L BRANDS THOUGHTS

L brands (LB; mkt cap. $9.88B) is interesting due to its asymmetric risk and reward. Based on an equity price of **$32**, I estimate it offers 30-40% upside with downside of 15-20%. However, this opportunity will require *patience.* Based on previous retail turnaround situations, I estimate it will take 3 years for the market to recognize LB's earnings power. Given the risk and patience required, I would size the *initial* position conservatively @ ~50bps and scale in (pending no changes to LB's secular outlook).

L Brands has 3 core issues:

- Weak Victoria's Secret (VS) comparable store sales
- Too many stores and;
- High leverage

Over the last 8 quarters, VS comparable store sales have deteriorated from consistently positive to consistently negative. The start of the weakness coincides with the departure of Sharon Turney, former VS CEO, in February 2016. Hindsight being 20/20, it's clear that the VS segment was managed to *maximize* profits (15% and 18% in FY15 and FY16, respectively) and I suspect either Ms. Turney wasn't incentivize or provided the latitude to pivot to an athleisuire or bralette focus and *discount*. Enter Les Wexner, who swiftly resets the strategic course of the VS brand by: increasing assortment focus to athlesuire and bralettes and more importantly *discounts* (as evidenced by FY17 OM of 12.6%).

Keys to retail turnarounds are: 1) *discounting* to drive traffic 2) *cutting fixed expenses* to reflect a new reality. There is no doubt that it hurts the short-term operating profit and free cash flow but without traffic (volume), there is no margin to protect. As shown in the table (right), I would argue that VS operating margin is closer to a bottom than the market expects. Second, I would highlight the fact that VS segment margin doesn't even need to recover to average [~16%] to make the investment case. In fact, due to discounting and consumer preference changes, I conservatively assume a VS segment margin of 10% [and BBW segment margin assumption of 19%]**.**

	LB OM	VS OM	BBW OM
2003	10.8	18.6	18.4
2004	10.9	18.9	18.4
2005	10.2	19.9	17.6
2006	11	18.6	17.8
2007	11	13.8	13.2
2008	8.9	11.1	9.1
2009	10.1	10.9	15
2010	13.4	16.1	18.4
2011	11.9	17.7	19.2
2012	15	18.1	20.8
2013	16.2	16.8	20.8
2014	17.1	17.6	22
2015	18	18.1	23.9
2016	15.9	15.1	23.6
2017	13.7	12.6	23

L Brands operates 3,075 stores which at first blush seems too many given my view that specialty retailers need only 500 - 600 to adequately cover the US. Victoria's Secret (VS) US has about double that figure or 1,120 stores while Bath & Body Works (BBW) US operates triple that figure or 1,596 stores. However, not all stores are created *equal* and it worth mentioning that the average VS and BBW store size is 6,400 ft^2 and 2,500 ft^2, respectively. Furthermore based on many LB investor day presentations, 99% of stores are cash flow positive stores. To be clear, LB will have to close *some* stores and that may take time as Wexner is wedded to idea that physical stores are very valuable but the overstored store narrative taken out of context is misleading at best and emotional at worst.

Based on Moody's latest rating assigned to L Brands most recent senior note offering the company is levered 3.4x based on debt to EBITDA and covers interest 3.2x over. Adjusting debt to include leases (8x capitalization), L Brands leverage jumps to 4.8x. As such, LB will have to use some future cash flow to bring leverage down.

Given the recent weakness, it's easy to overlook that VS is a solid retail business. It sells emotive seasonless product that lends itself well to the physical store format. It generates sales per square foot of $784 and generates 20% of its sales from direct/online. Based on my experience, if the downside can be estimated for a good retail business that's fallen on hard times, the upside takes care of itself.

Key drivers		***Rationale***
Sales CAGR	2.5%	Comp growth +2% (1.5% traffic, 1% ticket)
Op margin	14.50%	15 yr avg. = 12.9%;VS = 10% BBW = 19%
Discount rate	9.0%	Mid-cap soft-line retailer; Debt = ~7%
Terminal growth rate	2.5%	LT comp growth
Multiple	16.00x	Retail avg. mid-teen; 6-8% normalized earnings yield
Term reinvestment rate	20.0%	Need to reinvest FCF to grow op income

	t	*0.25*	*1*	*2*	*3*	*4*	*5*
(in 000s)	**FY17A**	**FY18e**	**FY19e**	**FY20e**	**FY21e**	**FY22e**	**FY23e**
Net income							
Sales	12,362	12,671	12,988	13,313	13,645	13,986	14,336
EBITDA	2,299	2,133	2,198	2,251	2,316	2,384	2,451
Depr	571	296	315	320	338	356	372
EBIT	1,728	1,837	1,883	1,930	1,979	2,028	2,079
Net Income	983	1,006	1,038	1,071	1,105	1,140	1,175
Balance sheet							
Cash	1,515						
WC (ex-cash & ST debt)	(166)						
Assets	8,149						
Debt	5,794						
Equity	(753)						
Cash flow							
NOPAT	1,406	1,374	1,427	1,468	1,522	1,577	1,631
Capex	(707)	(750)	(750)	(700)	(700)	(700)	(700)
FCFF	699	624	677	768	822	877	931
DFCFF		305	621	646	634	621	605
Discounted interim FCFF	3,433						
Terminal FCFF	13,910						
Total FCFF	17,344						
Debt	4,620						
Equity value	12,724						
Shares	287						
Intrinsic Value (IV)	**$ 44.3**						
Price	$ 35.5						
Price / IV	80.1%						

SALES CAGR

OP MARGIN	**$ 44.33**	0.0%	1.5%	2.5%	3.5%
	11.5%	$ 23.6	$ 27.4	$ 30.1	$ 33.0
	12.5%	$ 27.7	$ 31.9	$ 34.9	$ 37.9
	13.5%	$ 31.9	$ 36.4	$ 39.6	$ 42.9
	14.5%	$ 36.1	$ 40.9	$ 44.3	$ 47.9
	15.5%	$ 40.2	$ 45.4	$ 49.1	$ 52.9
	16.5%	$ 44.4	$ 49.9	$ 53.8	$ 57.9