tax | Unlevered Beta | Levered Beta | Debt Ratio | Equity Ratio | Cost of Equity | WACC |
| Base Case | 6.7% | 21.0% | 0.94 | 1.09 | 31.66% | 68.34% | 9.7% | 8.33% |
| Increase in Equity | 6.7% | 21.0% | 0.94 | 1.03 | 22.22% | 77.78% | 9.4% | 8.51% |
| Increase in Debt | 6.7% | 21.0% | 0.94 | 1.19 | 44.44% | 55.56% | 10.3% | 8.09% |

Source : Own elaboration

3. Interest expense

Forecasted using the 10-year interest payment forecast based on Bath & Body Works' issued notes. The forecast reflects expected annual interest payments for each year from 2024 to 2033. The payments decrease as various bonds mature over the period, leading to a reduction in the total interest obligations.

4. Capex and Depreciation

Per company's annual report of 2023, There will be no major capital expenditures within the next 10 years. As described in the company overview, BBW's predominant strategy is to decrease its stores and increase its online sales. There will be no major depreciation changes throughout the forecasted years, so there will be no major changes in long-term assets.

5. Cost of Sales and Operating Expenses

Forecasted using the historical average of cost of sales and expenses over the last 5 years.

6. Tax Rate

The current federal tax rate of 21% was used in the forecast calculation.

7. Non-Operating Expenses :

Non operating income/expenses is not related to the core business of BBW and we will therefore establish 0\$ projected to the future

ANALYSIS AND RECOMMENDATION

Based on the forecasted figures, we calculated the Enterprise Value to be \$13,957 million, which translated to a share price of **\$36.18** (FCFF) and **\$39.31** (FCFE). Bath and Body Works Inc.'s stock price is **\$33.20** (August 2024 - post Q2 results) . Both our valuation models indicate that the stock is undervalued. This is because of :

- Consistent revenue growth at 5.66% over the past 10 years.
- Growth in net profit margin by 10% post the separation into a standalone company
- Stable dividend payout ratio at 20%
- Management's strategic focus on controlling costs and inefficiencies.
- Bath & Body Works' current and future strategy emphasizes enhancing IT systems and expanding its online presence to boost revenue, along with reopening off-mall stores, all of which indicate strong potential for future growth.
- Given the company's increased focus on reducing its debt in the capital structure, we have forecasted to reduce their debt by 11% YoY, thereby increasing their profitability and subsequently the shareholder value.

Therefore, based on our valuation model, we recommend buying Bath and Body Works stock.

SCENARIO & SENSITIVITY ANALYSIS

We performed a scenario analysis to determine how sensitive is the final value of the firm per share for change in Revenue Growth rate, WACC and Cost of Equity.

Components used as variables:

To conduct this analysis, we varied two key components: **Revenue** and **WACC**.

1. **Revenue** : The baseline forecasted revenue growth is 4.56%. Using a 1/9th sensitivity adjustment model, we evaluated an optimistic (best-case) scenario with a growth rate of 5.07% and a pessimistic (worst-case) scenario with a growth rate of 4.09%.
2. **Capital Structure and Levered Beta**: In our analysis, we explored two additional scenarios: one with an increased proportion of equity, and another with an increased proportion of debt (as mentioned below).

| Calculation of Cost of Capital for Bath and Body Works. | | | | | |
|---|--------------|------------|--------------|----------------|-------|
| | Levered Beta | Debt Ratio | Equity Ratio | Cost of Equity | WACC |
| Base Case | 1.09 | 31.66% | 68.34% | 9.7% | 8.33% |
| Increase in Equity | 1.03 | 22.22% | 77.78% | 9.4% | 8.51% |
| Increase in Debt | 1.19 | 44.44% | 55.56% | 10.3% | 8.09% |

Source : Own elaboration

Calculation:

Free Cash Flow to Firm:

| | | Riskier Scenario | | Standard | Favourable Scenario |
|------------|---|------------------|----------|----------|---------------------|
| | Calculation of Cost of Capital for Bath and Body Works. | | | | |
| | FCFF | WACC | | | |
| | Revenue Growth Rate | | 8.51% | 8.33% | 8.09% |
| Worst Case | | 4.06% | \$ 33.65 | \$ 35.20 | \$ 37.40 |
| Base Case | | 4.56% | \$ 34.59 | \$ 36.18 | \$ 38.42 |
| Best Case | | 5.07% | \$ 35.57 | \$ 37.18 | \$ 39.47 |

Source : Own elaboration

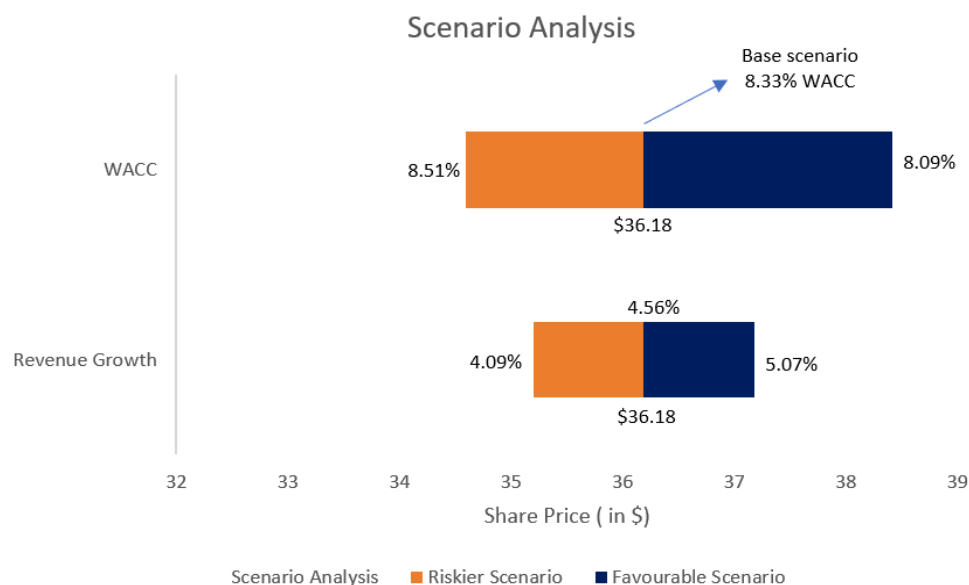
Free Cash Flow to Equity:

| | | Favourable Scenario | Standard | Riskier Scenario |
|-------------------|--|-----------------------|----------|------------------|
| | Calculation of Cost of Capital for Bath and Body Works. | | | |
| | FCFE | Cost of Equity | | |
| | | 9.40% | 9.70% | 10.30% |
| Worst Case | Growth Rate | 4.06% | \$ 40.05 | \$ 38.20 |
| Base Case | | 4.56% | \$ 41.46 | \$ 39.31 |
| Best Case | | 5.07% | \$ 42.93 | \$ 40.93 |
| | | | \$ 37.35 | |

Source : Own elaboration

Inferences:

1. As the equity increased in the capital structure, the WACC increased from 8.33 to 8.51%. A higher WACC leads to a lower price in share. This is because the returns are discounted at a higher rate, thereby reducing the present value of the future cash flows.
2. The most favourable scenario is at the best case revenue growth at 5.07% and the lowest WACC at 8.09% which signifies a higher debt in the capital structure at 44% compared to the base case scenario of 31%.
3. As the company aims to reduce its overall debt, currently at 138% of its capital structure, it can maintain a debt level between 36% and 44% to achieve a more optimal WACC.



Source : Own elaboration

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