
MCINTIRE INVESTMENT INSTITUTE MEMORANDUM

TO: MII MANAGERS
FROM: RYAN PLOGGER, CONGLOMERATES SECTOR HEAD
SUBJECT: POTENTIAL SHORT POSITION
DATE: 4/21/2009

DILLARD'S INC. (NYSE: DDS) AS A POTENTIAL SHORT POSITION

I am presenting Dillard's Inc. as a potential short position for MII to add to its portfolio.

A. Introduction

Dillard's Inc. is a 55 year old company which operates 315 retail department stores located primarily in the Southeast, Southwest, and Midwest. The company sells men's, women's, and children's apparel, cosmetics, accessories, and home furnishings and decorations. It operates its own clothing line and has recently purchased a small construction firm. Throughout the rest of this memo the construction firm will be neglected, as it does not significantly impact the company's profits nor is it relevant to the overall valuation of the stock.

Before I evaluate this company, I want to make sure that the assumptions I used while considering the company are well understood. These assumptions may be addressed later in the memo, but some are merely educated guesses as guided by historical perspective and stock fundamentals. They can affect stock price without the company's influence. My assumptions are as follows:

- i. The current market climate is a Bear Market Rally.
- ii. The commercial real estate market is still in a deteriorating state.

These assumptions are necessary for a timely discussion and valuation of this security. Should one of these assumptions be violated, the validity of the arguments put forth in this memo may be impaired or compromised in the sense that the stock price may not accurately reflect the company's market position. Although DDS is susceptible to market forces beyond management control (or our predictions), this memo is not written as a recession play. This means that, while DDS stock price is likely to participate in any large scale rally or pullback in the market, many of the thesis points and arguments in this memo are not dependent on market condition.

In this memo we will compare Dillard's against one of more of its peers. This peer group will include Macy's (NYSE: M), Nordstrom (NYSE: JWN), J.C. Penny's (NYSE: JCP), and Saks Incorporated (NYSE: SKS). Of this peer group, Nordstrom is the most comparable retailer to Dillard's. Both companies specialize as luxury retailers and do not benefit from a discounter status nor do they target specifically only upper class clientele.

B. Thesis points

There is no doubt that the retail industry has taken its lumps these past two years. From 2007 to the beginning of 2009 the Retail (Department and Discount) industry is down over 30% while department stores like Macy's and J.C. Penny have tumbled more than 60%¹. Many companies haven't seen stock prices this low since 2000. Jobless claims, helpful indicator of economic strength is still above 650 thousand in the week ending April 4th.² Dillard's and other department stores do not enjoy the recession proof environment that pure discounters like Wal-Mart do. In fact, Wal-Mart has seen a 10% increase in stock price since the beginning of 2007.

While it is apparent that the department store industry has been heavily hit by the recession, this bear market rally seems to have lured investors into an overly optimistic view of economic recovery. This situation could provide MII with some great shorts; many companies who are not financially stable are trading at unsustainable levels. While this rally does benefit MII's current opportunity with Dillard's, the rally is not necessary for this short position to be profitable. I will focus on three thesis points for my argument:

- I. Dillard's has a weak and outdated management team and business model, which is slow to respond to economic stimuli.
- II. The company's stores are located in deteriorating market places and areas, most notably suburban malls.
- III. Department stores are seeing decreased margins, a decreasing customer base, and less customer loyalty.

Besides these three points, I will later discuss some short term conditions which will prove to be catalysts for Dillard's demise, but for now let us concentrate on the company's shortcomings.

- I. Dillard's has been managed by the Dillard family since its founding some 70 years ago³. William Dillard is succeeded by his son William Dillard II as the CEO of the company. Since W. Dillard II was appointed CEO the company's value has decreased from \$4.36 billion to less than \$246 million⁴. The family's control of the company has been sorely contested over the past couple years. Both William Dillard's the father and William Dillard's the son notoriously held on to seasonal inventories too long before marking them down. The company has seen decreases in its gross margin from this practice and from maintaining a huge inventory. During the 2001/2002 recession William allowed the company to experience 5 straight quarters of negative earnings before taking adequate cost cutting measures and inventory reductions to keep the company profitable. The company was again slow to respond to the economic slowdown leading up to the current recession. DDS didn't begin aggressive store closings and cost restructuring until halfway through 2007. The CEO's business sense has long been questioned by investors and there have been several attempts to decrease the family's power in the company. The family controls 99% of the company's voting stock (Class B) and thus is allowed to elect 8 of 12 of the members of the board. The family has indicated no desire to divest its Class B shares in the near future.

¹ www.google.com/finance

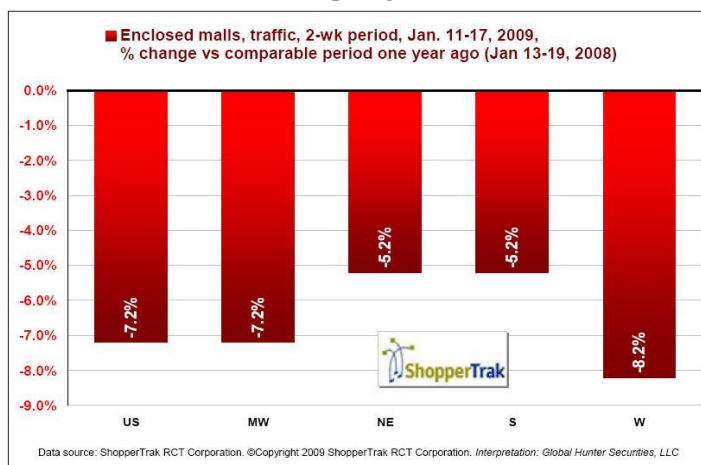
² US Department of Labor

³ www.Dillard's.com

⁴ www.bloomberg.com

The average age of the company's officers and directors is nearly 60 years old. Over the years DDS has been through numerous recessions and, as is obvious by their existence, they have weathered the storms; however, the management has often relied upon its loyal customer base to make it through difficult economic times. Dillard's seems to have split its clientele. They would like to be considered an upscale department store, but they have been forced to reduce prices drastically to attract customers. Thus they are torn between high end customers who are interested in the brand recognition and expensive merchandise and middle income customers who are looking for high quality for reasonable prices. I believe they have failed to capture either market share. From 2002 to 2006 Dillard's saw a decline in sales from \$8.15 billion to \$7.56 while Nordstrom experienced an increase from \$5.6 billion to \$7.7 billion⁵.

II. It is no new news that enclosed malls have been losing favor with the American consumer over the past couple years. In particular 2008 was a very difficult year for retailers in enclosed and outdoor malls. As consumers decrease their discretionary spending during this economic recession mall traffic has plunged.



Many stores compare these numbers to their sales in order to judge their performance. We can see that the US mall traffic was down 7.2%, but we also see that Dillard's same store sales were down over 12% during January⁶. Many department stores have been forced to close locations which were underperforming. Retail vacancy is up to a reported 7.1% at year end 2008 as compared to 5.2% at the end of the year 2007⁷. More than 400 of the country's 2000 largest malls have closed in the past 2 years⁸. Department stores, which are considered "anchor stores" for malls, are less sought after now and many department stores are hesitant to commit to malls at all. Retailers have been moving towards opening off-mall stores which are located near the mall but not in the physical building. Trends are also pointing to a growth of "lifestyle centers" which are affluent suburban boutique style malls. These centers do not lend themselves well to "big box" retailers such as Dillard's.

Last year Dillard's experienced \$197 million dollar pre-tax charge related to asset impairment and store closings of 32 locations. When Dillard's decides to close a leased store, they are obligated to fulfill lease obligations to the lessor. In addition, since Dillard's owns

⁵ <http://www.plunkettresearchonline.com/ResearchCenter/Trends/display.aspx?Industry=4&index=2>

⁶ www.marketwatch.com

⁷ <http://www.nytimes.com/2009/04/05/business/05mall.html>

⁸ http://www.theweek.com/article/index/94691/The_vanishing_shopping_mall

many of their store locations, they may be forced to exit ownership under less than satisfactory conditions. With the commercial property market in such a deteriorated condition, disposal of unprofitable stores is often delayed or made more difficult.

- III. Profit margins are an indicator as to the health of a company and its overall profitability. Dillard's Gross profit as a percentage of sales has decreased over the past 2 years. The margin was 34.1%, 33.6%, and 29.6% for 2006, 2007, and 2008 respectively. While other retailers have experienced the margin squeeze from markdowns, they haven't been as great. Nordstrom's margins decreased by only 2% and Macy's decreased by less than 1% over the same time period. Dillard's margins have been far reduced due to markdowns in order to move inventory; however, market trends suggest that the American shopper has been taught to wait for markdowns. This means that even given a return to economic health, many consumers will wait for mark downs to occur before purchasing an item. Thus margins will likely never return to their highest levels. This deterioration in margins will likely continue or increase in fiscal 2009 unless a drastic turn around in consumer spending occurs.

Department stores are seeing a decrease in their customer base and customer loyalty. During this recession department stores that cater to middle-income families have been hit hard and as jobless numbers continue to increase this trend looks likely to continue. As is confirmed by my VAR, many customers are shopping at Dillard's only for specific items and even then only on an irregular basis. In addition, many boutique style stores such as American Eagle and Aeropostle are forecast to experience significant growth in the next 5 years. This translates to direct competition with Dillard's for young buyers. Also, many discounters have improved their positions during this economic downturn. While normally Dillard's would not directly compete with discounters like Kohls and Target, many of Dillard's middle income customers are likely to trade down to these discounters during the recession. By 2008 department store visits were down 6%⁹. In the future department stores will continue to see extremely tough competition as more specific apparel retailers enter the market and discounters attract more bargain minded customers. The apparel retail industry sees particularly low barriers to entry and thus is exposed to a considerable amount of risk from new competition.

C. Catalysts

Debt and contractual obligations due within the next year total over \$410 million¹⁰. This number exceeds Dillard's operating cash flow of \$350 million by over \$60 million dollars¹¹. In the current credit market, Dillard's will have a difficult time refinancing this debt and could face increased interest expenses due to poor credit conditions. In their most recent 10-k report the company outlined its expectation to finance its working capital expenditures and debt repayments through cash on hand, cash flows from operations, *and* utilization of its credit facility. This is in stark contrast to previous reports where financing has been purely from operating cash flows. Dillard's credit rating was also recently reduced by S&P to B- status. This is seven steps below investment grade. This cut came along with cuts to 5 major department stores as S&P feared a slowdown in department sales¹². Jobless rates will also continue to hinder retail

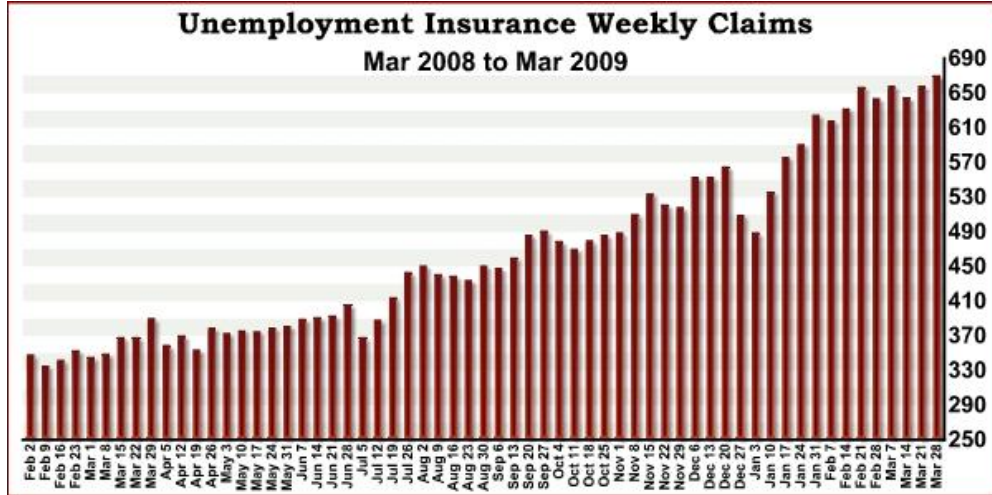
⁹ Nielson North America

¹⁰ This is the company's contractual obligations less inventory purchase orders. The purchase orders are removed from the obligations total because the net cash flow from operating activities takes inventory purchases into account.

¹¹ 10-k Report, pg. F-9

¹² www.google.com/finance

recovery. The jobless claim rate is important to observe because this number chews into household income and thus decreases disposable cash that can go towards retail purchases. If



unemployment continues to increase or even flattens off, the retail industry will likely continue to see decreased sales numbers. This is especially prudent for companies that target middle income families. The catalysts listed above will contribute to stock price depression in the coming months unless contrary news is reported.

D. VAR

Customer Pole

1. When you go to Dillard's are you more likely to purchase a specific item or to shop for your wardrobe in general?

"Both, sometimes specific, sometimes general. More often, specific." – Female Early 50's from Virginia

"Specific item" – Female, 18 years old from Virginia

"I usually shop for shoes or makeup." – Female, early 60's from Florida

"I am usually looking for something specific." – Female, 20 from Georgia

2. Would you rather shop at Dillards or one of their competitors (Nordstrom, Macy's, or Bloomingdales) and which one?

"It depends what I am looking for. Nordstrom is too high end. I prefer the other three. If I HAD to pick, I would pick Macys or Dillard's." – Female Early 50's from Virginia

"Nordstrom or Bloomingdales. Macy's is [unpleasant]." – Female, 18 from Virginia

"I would rather shop at Dillards but occasionally shop at Macy's and Nordstroms." – Female Early 60's

"I would probably rather shop at Nordstroms, but feel that Dilliards is cheaper, but still high quality." – Female late 40's

3. In your opinion does Dillards carry fashionable clothing?

Yes - Consensus opinion

4. Have you ever or would you ever buy housewares from Dillards? Do you think their products and prices compete effectively with stores such as Crate&Barrel, Bed Bath & Beyond, or Pottery Barn?

"No and yes but not as great of choices of products as those stores mentioned." – Female Early 50's from Virginia

"No. Department stores charge too much." – Female early 50's from Florida

5. Do you consider Dillards to be overpriced, underpriced, or adequately priced?

Adequate to overpriced – Consensus opinion

6. Does Dillards possess any competitive advantage that other department stores do not?

No – Consensus opinion

7. How regularly do you shop at Dillards?

"Whenever at Short Pump, maybe 4 times a year." – Female Early 50's from Virginia

"A few times a year maybe? If I need shoes for prom or something I'll usually look at Dillards. They have reasonably priced shoes." Female, 18 from Virginia

"About once a month" Female early 60's from Florida

"Monthly" Female late 40's from Florida

"Not regularly" Female early 50's from Florida

"5 or 6 times a year" Female 20, from Georgia

8. Do you think that Dillards competes effectively (in terms of fashionable clothing and pricing) with boutique type stores like Ann Taylor, Abercrombie & Fitch, or J. Crew or discount stores such as Target, Wal-Mart, or Kohls?

"No and No" – Female Early 50's from Virginia

"no, I do not. I'm just not a big department store person unless I need something specific" – Female, 18 from Virginia

"Yes." – Female early 60's from Florida

"Depends on the location of the store(geographically), and the buyer for that store. College towns and bigger cities have better selection than small town Ocala. We cater to the elderly, not quite so fashionable for the younger crowd." – Female late 40's from Florida

9. During this economic recession is Dillards somewhere you would consider shopping?

"Yes" – Female Early 50's

"Just for something specific" – Female early 60's from Florida

"Yes, but only for the special items now, not everyday wear." – Female late 40's from Florida

10. Do you ever shop online at websites such as Overstock.com or other online retailers which are not affiliated with a major department store? If yes, is it ever for the same type of products which you might find at a Dillards Store(Dresses, suits, purses, etc.)? Do you ever use dillards.com?

"No and yes" – Female Early 50's

"Yes, for different products such as hunting clothing, this year winter clothing such as ski jackets, etc. I never have used dillards.com." Female early 60's from Florida

"I prefer shopping online. I have never been to dillards.com. I check ebay first and foremost and then the thrift stores." Female early 50's from Florida

Notes:

I am still waiting to hear back from several of the men that I emailed. I've also contacted several store managers and spoken with their secretaries as to the best time to get in touch with them. I expect to gather a bit more VAR in the next couple of days and will hopefully have a follow up report with more information for the managers within the week.

APPENDIX

Stock Data:

Last Trade Price	7.26
Average Volume	715,000
Market Cap	558 M
P/E	(negative earnings)
F P/E	16.64
Beta	2.42
Dividend	0.04
Shares Outstanding	73.45 M
Short Interest as Percentage of float	8.5%

The company's 10-k report can be found at the following link:

<http://www.sec.gov/Archives/edgar/data/28917/000119312509070701/d10k.htm>



DDS (Dillards Inc) NYSE © StockCharts.com
 17-Apr-2009 **O** 6.85 **H** 7.77 **L** 6.37 **C** 7.60 **V** 3.5M **Chg** +0.67 (+9.67%) ▲



MII Ideas

1. More sector head involvement. Maybe try including sector heads after the meeting in discussion about the stock presentations.
2. Help encourage more presentations by keeping the watch list up to date.
3. I'm not sure how to go about improving this, but I've had several investment ideas which I have been unable to do a presentation on. I wish there were some way to pass these on to management in a fashion that wouldn't require hours upon hours of work.
4. Make sure to review the management decisions on the previous week's presentations. I am always curious to hear how the management felt. It makes it easier for me to learn about what I should be looking at in a stock.
5. Keep the website up to date. The current names are not current.
6. Publish a yearly report. I read the 2005 report and found the information very interesting and helpful. I think I would be a good idea to publish one every year.