Ascena Retail Group, Inc. (ASNA)

Stock Pitch Report by Faizan Muhammad

Industry: Retail	**Current Price:** $2.02	**Research Analyst:**
Ticker: ASNA	**Target Price:** $16.70 (+726%)	***Faizan Muhammad***
Recommendation: LONG	**Market Capitalization:** $396m	***faizan.m.dewan@gmail.com***

Company Overview:

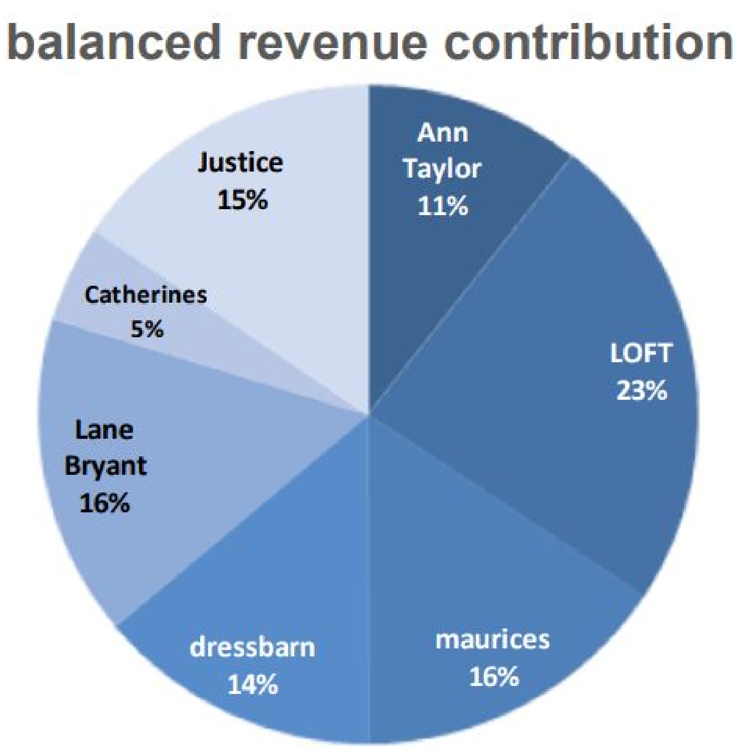
Founded in 1962, Ascena Retail Group is a specialty retail company that owns and operates a whole host of popular retail brands that are focused exclusively on women and girls and are spread across their Premium Fashion, Value Fashion, Plus Fashion and Kids Fashion segments. Ascena has a total of 4,690 stores that are mostly in the U.S.

Ascena's Premium Fashion segment accounts for nearly 34% of all its sales, as of Q2 FY 2018. This segment includes two brands -- Ann Taylor and LOFT. These brands were acquired through the acquisition of Ann Inc. in 2015. Ascena bought Ann Inc. for $2.16bln. Ann Taylor is a popular brand name in the women's clothing space. It includes 322 specialty retail stores and e-commerce operations. Due to a very loyal customer base and recognizable brand name, Ann Taylor enjoys a wide economic moat among peers. LOFT is another well-known name in the female retail space. LOFT includes 678 specialty retail and outlet stores, e-commerce operations and certain licensed franchises in international territories.

The Value Fashion segment contributes to 30% of all sales. It includes the brands Maurices and Dressbarn. Ascena was started with the Dressbarn brand in 1962. Dressbarn includes 779 specialty retail and outlet stores and e-commerce operations, offering moderate to better quality special occasion, career and casual fashion for working women. Dressbarn retail stores are located primarily in convenient strip shopping centers in densely populated markets in the suburban areas.

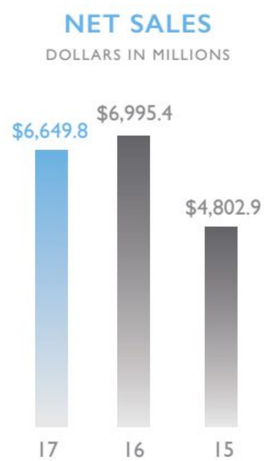
Ascena's Plus fashion segment brings in about 21% of the total top line. Plus fashion brands include Lane Bryant and Catherines. Lane Bryant includes 764 specialty retail stores and outlet stores along with some e-commerce operations. Lane Bryant is a widely recognized brand name in the plus-size fashion, offering a moderate price point to female customers in plus sizes.This is the go-to place for slightly overweight women, and due to the customer loyalty, this brand enjoys wide moats. Catherines includes 359 specialty stores and e-commerce operations, offering a variety of plus sized and extended sized classic apparel and accessories to female customers in the moderate price range.

The Kids Fashion segment is responsible for about 15% of all of Ascena's sales. This segment consists of the Justice brand, which has 900 specialty retail and outlet stores, e-commerce operations and certain licensed franchises in international countries. The Justice brand offers fashionable apparel for girls aged 6 to 12. Justice's retail stores are located in mall locations, strip shopping centers, lifestyle centers, and outlet centers.



Financial overview and Investment thesis:

Even with staggering revenues of $6.6 billion in 2017, Ascena is in a financial pinch, with its stock price down 90% from its 2014 highs of $22/share. The market is valuing the company at $2.02/share today. Jeez! That must've been painful. Let's take a look at the timeline of this adversity.



At $22/share in 2014, Ascena was valued at $4.4 billion, priced for a very rosy future at more than 40 times earnings. This was a crazy valuation for a brick and mortar retail company. Ascena made $4.79 billion in revenue in Fiscal Year 2014, with an EBITDA of $210 million. In Fiscal Year 2015, Ascena disappointed expectations with $4.9 billion of revenue and a loss of $236 million. Due to the headwinds created by e-commerce and a poor brick and mortar retail environment, Ascena had to write down impairments in intangible assets by $306 million, which ultimately showed up in the special charges section on the income statement.

This was a disciplined write-down and shows that the company doesn't value its intangible assets at unfair values like some of the dishonest companies. The stock price closed 2015 at $10/share. In mid-2015, Ascena bought Ann Inc for $2.1 billion. The deal was $1.8 billion cash and $300 million stock.The cash portion of the purchase price was funded with borrowings under a $1.8 billion seven-year, variable-rate term loan.

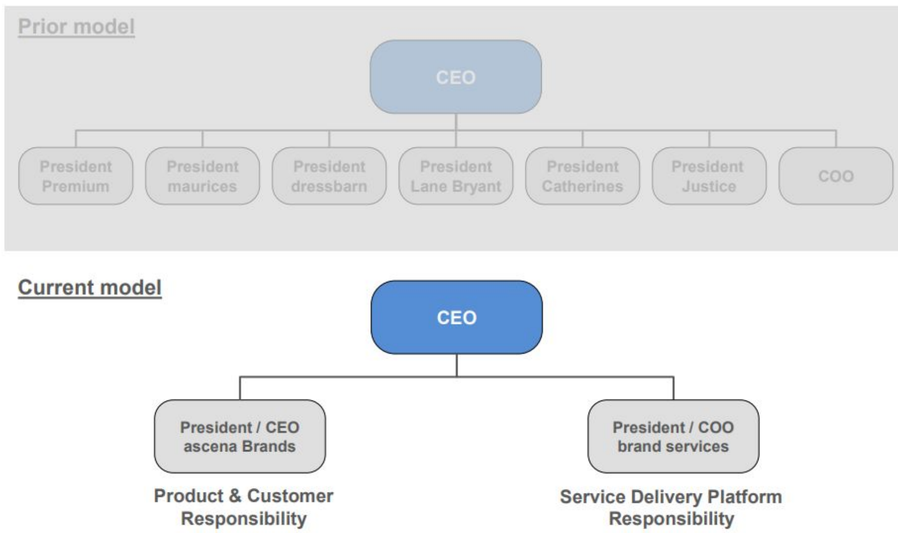
2016 proved to be another volatile year for ASNA, as the results from the acquisition didn't quite please the investors. Although revenues were at $6.9 billion in 2016, net income was negative $11 million. Acquisitions are hard in the retail industry, and operations don't go well in the initial period. ASNA ended 2016 at $6/share.

In 2017, Ascena wrote off a huge impairment of intangible assets. In Q3 2017, special charges were $1.34 billion. Ascena wrote down the value of its intangible assets by a huge amount. Again, this shows great discipline. This drove the share price down to its all-time lows in the $2 region. To understand these write-offs, we need to understand what intangible assets are. They include goodwill, trade name and other things that show the intangible value. They are written off because the company thinks that due to headwinds, the value of our company’s goodwill and trade name should be less than what it is now. This is considered as an expense, and this drove FY 2017 net income to -$1.06 billion. Your average investor will look at this negative number and back off from finding anything else about the company. But this isn’t the actual physical loss of something. It’s just a paper loss. Most of these write-offs were in Ann Inc. Page 73 of Ascena’s 2017 10k shows that Ann Inc. wrote up goodwill and intangible value aggressively before the acquisition process. The seller got the better deal, after writing up goodwill. I believe that most of 2017 write down was to put a fair value on the inflated intangible values at Ann Inc.

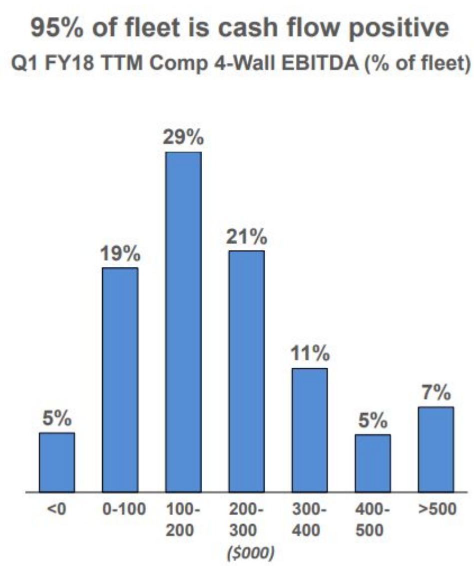
My job as a value investor is to look for value in the most out of favor sectors. One must buy when irrational selling is at peak levels. As Michael Burry says: “Eventually, illiquidity and disgust will pair up in tandem pugilism”. As of today, Ascena Retail is valued at $2.02/share, or $394 million. Yes, a company with $6bln in yearly revenues is valued at this price. This is a company with $100 million in Free Cash Flow. It is the third biggest specialty retail company in the US by revenue, with peers with similar revenues valued at $4bln or more. Ascena holds $413 million in cash and cash equivalents, which shows that this company is being valued less than its cash holdings. Thanks to continued pessimism by investors. It is true that profits are not there.

And the brick and mortar retail business is deteriorating due to the internet. But what really shines in this company is its new operating model that has been implemented in late 2017 as part of the company’s “Change For Growth Plan”. I believe that the new model is going to improve everything from profitability to growth.

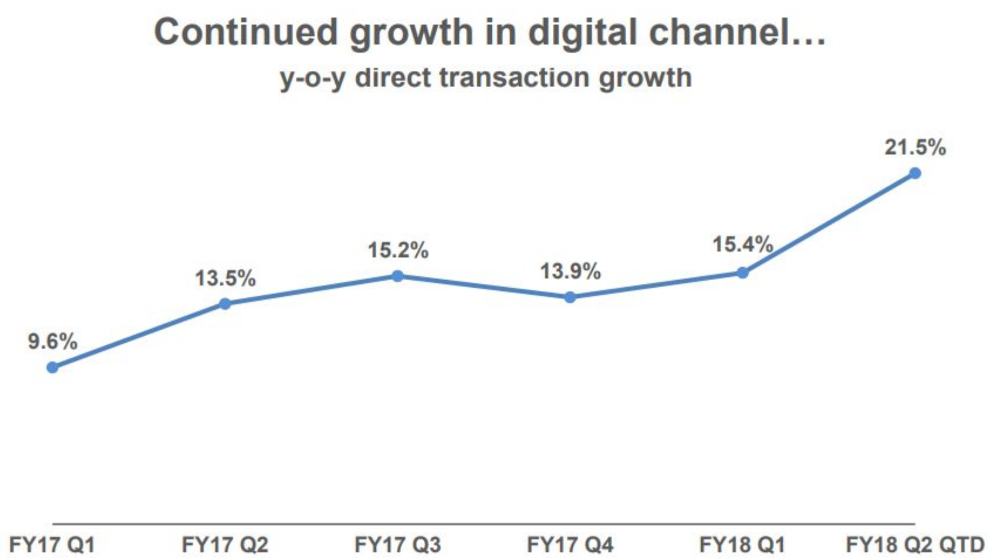
The prior management structure of the company was that there had to be David Jaffe, the CEO and under him, there were presidents for all the brands. Now it's way more efficient and it ensures a centralized control of the brands where all brands are working together.



Another great thing about the company's new plan is that stores that are unprofitable are being closed down. Statistics show that 5% of all the stores have negative cash flow. Ascena has taken its first step by closing more than 100 stores in Q2 2018, which is more than the stores closed in all of 2017. This won't reduce top line. Ascena wants to have an omni-channel where they don't want to have multiple stores in one location. The closed stores' operations will be replaced by the e-commerce arm of Ascena.



This brings me to Ascena's efforts in embracing the internet. Ascena has a website and their e-commerce business has been growing very fast, which shows that they're building a strong presence on the internet too. This also brings me to the CEO, David Jaffe's quote: "Retail is changing and so must we."



Ascena is attacking structural costs and is streamlining efficiencies with a cost synergies program that is expected to lead to a $250 million to $300 million in annual cost savings by 2020. This will be very helpful in earning a profit and delivering shareholder value.

Another reason why I love ASNA is that the bear case on the stock is very poor. A good way to check if your investment thesis is right is to check both sides of the story and determine what the opposing arguments are so that you can check whether your difference of opinion is valid. One of the bear arguments is that the company has lots of debt. I'd argue that Ascena continues to pay its term loan with ease, and the balance sheet is pristine, with Ending Q1 2018 fiscal liquidity of $800 million dollars.

Another bear argument is that one of Ascena's online strategies that include buying merchandise online and picking it from the store will ultimately fail and it will lose most of its customers. This is a very poor argument, as it is obvious that this isn't the only way customers are required to buy online, and it's just an option. Also, this strategy is present in only the Premium brands.

There's another talk among the bears that Ascena is fighting the Internet instead of embracing it, which is completely wrong, given the evidence of heavy CapEx spending on e-commerce and the growth in e-commerce transactions.

Management's interests are perfectly aligned with shareholders, as most of their compensation is based on the long-term success of the company. There are 16 million shares to be issued upon the exercise of outstanding options at an average exercise price of $11, which means that right now, the management's equity compensation is worthless and it's in their interest to turn around the company.

	(a)	(b)	(c)
Plan Category	**Number of Securities to be Issued upon Exercise of Outstanding Options**	**Weighted-Average Exercise Price of Outstanding Options**	**Number of Securities Remaining Available for Future Issuance Under Equity Compensation Plans (Excluding Securities Reflected in Column[a])**
Equity compensation plans approved by security holders	16,413,717	$ 11.42	17,449,970
Equity compensation plans not approved by security holders	—	—	—
Total	16,413,717	$ 11.42	17,449,970

Valuation:

I believe that the new operating plan will help the company reach its former glory and start creating profits. The effects of the new operating model can be seen as guidance for net income for Q3 2018 is positive, showing that profitability is gradually returning back. Based on my estimates, I believe that by 2023, ASNA will reach the profitability level of their peers, which is a net income of around 4.5% of revenue. I also think that the new plan will enable ASNA to compete with internet competitors and estimate a 2% annual increase in top-line revenue:

2023 revenue estimate: $7.2 billion

2023 net income estimate: $327 million

2023 EPS: $1.67/share

I'll use a P/E ratio of 10, which is quite conservative, considering that the average competitor trades at 15x earnings.

Estimated value of ASNA in 2023: $3,270,000,000

2022 Target price ASNA: $16.70/share (**+726%**)

Investment Risks:

1. Downturn in the economy: This can hurt sales badly in the Premium Fashion segment which is one/third of the company's sales.
2. Interest rate risk: The term loan of $1.80 billion (now remaining balance = $1.5bln) is based on a variable interest rate. For every 0.125% of rise in interest rates, the company will have to book $1.2 million of more interest expenses.
3. Acquisition: This is a risk to my investment thesis, and could be a risk to the investment as well. If the stock goes down to $1.50 and someone wants to buy it at a 30% premium at $1.95/share, the investment still goes wrong.

ASNAI is trading for pennies on the dollar.

BUY