

The Enlightened American

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American Eagle Outfitter is a leading clothes retailer specializing in the 15-25 year old demographic, with start-up programs targeting kids (via the 77kids brand) and thirty-somethings (via Martin + Osa). The vast majority of their operations are in the US with some in Canada.

Intrinsic Value: \$15 - \$18 per share

Accumulation Range: \$11 per share or better

(Note all charts list the wrong FY. FY 2007 should be FY 2008 and so on.)

RISKS

- **Standard industry risks:** *cutthroat industry competition, fashion trend changes, economic downtrends, standard SEC filing fare, etc.*
- The company's mature profile may limit growth going forward. Management is responding with the roll-out of the aerie, 77kids and Martin+Osa brands in an effort to expand their potential market. Only aerie has gained traction so far. In general, fashion trends change and "cool" brands naturally go stale despite revamp efforts.
- Business trends are deteriorating markedly.

○ Efficiency measurements

FY END	2007	% delta	2006	% delta
Same-store growth	1%		12%	
Sales	\$ 3,055,419	9.3%	\$ 2,794,409	20.3%
sales avg/selling sf	\$ 638	-0.6%	\$ 642	11.3%
total selling sf	4,595,649	8.9%	4,220,929	8.3%
sales avg/gross sf	\$ 517	-1.3%	\$ 524	11.3%
total gross sf	5,709,932	10.4%	5,173,065	8.4%
total stores at YE	987	8.3%	911	4.8%
number of employ	38,700	40.2%	27,600	20.0%
sales/emp	\$ 78,951	-22.0%	\$ 101,247	0.3%

The Enlightened American

- **FY 2008 (ignore the erroneous graphic) quarterly sales breakdown:**

FY 2007	Q1	Q2	Q3	Q4	FY Total
Net Sales	\$ 612,386	\$ 703,189	\$ 744,443	\$ 995,401	\$3,055,419
Gross Profit	\$ 298,459	\$ 316,447	\$ 352,917	\$ 455,315	\$1,423,138
Net Income	\$ 78,770	\$ 81,344	\$ 99,426	\$ 140,479	\$ 400,019
% of Sales	20.0%	23.0%	24.4%	32.6%	
% of Gross	21.0%	22.2%	24.8%	32.0%	
% of Income	19.7%	20.3%	24.9%	35.1%	
% delta YOY sales	17.2%	16.7%	6.9%	2.3%	9.3%
% delta YOY gross	17.3%	15.0%	2.5%	-2.4%	6.2%
% delta YOY income	22.8%	12.8%	-1.5%	-6.4%	3.3%

FY 2006	Q1	Q2	Q3	Q4	FY Total
Net Sales	\$ 522,428	\$ 602,326	\$ 696,290	\$ 973,365	\$2,794,409
Gross Profit	\$ 254,369	\$ 275,261	\$ 344,324	\$ 466,475	\$1,340,429
Net Income	\$ 64,156	\$ 72,099	\$ 100,945	\$ 150,159	\$ 387,359
% of Sales	18.7%	21.6%	24.9%	34.8%	
% of Gross	19.0%	20.5%	25.7%	34.8%	
% of Income	16.6%	18.6%	26.1%	38.8%	

- The company released 2009 Q1 guidance below expectations and then lowered them on 04/09/2008, thus confirming further softening.
- Over half of their short-term liquidity (\$372M) is locked up in auction-rate securities. While management stated that cash on hand is more than enough to fund operations through the spring, the seasonal pick-up toward the back end of the year could strain resources.
 - The company disclosed opening and drawing down a \$75M credit facility subsequent to FY 2008, meaning the company is not debt-free, as is often asserted when browsing internet research on the stock.
- Balance sheet lacks “hard” assets:
 - About one-third of their \$1.9B in assets is investments.
 - Over 80% of property, plant & equipment (PPE) consists of leasehold improvements and fixtures. My estimate is ~\$535M of PPE (\$626M) as of the 2007 10K filing falls into this category.
 - While there is no doubt that these improvements provide value for the company as an ongoing-concern, they provide little backstop when valuing the company on a non-ongoing basis.
 - For example, if business were to deteriorate considerably, I doubt the company would be able to monetize its capitalized leasehold improvement assets to raise cash. In fact, it may even have to write down unplanned store closings.
- American Eagle is committed to an aggressive capex program (\$250 - \$275M) even as their business trends are declining markedly. A heavy consumer retrenchment could leave the company flat-footed.
- Martin + Osa brand failing to gain traction, losing \$0.15 per share in Q4 2008 (which saw \$1.82 net EPS). The failure of this brand to stick strikes a blow to

The Enlightened American

AEO's attempt to expand their demographic base as aerie still targets the 15-25 year old core female market.

- As exposed as you can get to the US economy.

UPSIDE POTENTIAL

- Outstanding track record with positive net income & free cash flow generated in each of the last 10 years.
- Best-in-class retailer led by solid management.
- Barring liquidity issues, the company's balance sheet is unencumbered and large enough to support expansion and returning cash to shareholders via dividends (2% yield) and buybacks (41.3M shares authorized through FY 2010).
- Even as their main AE brand may be facing consumer fatigue (Aeropostale appears to be taking share), the new aerie brand could do something similar to the "tired" Victoria's Secret brand among younger women. The company senses a growth opportunity in this market and is aggressively pursuing it by opening 80 aerie stores in 2008 along. For reference, Victoria's Secret generated \$7B in sales & \$1B in operating income in 2006

VALUATION

Valuing AEO in the face of a likely consumer-led recession was difficult. One of the truisms of value investing is an emphasis on bottoms-up investing; that is, one should not let macroeconomic forecasts cloud the picture when making buy/sell decisions. In this case, I don't know how it can be avoided.

As far as I can tell, American Eagle only has value as an ongoing concern. Once you back out the cash, its assets are too specialized to be of real value outside the retail space. But in order to come to a valuation on the company, we must make some judgment as to prospects going forward. It strikes me that AEO is heavily exposed to the consumer. I've read some reports stating that their core market (the late teen college crowd) is insulated from the broader economy since they don't have mortgages, real jobs, etc and will likely keep spending despite the gloom. But I have known many college-age kids, past & present, who relied on parents to fund their college years or spent student loan money for other purposes. My point is these young consumers may not be as insulated as some would think.

Perhaps this is a stock that's "too hard." After all, who can forecast the economy accurately enough to judge its effects on a specific store? But we've come all this way so let's give it a go. Here is my quick chart showing FCF ratios over the last 5 years:

Fiscal Year Ended	2003	2004	2005	2006	2007	AVG RATIO
Ratio of FCF:Revenues	0.04	0.09	0.13	0.11	0.07	0.09
Ratio of FCF:OCF	0.62	0.74	0.82	0.60	0.46	0.65
Ratio of FCF:Earnings	1.52	1.25	1.31	0.88	0.53	1.10

The Enlightened American

We can see that, on average, AEO has managed to convert 9% of revenues, 65% of operating cash flow and 110% of earnings into free cash flow over the last five years. I've adjusted 2006 (shown as 2005 in the chart) numbers to remove the one-time proceeds from sales of trading securities (\$184M).

I have seen some money managers posit double-digit growth for AEO. A few examples:

- Scott Black from Barron's 2007 Mid-year Roundtable
- Meryl Witmer from the 2008 Roundtable

I have tremendous respect for both managers but we now have the added hindsight of Q4 results along with several months of deteriorating same-store numbers to know that those projections are overly optimistic. Assuming 2% growth over the next 5 years and I am not sure if this is overly conservative – there are significant economic headwinds for the American consumer and I am not convinced that AE (or any clothes retailer) can maintain brand positioning over the next 5 years – regardless, here are some scenarios:

1. 5-year average FCF: \$269M implies intrinsic value (IV) @ \$19 per share (13x P/FCF)
2. TTM FCF: \$214M implies IV @ \$15 per share (16x P/FCF)
3. Best adjusted FCF (2005): \$384M implies IV @ \$24 per share (9x P/FCF)
4. Arbitrary FCF: \$100M implies IV @ \$7.20 per share (34x P/FCF)

The question is which scenario paints a truer picture going forward? I've already discarded the third scenario as AEO is clearly decelerating. The recently lowered guidance means projected Q1 FY 2009 EPS of \$0.18 - \$0.20 will be about half the year previous. This is worse than it looks as the company bought back 18.7M shares over the year. If I extrapolated that 50% reduction over the whole year, we're looking at \$200M in earnings for this fiscal year. Is that number realistic? It is hard to say. Retailers do their biggest business in the back half of the year but the economy is visibly slowing and consumer prospects seem bleak. Let's split the difference between that projection (\$200M) and last year's \$400M net income and use a base earnings figure of \$300M. The average earnings to FCF ratio is 110% but that is an average. We are clearly approaching a trough in the cycle and 2007's conversion rate of 53% confirms this. If we use the 2007 number, we're looking at ~\$150M FCF and an IV around \$11 per share. If we split the difference between 2007 and the average, 80% conversion gives us \$18 IV on ~\$240M FCF.

I'm disinclined to believe the \$11 per share figure other than as a worse case scenario; if consumer spending does undergo a prolonged downtrend, management seems competent enough to handle that appropriately (though CEO Jim O'Donnell acknowledged that managing the operating levers has minimal impact on the income statement). The \$18 high-end seems appropriately conservative and if management executes, there's a good chance the stock is worth more. This valuation scenario implies it will take 5 years for

The Enlightened American

AEO to again reach its current 5-year average FCF level of \$269M, which is plausible if the recession is not shallow and AEO has trouble maintaining market position.

I have no illusions that these estimates are precise or even accurate – they are only ballpark guesstimates to give me a sense of what value may lurk in the shares. By demanding a margin of safety, I hope to avoid any serious mistakes. If I'm wrong, I would much rather be wrong on the upside, not the downside. My estimate is much lower than those found in the Barron's Roundtables, Morningstar, S&P and various internet blogs. Mistakes of omission may make self-reflection painful but mistakes of commission will hurt my bank account as much as my ego.

I do not know if AEO will drop down to my accumulation range. But it may drop low enough to make for an attractive prospect for writing puts, where we can leverage time decay on a low strike price to add another layer of safety margin to our thesis.

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Disclosure: The author received no compensation and is not affiliated with the company reviewed in this report with the possible exception of being a shareholder. The author reserves the right to buy or sell the stock as deemed personally prudent without further notification.