GRANT'S
INTEREST RATE OBSERVER®

Vol. 31, No. 2c | Two Wall Street, New York, New York 10005 • www.grantspub.com | JANUARY 25, 2013

Call on prosperity

Janna Ryan, wife of the 2012 Republican vice presidential nominee, wore a $70 printed Dana Buchman dress on the day her husband's candidacy was announced in August. You wonder if it was the right thing to do. Kohl's Corp. (KSS on the New York Stock Exchange), retailer to the American middle class, proceeded to have just as forgettable a 2012 as the Republican ticket did.

No time for regrets, however. We write to propose that Kohl's is on the mend (never mind the GOP). Management is taking concrete steps to address the problems of 2012—and of 2011, too—while improvements in national hiring and wage growth may presage a more optimistic Kohl's shopper. But whatever macroeconomic gifts the gods may bestow or withhold, management continues to repurchase stock at the prevailing deflated valuation. Count us bullish.

The first Kohl's store opened in Brookfield, Wis., in 1962. Fifty-one years later, there are 1,146 Kohl's locations generating $19 billion of sales. Private-label merchandise is a specialty of the house: Marc Anthony, Food Network, Vera Wang, Candie's, among others. Another corporate trademark is oblong, wide-aisle store design—"racetrack" is the name of the concept. In-store electronic signage, handy for markdowns, or—thinking ahead to the Fed's QE 5, 6 and 7—high-frequency markups, is still another.

One way to think about Kohl's is how little it resembles Macy's. For instance, Kohl's prefers to locate in strip, not shopping malls, and in the Midwest as opposed to the East. Some 53% of Kohl's revenues are derived from private-label goods vs. 20% for Macy's. Not forsaking its Cheesehead roots, Kohl's makes its headquarters in Menomonee Falls, Wis., 20 miles northwest of Milwaukee. In the latest fiscal year, women's apparel delivered 31% of sales, menswear 19%, home products 19%, children's wear 13%, accessories 10% and footwear 8%.

Since going public in 1992, Kohl's has achieved compound annual growth in sales per share of 15.6% and in earnings per share of 20.6%. But America isn't growing the way it used to, and neither is Kohl's. In fiscal 2011, sales grew by 2.2%, net income by 4.2%. A shrinking equity capitalization, though no substitute for prosperity, significantly improved results for the individual stockholder. Thus in 2011, sales and earnings per share grew by 15.5% and 17.5%, respectively. The essential bull case is that, with or without top-line growth, the Kohl's share count is likely to continue to fall. Growth, should

Kohl's Corp.
(in $ millions, except per-share data and store metrics)*

	TTM	2011	2010	2009	2008	2007
Sales	$18,956	$18,804	$18,391	$17,178	$16,389	$16,474
Cost of merchandise sold	11,901	11,625	11,359	10,680	10,334	10,460
Gross profit	7,055	7,179	7,032	6,498	6,055	6,014
SG&A	4,232	4,243	4,190	3,951	3,769	3,548
Depr. and amort.	815	778	750	688	632	535
Operating income	2,008	2,158	2,092	1,859	1,654	1,931
Interest expense	318	299	304	301	275	228
Taxes	626	692	668	585	522	643
Net income	1,064	1,167	1,120	973	857	1,060
Diluted shares	248	271	306	306	307	320
Earnings per share	$4.35	$4.30	$3.66	$3.17	$2.80	$3.31
Number of stores	1,146	1,127	1,089	1,058	1,004	929
Comp. store sales	-0.3%†	0.5%	4.4%	0.4%	-6.9%	-0.8%
Sales per sq. foot	$230	$220	$222	$217	$222	$249
Cash	550	1,205	2,277	2,267	643	181
Long-term leases	2,086	2,103	2,104	2,046	n/a	n/a
Debt	2,492	2,009	1,894	1,894	2,053	2,052
Net debt	4,028	2,907	1,721	1,673	1,410	1,871
Currrent price	$43.70					
P/E	10.0x					

*fiscal years end in January
†trailing 11 months
source: company reports, the Bloomberg

it materialize, would constitute a kind of special dividend. Certainly, the market isn't counting on it.

The market seems not to be counting on much, and perhaps for cause. In 2011 a cotton price spike led to decisions that delivered too little inventory. Management tried to push price increases onto consumers while the competition didn't. In consequence, comparable sales only grew 0.5%, driven by a 1% fall in same-store sales and 37.2% growth in e-commerce. In Kohl's fiscal 2012 (the year that ends next week), a plunge in cotton prices and a buoyant spring selling season led to decisions that delivered too much inventory into a weak winter and, in consequence, a contraction in profit margins. Full-year operating margins are expected to come in at 9.8% in 2012 vs. 11.5% in 2011.

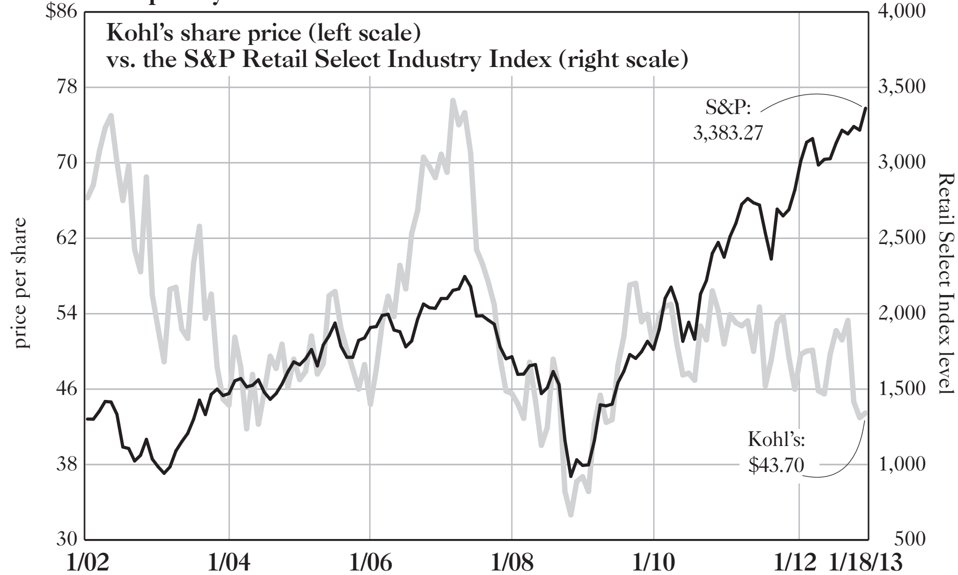
"What's gone wrong?" colleague Evan Lorenz asked Richard Jaffe, retail analyst at Stifel Nicolaus. "You could say the product wasn't as desirable, and certainly that explains some of it," Jaffe replied. "You could say that the promotions weren't effective. . . . The closer you look at the promotions, I saw them as a source of weakness. I thought Kohl's was, in many places and in many categories, the best value for the consumer. In some cases, not just the best value by price quality and fashion, but also the lowest price."

At the start of 2012, management talked about earnings of $4.75 a share in the context of 2% growth in same-store sales. But, in the 11 months through December 2012, same-store sales actually fell by 0.3%, and now management is talking about EPS on the order of $4.12.

Some bears doubt that Kohl's can ever set things right (J.C. Penney shows how hard it can be). They contend that off-price retailers like T.J. Maxx and Ross Stores have rendered the very concept of a middle-market department store obsolete. Remarks one such doubter: "What is the moderate department store's core value proposition if they are not branded but … are also not the lowest price out there for non-branded goods?"

But, we think, the bears go too far. "While Wal-Mart has had great success with its private-label clothing brands such as George and Faded Glory," observes Lorenz, "these brands lack the fashion cachet that Kohl's brands have (ask Janna Ryan). While the off-price channel has flourished in the Great Recession and subsequent Great Funk, and serves as an important safety valve for the discharge of excessive inventory, it's unlikely to take the dominant role in selling branded goods. Branded-goods makers have brands to protect. Chronic markdowns don't help."

Prosperity via the share count



source: The Bloomberg

Yes, an honest bull must acknowledge, Kohl's has built-in vulnerabilities. Any vendor of private-label brands does. Design risk is inherent in conceiving and marketing one's own lines of clothing. "After all," Lorenz observes, "they have to decide which fashion trends to promote and which Chinese factories to commission to turn concept into merchandise. Just as the potential rewards are greater (in the shape of superior margins), so are the risks greater (nail the fashion trend, or else)."

The strongest evidence in support of the viability of the Kohl's business model is Kohl's own operating record. Between fiscal 2007 and fiscal 2011, selling, general and administrative expense as a percentage of sales averaged 23% vs. 28.9% for a peer group consisting of J.C. Penney, Macy's, Dillard's, Saks, Nordstrom and Bon-Ton Stores. Over the same five years, Kohl's operating margin averaged 10.8% vs. 5.2% for its peers.

As to the suggestion that Kohl's is a relic of the analogue age, the best rebuttal is the vitality of the company's online presence. In the third quarter, digital sales jumped by 50% from the year-earlier period to $295 million, or 6.6% of total revenue. Then, too, on Facebook, Kohl's has elicited 10.1 million "likes," compared to 10.3 million for Macy's, though, in terms of trailing 12-month revenues, the latter is 43% larger than the former.

Kohl's has a loyal corporeal fan base, too. In the third quarter, the Kohl's store card was the plastic swiped in 58% of Kohl's sales. Company cardholders, plied with discounts, tend to be repeat customers who spend more than the average non-card holder. Only Macy's comes close to Kohl's in this respect, with Macy's-branded credit cards financing 47% of Macy's sales.

Retailing consultant Elizabeth A. Haynes tells Lorenz that Kohl's secret strength might lie in its presence in somewhat unglamorous strip shopping centers. "You can drive up to the door," she points out, "you can go in, you can do all the things you need to do inside their box at a higher level of taste for the different categories that are there, and then you leave. It is really, really compelling for people with families and women with smaller children. . . . That has to be proven out that it is something that millennials actually want, because they are not there yet. It is something that, by and large, Gen X has wanted."

So it was an atypical Kohl's location—mall-based, not shopping-center-based—that Lorenz went to inspect in Jersey City, N.J., directly across the Hudson River from Manhattan. Set down at the Newport Centre mall—a super-regional mall, if you please—in the company of Sears, J.C. Penney and Macy's, Kohl's gave a good account of itself.

"From a casual walk-through," Lorenz begins his report, "it's obvious that Sears and Penney are struggling, but not so Kohl's and Macy's. Alone among the four, Sears keeps selling big-screen TVs, tools and white goods in competition with the big-box retailers like Home Depot and Internet retailers like Amazon. At the front of the Sears store at Newport Centre is a stack of 24-bottle packs of flat water for $1.99. A great price, but you have to wonder: Who wants to lug 24 bottles of water around the mall? Penney, like Sears, looks as if the front office decided to skip a capex cycle or two and go light on the fashion-forward inventory.

"As between Kohl's and Macy's, the latter is the more upscale, the former easier to navigate," Lorenz goes on. "I like the racetrack-style layout at Kohl's. And though I am spinning a bullish story on KSS, I'm bound to admit that Macy's has a deeper and seemingly better women's clothing department than Kohl's—though, on that subject, what do I know? But Kohl's has it all over Macy's in housewares. Aspiring amateur chefs like me can roam around among the pots and pans and utensils while watching broadcast images of celebrity chefs such as Bobby Flay whipping up that delicious something or other. Naturally, these celebrities are using Kohl's products. I also noticed that Kohl's has succeeded in integrating its Website into its store.

"Each of the four retailers were running major clearance sales as they transition to spring from winter merchandise," Lorenz concludes. "Because of the aforementioned electronic signage—it's mounted over every merchandise rack—Kohl's was best in drawing attention to its markdowns. Penney was the worst."

One of the more thoughtful bulls on Kohl's is the founder and managing partner of MCN Capital Management, Mathew Klody. If you haven't heard of MCN yet, it's because it's only getting started. (Klody previously worked at Sheffield Asset Management and Alleghany Corp.)

Kohl's, Klody relates, "has hired a new general merchandising manager (GMM) from Macy's. They are looking for a new head of design in New York. That search is ongoing. They've also created a new position, 'GMM for the center of the store,' which is like accessories. That's been a weaker area—jewelry, purses, those types of things. They now have a dedicated person to address that. They are also trying to create reasons for non-Kohl's customers to get into the store and be more fashion-forward. What they are doing is having these high-end designers doing limited-edition runs. Narciso Rodriguez was the first one—that came through in November. Management has said that went fairly well. We'll hear more on their earnings call. They are doing Derek Lam next year just to try to get some new customers into the store. Target has been very successful at that. We'll see."

"We'll see" well describes the market's stance vis-à-vis KSS. Based on consensus expectations, which have been drooping, Kohl's trades at 10.6 times fiscal 2012 earnings (the year that closes at the end of this month) and 9.6 times fiscal 2013 earnings. Implicit in the Kohl's outlook is operating margins on the order of 9.6% to 9.8% vs. margins of 11.4% and 11.5% earned as recently as 2010 and 2011. A return to an 11% operating margin would, other things staying the same, generate an extra 73 cents per share in fiscal 2013, which would value the stock at 8.4 times the estimate.

As befits a commonsensical Midwest institution, Kohl's has a manageable level of debt—$4 billion, net of cash, or 1.4 times trailing 12-month EBITDA. And it presents that debt conservatively, folding in the grand total of $2.1 billion in long-term capitalized leases. On a trailing basis, EBIT covers interest expense (again, including capitalized lease payments) by 6.3 times.

Kohl's paid no dividend when it was in growth mode. Its first payout was the one the directors declared on Feb. 23, 2011, and the stock today yields 2.9%. Share buybacks are the larger part of the company's stockholder rewards program. Between the third quarter of 2010 and the third quarter of 2012, it bought in 24% of shares outstanding. With a $3.5 billion buyback program in place today, the company is set to buy a little more than 10% of its market cap every year for each of the next three years. "In terms of dividends," Kohl's chief financial officer, Wesley S. McDonald, told listeners-in on the Kohl's third-quarter conference call, "assuming you buy back a number of shares over the next three years, that would pretty much build in a double-digit dividend increase every year, holding the actual payout in dollars to be about $300 million."

By the looks of things, Kohl's is managing its finances to conform to the idea of a so-called new normal of perpetually slow economic growth—though reliably strong corporate cash-flow growth. Certainly, there hasn't been much top-line growth since the fateful year of 2007, when sales per square foot at Kohl's stores averaged $249.14. They slumped to $226.24 in 2008 and—the punch line—have recovered only to $229.86 as of the latest 12 months. Hats off to management for not building empires with the stockholders' money. Then, again, the view into the economic future is probably no clearer in Menomonee Falls than it is on Wall Street. What if growth returns?

"Something can go right. This is America after all." So quipped the investor Michael Harkins in August on CNBC. Under the heading of unscripted bullish outcomes was last week's news from Lennar Corp. The homebuilder told dialers-in to its earnings call that the new-new normal in residential real estate construction features rising costs for land and construction materials as well as shortages of electricians, carpenters, plumbers and laborers.

"Initial jobless claims for the week ended Jan. 12 fell by 37,000 to 335,000, the lowest since the week ended Jan. 19, 2008," Lorenz relates. "The trailing four-week jobless claim average is now 359,300, down from the peak of 659,300 reached in the week ending March 27, 2009, and below the 367,800 registered on March 28, 2008. Housing starts, with a big assist from multi-family starts, hit 954,000 in December, the most since June 2008 (economists were looking for 890,000). And if real median household income grew in 2012, as it may have done, it would be the first time since 2007."

In conversation with Lorenz, Richard Jaffe, the Stifel analyst, allowed himself to contemplate what could be described as either a fantasy or a simple return to the state of play before the Great Recession: "Could this company return to historically high operating margins, regain market share and return both to peak operating margins driven by peak sales per square foot? Roughly, you are looking at $20 billion in sales, 12% operating margins, $2.4 billion in operating profit and earn something like $7 a share on what is today a $44 stock. That's what the math works out to. That is a mature business with limited growth and peak sales per square foot, so perhaps the multiple is only 12 times."

Anyway, the market would be pleasantly surprised.

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