

## L Brands, Inc (LB) Memo

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### Company Description

Founded in 1963 and based in Columbus, OH, L Brands, Inc. (LB), is a specialty retailer of women's intimate and other apparel, beauty and personal care products, home fragrance products and accessories. The company sells its merchandise through specialty retail stores in the United States and Canada, which are primarily mall-based, and through its websites, catalogue and other channels. The company was formerly known as Limited Brands, Inc., and changed its name to L Brands in 2013. The company conducts its business primarily through two reportable segments Victoria's Secret and Bath & Body Works. The Victoria's Secret segment sells merchandise under brand names such as Victoria s Secret and PINK. The Bath & Body Works segment sells merchandise under brand names such as Bath & Body Works, C.O. Bigelow, White Barn Candle Company and other brands. The Other segment includes Henri Bendel, featuring accessories and personal care products; Mast Global, an apparel merchandise sourcing and production company; and International retail, franchise, license and wholesale operations, which comprises the company-owned La Senza and Bath & Body Works stores in Canada and Victoria s Secret stores in Canada and the United Kingdom.

### Thesis / Key Points

#### ➤ **Growth potential demonstrated by solid financial data**

L Brands has a higher gross margin of 0.46 which is 0.10 higher than its competitors' margin of 0.36 for both Gap Inc. (GPS) and Hanesbrands Inc. (HBI). Its operating margin of 0.16 is also higher than the margin of 0.13 for GPS and 0.14 for HBI. (Appendix I). The revenues and earnings have been increasing from 2010 to 2014. There is a 24.9% rise in revenues in the four-year period while earnings growth 55.3% over the four years. Revenue is estimated to continue to grow from 10.77B in 2014 to 11.91B in 2016, a 10.6 percent growth. Earnings are estimated to grow from \$3.20 in 2014 to \$4.14 in 2016, a 29.4% rise (Appendix III Exhibit 2).

VS/PINK 's selling square footage grows 4% from 2008 to 2012 while it grows 6% from 2013 to 2014 (Appendix IV Exhibit 1). The accelerating of square footage growth of VS is a key driver of total company growth. Moreover, the comparable store sales are positive for all quarters for division L Brands, VS Stores & VS Beauty, BBW from 2012 to 2014, showing that L Brands is seeing an increase in yearly quarterly sales for these divisions (Appendix IV Exhibit 2). The strong financial data indicates that sales will likely be continuing to grow in the future.

#### ➤ **Great management team with effective and proactive strategies**

##### 1) Revamping and Repositioning Business

The company's management team is proactive in revamping its business by developing new, differentiating product line, improving store experience, localizing assortments and enhancing its direct business. These measures facilitate it to generate incremental sales and increase store transactions through higher conversion rate. Its Body by Victoria bras, New Victoria fragrance, Pink wear everywhere bra and fabulous bra have been well-received. During June 2014, the company focused specifically on incredible bra, which worked well for its sales and in July, the company's "very sexy" collection in lingerie and "back to school" in Pink propelled growth. BBW also constantly adds new fragrances and collections to their core categories, thus contributing to a steady rise of comparable store sales for the brand.

In addition, the company is repositioning its La Senza brand by focusing on the younger generation and providing fashionable assortments at a reasonable price. Moreover, to drive growth, it remains focused on adding the entire PINK and lingerie assortments at its Victoria s Secret stores and seeks to expand in the adjacent categories.

The company's travel retail concept also appears to be a long term revenue diver. These are small Victoria s Secret stores (of about 1,000 square foot) operating under a wholesale model, and primarily located in heavy foot fall areas, like airports and tourist destinations. These stores provide significant growth opportunity and are an innovative way to promote and market the brand.

##### 2) Marketing strategy to create brand recognition and consumer loyalty

For apparel and fashion industry that sells image and lifestyle, marketing is highly important. L Brands' strong customer base is in part achieved through its marketing and advertising strategies. The annual Victoria's Secret fashion model show helps showcase items and generate large revenue. According to Nielsen, their 2013 fashion show drew 9.71 million viewers and was the number one show among young adults. Victoria's Secret's supermodels as angels are also one main marketing strategy of VS as they associate the image of VS to beauty and sexy, thus attracting consumers. Pink has a college line that uses promotions such as college tours, tie-ins with music channel MTV and social media like Facebook and MySpace. It announced a partnership with NFL teams in 2011 and began selling apparel containing NFL team logos and names, thus attracting female college and sports fans. The college-oriented line now becomes one of the drivers behind VS's comparable sales growth, especially during back-to-school and holiday periods. These effective marketing strategies ensure that VS continues to be a leader in the women's intimate apparel and lingerie sector.

##### 3) Inventory management and cost containment strategy

VS grows inventory slower than sales. Sales increase 37% from 2009 to 2013, but inventory only increases 12%. As a result, the company is able to increase its operating income from 811M in 2009 to 1743M in 2013. Operating income rises 115% over the four years though sales only rises 37% because VS is able to lower its cost by increasing inventory turnover (Appendix IV Exhibit

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3). Stores do not store the full assortment, but only right size products. Currently more than 725 stores do not carry the full PINK assortment and more than 875 stores do not carry the full Lingerie assortment, thus preventing inventories from accumulation. Moreover, VS prevents having excess inventory on the account by offering compelling discounts as it plans to enter the next quarter with optimum inventory levels.

### ➤ **International expansion fuels future growth momentum**

L Brands' Victoria's Secret and BBW has strong performance in its domestic market, hence encouraging L Brands to invest further overseas. Currently L Brands has 17 Victoria's Secret/PINK, 230 Victoria's Secret Beauty & Accessories, 66 BBW and 460 La Senza (153 Canada, 307 Rest of World) overseas. In 2013, the company opened 160 international stores, bringing its total to 863 stores outside the U.S and L Brands plan to add 140 more this year.

L Brands sets a clear goal of its following steps in international expansion. Its current priority is growing business in North America. Currently L Brands opened 34 Victoria's Secret stores and 79 BBW stores in Canada and it planned to open 7 more Victoria's Secret and 10 more BBW stores. L Brands also plans to master the UK for Victoria's Secret. The four stores that L Brands opened in 2013 in U.K. performed well and L Brands plans to open six more stores. Besides, L Brands plans to master the Middle East for Victoria's Secret, BBW and La Senza and test in China for Victoria's Secret Beauty & Accessories and Victoria's Secret's Full Assortment Stores. Appendix IV Exhibit 4 shows the forecasted international store count in 2014.

L Brands adopts a partnership-based (franchise) business model by working with a small number of world-class partners. As its partners make capital investments, have real estate skills and build retail selling organizations, L Brands owns assortment, pricing, promotions, store design and real estate approval. This international business model will ensure the high efficiency of business and high quality of products. The substantial opportunity for international growth is accretive to the total company operating margin and will contribute to the company's long-term organic growth.

## **Misperception**

### ➤ **Significant long term debt**

There is one major concern that L Brands is currently carrying too much debt, since the total debt (5.00B)(Appendix II) is almost five times the total cash (1.15B). The already-elevated \$2.5 billion that LB had in 2010 has nearly been doubled as of earlier this year. LB's \$4.7 billion in long-term debt is very high for a company that earns less than one billion dollars per year and has FCF that is significantly lower than that. In fact, L Brands has been able to maintain a consistent leverage from 2005 to present as shown by the consistent Adjusted Debt/EBITDA ratio (Appendix IV Exhibit 5), showing that the company is managing its debt well. Also on the plus side, LB only has \$213 million in principal payments due in 2014 and \$700 million in 2017; the balance is due in 2019 and beyond. This means that, while the debt is expensive to service, it isn't going to cause a liquidity crisis any time soon for LB. I do wish, however, that the company would refinance some of this debt in the rock bottom interest rate environment we find ourselves in. Shaving even half a percent from the weighted average debt cost could save up to \$25 million annually. In addition, the company does employ some interest rate swaps as hedges against interest rate movements. The interest rate swap arrangements effectively convert the fixed interest rate on the related debt to a variable interest rate based on LIBOR plus a fixed percentage for \$400 million of the shortest duration debt the company has outstanding. This is a decent start and is lowering the cost of this \$400 million in debt.

### ➤ **Victoria Secret Direct Sales performance**

VS Direct Sales fell in 2013 due to lower apparel sales and absence of shipping and handling revenues as free shipping was introduced at the start of the year. Also, VS just announced that it would stop producing non-core apparels and focus on more profitable core businesses. This might improve future performance of VS Direct Sales. Besides, regarding one of its side brands LA Senza, LB has already written down the value of La Senza twice in just the past three years, including goodwill and intangible asset impairments totaling \$325 million since its' really small and produces flat to negative comparable same-store sales on a regular basis.

## **VAR**

### ➤ **Sample customer product review**

"I spend entirely too much money here, but I just can't help myself. There's always coupons, specials, and free gifts... how can one resist!?"

"I love everything on VS, they are dedicate and beautiful"

" Victoria's Secret is the one place I can always bras that are cute, functional. and sized properly for my body."

" I LOVE SHOPPING HERE BECAUSE THEY HAVE THE BEST FRAGRANCE OILS AND SPRAYS AT GOOD PRICES."

" Entering to any BBW store is a pleasure. The fragrances and so many choices keep me returning and I don't know anyone who complains of getting a gift or card."

### ➤ **Store managers' operating strategies**

".....balancing obviously being in stock with making sure our assortments are fresh and we have good ability to read, react and chase."

".....read the business day by day to determine when and how much to resort to promotional pricing. Some things we may not have to, some things we may - we need to drive more traffic. And most of these have been margin engineered. So if you are going to

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take it one day at a time, we have a lot of contingency in place, and we are going to take full advantage of maximizing this holiday season as best that we can."

### How It Plays Out

- Commanding a market leading position in the lingerie, personal care, and beauty segments, LB continues to grow into the future with operational efficiencies, new collections and diversified marketing strategies.
- Profits and revenues in the UK, Middle East and China start to become one of LB's reliable revenue segment.
- Gradual and moderate decrease of outstanding long term debt.
- A potential sale/closure/spin-off of LB's two noncore brands.

### Risks / What Signs Would Indicate We Are Wrong?

#### ➤ Increases in commodity prices might raise costs

Cotton prices increases by 80.5% from last year as cotton consumption continued to exceed cotton production for the fifth year in the row. As cotton prices increase, L Brands has to restructure production and absorb these higher material costs or pass higher costs to its consumers. Higher prices or lower quality could discourage consumer spending, resulting in a decrease in L Brands' net sales.

#### ➤ High competition in the industry

Hanesbrands, one of L Brands' major competitors is making aggressive moves to grow by making continuous acquisitions such as acquiring Maidenform. Hanesbrands adopts acquisition as the company's future primary growth strategy and it could take market share away from L Brands.

#### ➤ Turmoil in the credit market

The global credit markets have recently undergone significant disruption, and this may create difficulties for companies to obtain financing on reasonable terms. This may also considerably increase cost of borrowings, diminish the ability to obtain additional financing or refinance existing long-term obligations, and may deter L Brands expansion plans.

#### ➤ Prodigious spending on cash dividends

As demonstrated by Appendix V, LB has paid out prodigious dividends since 2009, aggregating to over \$15 per share in that time period. It is generally a good decision for companies to return extra cash to shareholders. However, LB has perhaps gone a bit overboard in borrowing money to finance dividends. Including all special and regular dividends, LB has returned \$3 billion to shareholders in cash over the past three years. That is an enormous feat for a company with a market cap of \$17 billion. Now shareholders are now paying \$300 million per year in interest to finance those dividends.

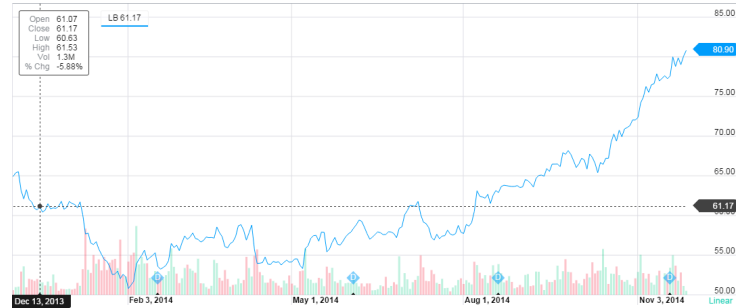
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### Signposts / Follow-Up

- Keep track of operating margin, inventory turnover, long term outstanding debt and cash flow statement
- Look at segmented geographic revenues and net profits, especially UK, Middle East and China

### Important Company Financial Data

52 week Range: **50.78 - 81.81**      Total Debt: 5.00B  
Market Cap: 23.65B      Total Cash: 1.15B  
Profit Margin: 8.63%      P/E: 24.93  
Current Ratio: N/A      Beta: 1.32



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### Appendix I: Comparable Analysis

#### Exhibit 1: Competitors

Company	Last Sale	Gross Margin	Operating Margin	52 Weeks High/Low	P/E Ratio	Market Cap
<b>LB</b>	\$66.61	0.46	0.16	\$50.78 - \$68.61	21.59	\$19.68B
<b>GPS</b>	\$42.00	0.46	0.13	\$36.13 - \$46.85	15.20	\$18.26B
<b>HBI</b>	\$111.16	0.36	0.14	\$58.13 - \$111.83	32.03	\$11.07B

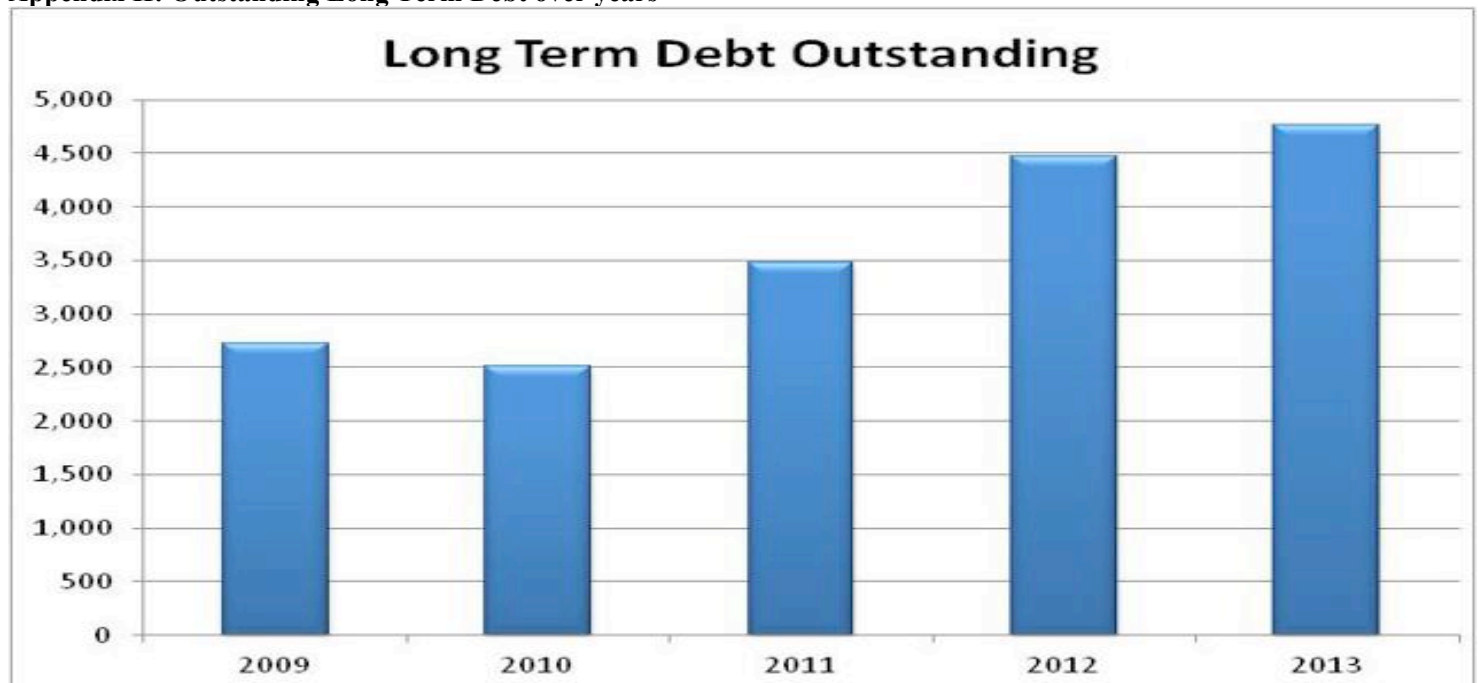
#### The Gap, Inc. (GPS)

- Gap Inc is a global specialty retailer offering clothing, accessories and personal care products for men, women, children and babies. Its brands include Gap, Banana Republic, Old Navy, Piperlime, Athleta and INTERMIX. Gap Inc was founded in 1969 in San Francisco, California.

#### Hanesbrands Inc. (GBI)

- HanesBrands is a manufacturer and marketer of everyday basic apparel. Its innerwear and activewear apparel brands include anes, Champion, Playtex, Bali, Maidenform, Flexees, JMS/Just My Size, barely there, Wonderbra and Gear for Sports. Its international brands include Zorba, Sol y Oro, Rinbros, Track N Field and Ritmo. Hanesbrands Inc. was founded in 2005 and is headquartered in Winston-Salem, North Carolina.

### Appendix II: Outstanding Long Term Debt over years



### Appendix III:

#### Exhibit 1: Segment operating income and operating income rates for 2013 in comparison to 2012

Source: 10-K report 2013

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			Operating Income Rate	
			2013	2012
	2013	2012	2013	2012
	(in millions)			
Victoria's Secret	\$ 1,132	\$ 1,188	16.9%	18.1%
Bath & Body Works	618	604	21.1%	20.8%
Other (a) (b) (c) (d)	(7)	(219)	(0.6)%	(22.3)%
<b>Total</b>	<b>\$ 1,743</b>	<b>\$ 1,573</b>	<b>16.2%</b>	<b>15.0%</b>

Both Victoria's Secret and Bath & Body Works are doing really well. The Others 2012 includes \$93 million impairments of goodwill, trade name and other intangible assets at La Senza, a \$27 million impairment of long-lived store assets at Henri Bendel and a \$14 million of expense associated with restructuring activities at La Senza.

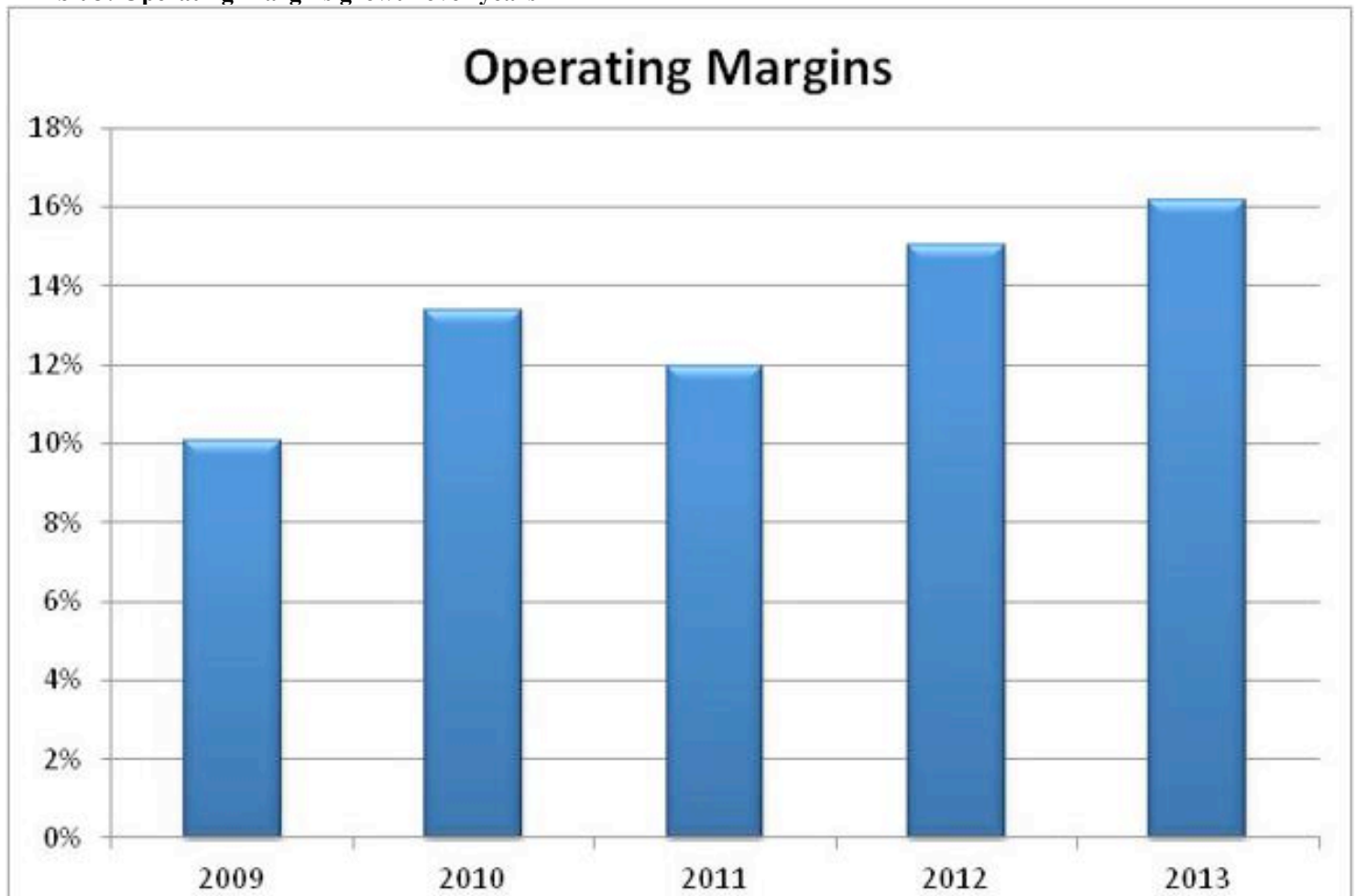
### Exhibit 2: Revenue and Earnings growth over years

Source: IR Presentation and The Wall Street Journals

Year	2010	2011	2012	2013	2014	2015 (Est)	2016 (Est)
<b>Revenues (\$ in Billions)</b>	8.62	9.61	10.36	10.45	10.77	11.28	11.91
<b>Earnings (\$)</b>	2.06	2.60	2.92	3.05	3.20	3.62	4.14

The revenues and earnings have been increasing from 2010 to 2014.

### Exhibit 3: Operating Margins growth over years



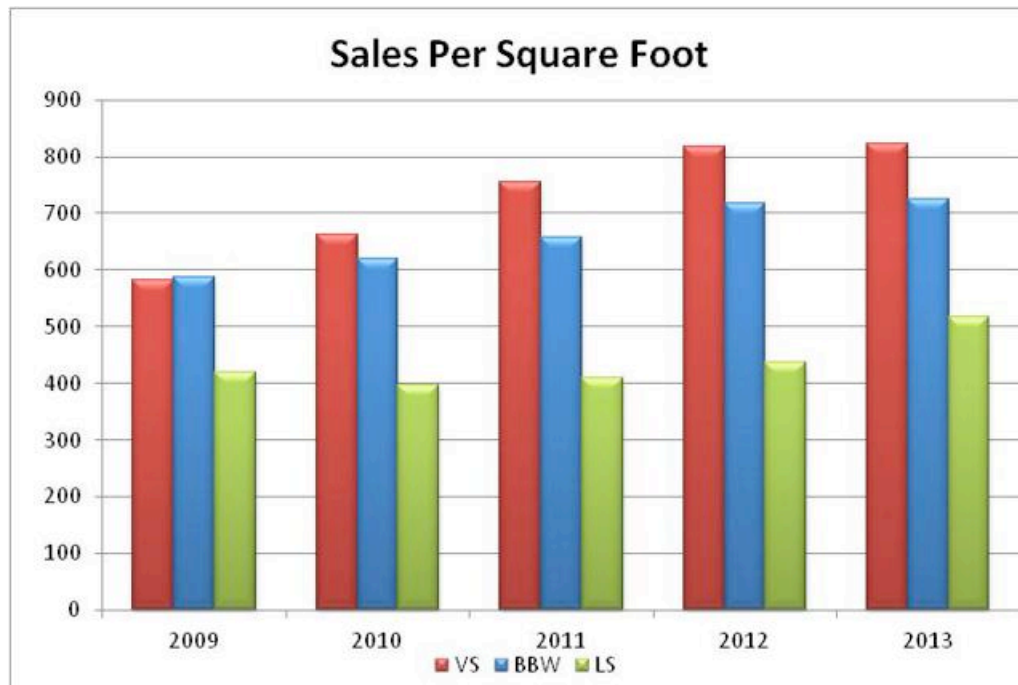
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### Appendix IV:

#### Exhibit 1: Square Footage Growth of L Brands comparison between period 2008-2012 and period 2013-2014

Source: IR Presentation

SSF Growth (CAGR)		
	<u>2008 - 2012</u>	<u>2013 - 2014</u>
Victoria's Secret / PINK		
Gross	4%	6%
Net of closures	3%	5%
L Brands		
Gross	3%	4%
Net of closures	1%	3%



As seen from the exhibit, Victoria's Secret / PINK square footage growth in North America is accelerating, driving total company growth.

#### Exhibit 2: Comparable Store Sales for different divisions from 2012 to 2014

Source: L Brands official website – Financial Information

Divisions	Year	Spring season		Fall season		Full Year
		Q1 (Feb - Apr)	Q2 (May - Jul)	Q3 (Aug - Oct)	Q4 (Nov - Jan)	
L Brands	2014	2%	3%	-	-	-
	2013	3%	2%	3%	1%	2%
	2012	7%	8%	5%	5%	6%

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Victoria's Secret Stores & Victoria's Secret Beauty	2014	2%	3%	-	-	-
	2013	3%	1%	4%	3%	3%
	2012	9%	10%	6%	3%	7%
Victoria's Secret (direct sales)	2014	0%	0%	-	-	-
	2013	6%	(6%)	(1%)	(1%)	(3%)
	2012	4%	3%	(2%)	(1%)	1%
Bath & Body Works	2014	2%	4%	-	-	-
	2013	3%	3%	3%	(1%)	2%
	2012	6%	7%	5%	7%	7%

The comparable store sales are positive for most quarters for each division, showing that L Brands is seeing an increase in sales for most quarters and years. It is likely that sales will continue to grow in the future.

### Exhibit 3: Comparison of inventory and sales growth from 2009 to 2013

Source: IR presentation

(in millions)	<u>2009</u>	<u>2013</u>	<u>\$ CHANGE</u>	<u>% CHANGE</u>
Sales	\$7,848	\$10,773	\$2,925	37%
Operating Income	\$811	\$1,743	\$932	115%
Inventory	\$1,037	\$1,165	\$128	12%

VS grows inventory slower than its sales, thus bringing huge operating income.

### Exhibit 4: International Store Count growth (2014 forecast)

Source: LB Financial Data

#### L BRANDS, INC. INTERNATIONAL STORE COUNT 2014 FORECAST

	<u>Year End 2013</u>	<u>2014 New Stores</u>	<u>2014 Closures</u>	<u>Year End 2014 Forecast</u>
Victoria's Secret Beauty & Accessories (VSBA)	198	95-105	(6)	287-297
Victoria's Secret UK	5	5	-	10
Victoria's Secret International	4	9-11	-	13-15
BBW International	55	20-30	(1)	74-84
<b>Total VS &amp; BBW International</b>	<u>262</u>	<u>129-151</u>	<u>(7)</u>	<u>384-406</u>
La Senza Canada	157	-	(13)	144
La Senza International	331	6-8	(75)-(80)	257-264
<b>Total Other</b>	<u>488</u>	<u>6-8</u>	<u>(88)-(93)</u>	<u>401-408</u>
<b>Total International</b>	<u>750</u>	<u>135-159</u>	<u>(95)-(100)</u>	<u>785-814</u>

The total number of international stores will grow in 2014.

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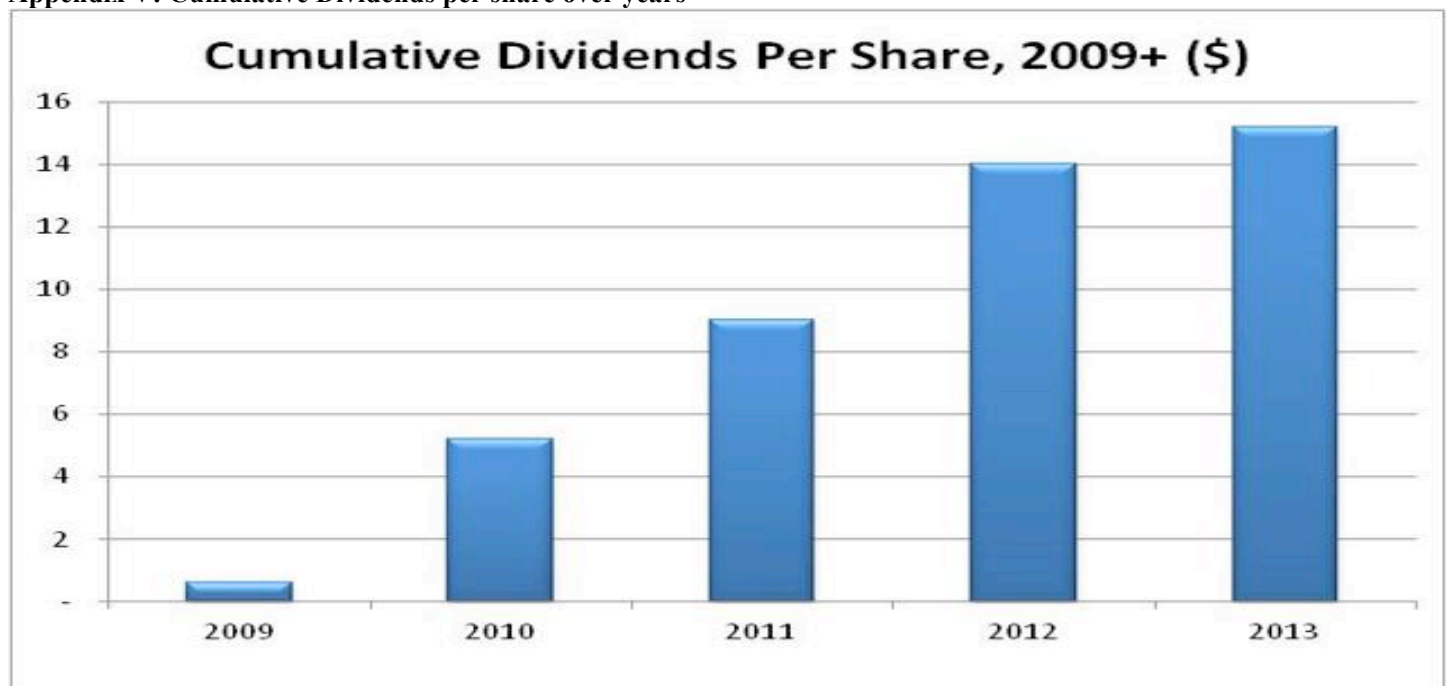
### Exhibit 5: Adjusted Debt/EBITDAR ratio over years

Source: IR Presentation

in billions	2005	2010	2011	Pro forma 2011 <sup>(1)</sup>	2012	2013	2014F
<b>Balance Sheet Debt</b>	\$1.7	\$2.5	\$3.5	\$4.5	\$4.5	\$5.0	\$4.8
<b>Capitalized Lease Obligations<sup>(2)</sup></b>	\$4.6	\$4.1	\$4.4	\$4.4	\$4.6	\$4.9	\$5.3
<b>Total Adjusted Debt</b>	\$6.3	\$6.7	\$7.9	\$8.9	\$9.1	\$9.9	\$10.0
<b>EBITDAR<sup>(3)</sup></b>	\$1.9	\$2.2	\$2.5	\$2.5	\$2.6	\$2.7	\$2.9
<b>Adjusted Debt / EBITDAR</b>	3.3x	3.0x	3.2x	3.6x	3.4x	3.6x	3.5x
<b>End of Year Cash</b>	\$1.2	\$1.1	\$0.9	\$0.9	\$0.8	\$1.5	\$1.3
<b>Debt Rating at End of Year</b> (S&P/Moody's/Fitch)	BBB/ Baa2/NR	BB+/ Ba2/BB+	BB+/ Ba1/BB+	BB+/ Ba1/BB+	BB+/ Ba1/BB+	BB+/ Ba1/BB+	BB+/ Ba1/BB+

There is no great change for the Adjusted Debt/EBITDAR ratio from 2005 to 2014, showing that L Brands has consistent leverage and is able to manage its debt level well.

### Appendix V: Cumulative Dividends per share over years





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### **Ideas for the Club**

After trying out the newly reformed associate coverage team program, I think there are a few major problems. First of all, the incentives for analysts to treat their weekly assignments seriously are not strong enough. Since I am the only associate on my team, I constantly get not enough research help from the analysts on the team. And some analysts just never replied to emails. They had time to spend on their own pitch in front of the whole club, but not a single minute for the team's weekly update memo. Secondly, the interaction between associates analysts is not strong enough. My analysts never came to me to discuss about their pitches or simply to have a conversation.

Then, regarding the application process, it is a great idea for different managers to have their own styles of conducting interviews. Being an associate now, I feel obligated to be concerned about everything about MII, so I would naturally reach out to applicants at the beginning of each semester. However, a few applicants complained that some managers have significantly higher admitting standards than others, thus making the whole application process a game of luck, in other words, a lenient manager is more important than other things.

Nevertheless, there are also some highlights within this semester. The internship and interview workshop has been fantastic. I think that people want to join MII to not only learn about investing, but also consult the best of their peers about careers. And the workshop indeed provided a lot of insights. Similar workshops should continue on a regular basis. Also, I think MII could further enhance the learning experience for members. For example, manager Kevin took the initiative to lead members to walk through every step of building financial models. In the future, maybe MII should hold more education sessions to fulfill the same purpose.