Abercrombie & Fitch Company

SUMMARY

Abercrombie & Fitch's fourth-quarter fiscal 2014 results failed to impress, as both top and bottom lines fell year over year. The company's sales declined due to store closures, adverse currency headwinds and a drop in comps. Further, the company expects results in fiscal 2015 to be adversely impacted by foreign currency headwinds, anticipating continued weakness in sales and earnings per share. Moreover, the stock has been underperforming lately due to its fading popularity among teenagers, which has weighed on its comps performance over the past 12 quarters. Though the company expects the unfavorable impact from lower logo sales to reduce in fiscal 2015, we would like to wait and see whether it materializes. The company is also losing market share to the rising popularity of fast-fashion retailers.

SUMMARY DATA

Risk Level *
Average, Type of Stock
Mid-Value Industry
Retail-App/Shoe
Zacks Industry Rank *
160 out of 267

Current Recommendation
UNDERPERFORM
Prior Recommendation
Neutral
Date of Last Change
12/23/2014
Current Price (03/19/15)
$21.34
Target Price
$19.00

Abercrombie & Fitch’s fourth-quarter fiscal 2014 results failed to impress, as both top and bottom lines fell year over year. The company's sales declined due to store closures, adverse currency headwinds and a drop in comps. Further, the company expects results in fiscal 2015 to be adversely impacted by foreign currency headwinds, anticipating continued weakness in sales and earnings per share. Moreover, the stock has been underperforming lately due to its fading popularity among teenagers, which has weighed on its comps performance over the past 12 quarters. Though the company expects the unfavorable impact from lower logo sales to reduce in fiscal 2015, we would like to wait and see whether it materializes. The company is also losing market share to the rising popularity of fast-fashion retailers.
OVERVIEW

Abercrombie & Fitch Co. operates as a specialty retailer of premium, high-quality casual apparel for men, women, and kids through a network of 1,000 stores across the U.S., Canada, Europe, Asia, Australia and the Middle East. Over the years, Abercrombie has extensively relied on its unique in-store experience as well as its lineup of leading product labels for sustained growth.

Abercrombie’s product portfolio includes knit and woven shirts, graphic T-shirts, fleece, jeans and woven pants, shorts, sweaters, outerwear, personal care products and accessories for men, women and kids, under the Abercrombie & Fitch, abercrombie kids and Hollister brands. Additionally, the company sells inner wear, personal care products, sleepwear and at-home products for girls through direct-to-consumer operations and Hollister stores under the Gilly Hicks brand. It also sells products through its e-commerce platform.

Region-wise, Abercrombie reports its sales under two segments – U.S. Stores and International Stores.

- **U.S. Stores:** The results from store operations and direct-to-consumer business in the U.S. and Puerto Rico are included in this segment.

- **International Stores:** The segment includes the store operations and direct-to-consumer business in Canada, Europe, Asia, Australia and the Middle East.

Abercrombie also provides sales performance of its brands:

- **Abercrombie & Fitch** is targeted at the college-going crowd. The brand is positioned as a luxury lifestyle concept, and uses the finest materials to create high-quality casual wear.

- **Abercrombie Kids**, themed as "classic cool", is aimed at pre-teens and is the children's version of Abercrombie & Fitch.

- **Hollister** is based on a South California theme, targeting youth in their late teens. Stores under this brand also offer intimate products of the Gilly Hicks brand.

REASONS TO SELL

- **Dismal Q4 Earnings and Outlook Pulled Down Estimates:** Abercrombie & Fitch posted dismal fourth-quarter fiscal 2014 results, wherein both the top and bottom lines declined year over year. The company’s sales declined due to store closures, adverse currency headwinds and a fall in comparable-store sales (comps). The company expects foreign currency headwinds to affect fiscal 2015 results as well and anticipates continued weakness in its top and bottom lines. This, in turn, caused the Zacks Consensus Estimates for the first quarter, fiscal 2015 and fiscal 2016 to fall significantly.

- **Negative Comps; a Major Concern:** The company's comps performance has shown a negative trend over the past 12 quarters. In the most recent quarter, the company witnessed a 10% decline in comps owing to sluggish performance in both domestic and international markets. One of the primary reasons behind the negative comps trend is the fading popularity of the company’s products among teenagers since the 2008 recession, which made youngsters switch to cheaper options. Moreover, the company has been losing its charm to the rising popularity of fast-fashion retailers, like H&M and Forever 21, among its target customers. Going forward, management expects the unfavorable impact from lower logo sales to reduce in the first half of fiscal 2015 and neutralize in
the second half. However, we believe this outlook to be overly optimistic and we would like to wait and see whether it materializes.

- **Risks of Operating in Overseas Markets:** A significant portion of Abercrombie's merchandise is manufactured outside the U.S. in Asia, and Central and South America. Further, more than a quarter of the company's total revenue comes from overseas operations. Accordingly, the company is exposed to political, social and economic risks associated with operations in these regions. An adverse movement in foreign currency exchange rates can also dent its operational performance.

- **Macroeconomic Challenges:** The apparel retail industry is consumer-driven and hence sensitive to the health of the economy. Spending on apparel and accessories is heavily dependent on the personal disposable income of consumers. Macroeconomic challenges like high household debt and unemployment may restrain consumers from spending on these items.

**RISKS**

- **Streamlining Operations and Expanding Overseas to Drive Top- and Bottom-Line Growth:** In the face of economic challenges, with teenagers becoming less active shoppers, Abercrombie has put in due effort to stay in the business by expanding its international operations. Moreover, the company has shifted focus toward closing its underperforming U.S. chain stores in order to drive top-line growth, while enhancing profitability. The company shut down all its stand-alone Gilly Hicks stores in fiscal 2014, while it continues to offer the brand's intimate apparel through its Hollister stores and direct-to-customer channels.

- **Hollister Seems an Attractive Global Expansion Option:** Abercrombie is aggressively expanding its Hollister brand stores in new markets and intends to open more stores in China (because of the rising middle class) and the UAE (because of the region's highest per capita spending on apparel among developing nations). Moreover, among developed economies, the company plans to open more stores in Australia and Japan, which provide substantial growth opportunities for value-focused products. The idea behind the expansion of this brand is that its smaller size of operation makes it cheaper and less capital intensive compared to the company's namesake brand. The growth of the Hollister brand internationally could augment overall performance.

**RECENT NEWS**

**Abercrombie & Fitch (ANF) Tops Q4 Earnings, Sales Miss** – Mar 4, 2015

Abercrombie & Fitch Co. failed to impress with its fourth-quarter fiscal 2014 results, as both top and bottom lines witnessed a year-over-year decline. However, its earnings per share managed to beat the Zacks Consensus Estimate.

Benefitting from efficient expense management and better-than-expected gross margin, the company's adjusted earnings of $1.15 per share in the fourth quarter beat the Zacks Consensus Estimate of $1.13, whereas the same fell 14.2% year over year.

Including certain one-time items, Abercrombie posted earnings of $0.63 per share, which plunged 25.9% year over year.
Sales and Comps

Battered by store closures, adverse currency headwinds and a fall in comparable store sales (comps), net sales declined about 14% year over year to $1,120 million. Moreover, quarterly revenues fell short of the Zacks Consensus Estimate of $1,168.8 million.

The fall in net sales reflects a 10% drop in domestic sales and a 20% slump in international sales, including direct-to-consumer sales, to $763 million and $357 million, respectively.

Including direct-to-consumer sales, the company’s total comps decreased 10%. Although U.S. and international comps declined 6% and 17%, respectively, total direct-to-consumer comps rose 1%.

Brand-wise, Abercrombie’s comparable sales, including direct-to-consumer sales at its Abercrombie & Fitch, abercrombie kids and Hollister stores, declined 9%, 6% and 11%, respectively. The company’s Abercrombie & Fitch, abercrombie kids and Hollister brands generated revenues of $424.1 million, $100.7 million and $593.5 million, respectively.

Quarter in Detail

In the fourth quarter, gross margin improved 190 basis points (bps) to 60.9%, backed by lower average unit costs, partly offset by unfavorable currency changes.

Adjusted store and distribution expenses, as a percentage of sales, expanded 50 bps to 39.4%, compared with the prior-year period. Savings from the company’s profit enhancement initiatives, which helped lower store payroll and other manageable store expenses and currency change benefits, were more than offset by increased direct-to-consumer expenses and negative comps.

Moreover, adjusted marketing, general and administrative expenses dipped nearly 1.3% to $113.9 million due to a fall in compensation expenses, partly offset by a rise in marketing costs. This excludes an expense of $5.3 million incurred in the fourth quarter, associated with the transition of the company’s CEO.

Fiscal 2014: A Glance

The company’s adjusted earnings for fiscal 2014 came in at $1.54 per share, down 19.4% year over year and also lagged the Zacks Consensus Estimate of $1.56. Including one-time items, the company’s earnings climbed 2.9% year over year to $0.71 a share. Net sales for the fiscal decreased 9% to $3,744 million, also missing the Zacks Consensus Estimate of $3,802 million.

Financials

Abercrombie ended fiscal 2014 with cash and cash equivalents of $530.2 million, gross borrowings of $299.3 million and shareholders’ equity of $1,389.7 million. As of Jan 31, 2015, inventories were approximately $460.8 million, down nearly 13% from the prior-year quarter.

During the fiscal, Abercrombie incurred $174.6 million as capital expenditure, allocated toward store openings, store remodeling, IT, distribution centers and other home office projects. For fiscal 2015, the company anticipates capital expenditure of nearly $150 million.

Further, the company continued to enhance shareholder value by repurchasing about 7.3 million shares, valued at $285 million in fiscal 2014. Shares available for repurchase under the company’s authorization were approximately 9 million as of Jan 31, 2015.
Moreover, management announced a quarterly cash dividend of $0.20 a share, payable on Mar 11, 2015 to shareholders of record as on Mar 3.

Store Update

The company ended fiscal 2014 with a total of 969 stores, including 799 stores in the United States and 170 internationally. During the reported quarter, the company opened 3 stores in the U.S. and 5 stores globally. Additionally, it closed 38 stores across the U.S. and 1 international store.

During fiscal 2015, Abercrombie intends to open about 15 full-price international outlets and 4 North American full-price outlets. Moreover, the company plans to open about 11 U.S. outlet stores during the fiscal. Store closures in the U.S., due to lease expirations, are expected to come at about 60, during fiscal 2015.

Outlook

Abercrombie ended fiscal 2014 on quite a weak note, as the company’s planned comps improvement failed to materialize and despite its stringent cost-control measures, the company was unable to offset the impact of soft sales.

Going forward, management’s primary target for fiscal 2015 is to improve both domestic and global comps, by focusing on customers and enhancing product range. Next, it plans to undertake significant investments to develop its direct-to-consumer and omni-channel operations. The company also plans to remain committed to control costs and target overseas expansion in high-growth markets.

Following a difficult fiscal 2014, Abercrombie provided an outlook for fiscal 2015, which it expects to be adversely impacted by foreign currency headwinds.

As for comps, management expects the unfavorable impact from lower logo sales to reduce in the first half of the fiscal and neutralize in the second half. Further, gross margin is anticipated to remain flat or rise marginally in fiscal 2015.

Abercrombie & Fitch Announces Quarterly Dividend – Feb 19, 2015

Abercrombie & Fitch Co. declared a quarterly dividend of $0.20 per share, payable to shareholders on Mar 11, of record as of Mar 3.
Abercrombie’s current trailing 12-month earnings multiple is 13.9x, compared with the industry average of 23.7x and the S&P 500 average of 18.3x. The stock is trading at a discount to the industry average, based on fiscal 2015 earnings estimates. Over the last five years, Abercrombie’s shares have traded in the range of 11.2x to 58.5x trailing 12-month earnings. Our target price of $19.00 based on 17.8x 2015 EPS reflects this view.

Key Indicators

<table>
<thead>
<tr>
<th></th>
<th>P/E</th>
<th>P/E</th>
<th>Est. 5-Yr</th>
<th>P/CF (TTM)</th>
<th>P/E</th>
<th>P/E</th>
<th>P/E</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>F1</td>
<td>F2</td>
<td>EPS Gr%</td>
<td>(TTM)</td>
<td>5-Yr</td>
<td>(TTM)</td>
<td>5-Yr</td>
</tr>
<tr>
<td>Abercrombie &amp; Fitch</td>
<td>19.9</td>
<td>18.1</td>
<td>14.0</td>
<td>4.5</td>
<td>13.9</td>
<td>58.5</td>
<td>11.2</td>
</tr>
<tr>
<td>Co. (ANF)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Industry Average</td>
<td>30.3</td>
<td>17.7</td>
<td>12.6</td>
<td>14.1</td>
<td>23.7</td>
<td>N/A</td>
<td>17.3</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>16.7</td>
<td>15.6</td>
<td>10.7</td>
<td>14.5</td>
<td>18.3</td>
<td>18.4</td>
<td>12.0</td>
</tr>
<tr>
<td>Ascena Retail Group</td>
<td>19.2</td>
<td>14.2</td>
<td>17.5</td>
<td>5.9</td>
<td>18.1</td>
<td>17.9</td>
<td>11.1</td>
</tr>
<tr>
<td>Inc. (ASNA)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Foot Locker, Inc. (FL)</td>
<td>15.6</td>
<td>14.0</td>
<td>10.3</td>
<td>13.1</td>
<td>17.1</td>
<td>27.3</td>
<td>12.2</td>
</tr>
<tr>
<td>Fossil Group Inc. (FOSL)</td>
<td>14.5</td>
<td>12.7</td>
<td>12.7</td>
<td>8.9</td>
<td>11.5</td>
<td>30.5</td>
<td>12.0</td>
</tr>
<tr>
<td>American Eagle Outfitters, Inc. (AEO)</td>
<td>22.3</td>
<td>19.0</td>
<td>17.0</td>
<td>16.0</td>
<td>26.5</td>
<td>30.0</td>
<td>15.3</td>
</tr>
</tbody>
</table>

TTM is trailing 12 months; F1 is 2015 and F2 is 2016, CF is operating cash flow
Earnings Surprise and Estimate Revision History

AEER CROMBIE (W)
Price ➔ EPS Surprises

AEER CROMBIE ($/sh) ➔ 2015 Consensus ➔ 2014 Consensus
2013 Consensus ➔ 2012 Consensus ➔ 2011 Consensus
Price ($)

Input: "Earnings Surprise and Estimate Revision History"
Output: "Earnings Surprise and Estimate Revision History"
DISCLOSURES & DEFINITIONS

The analysts contributing to this report do not hold any shares of ANF. The EPS and revenue forecasts are the Zacks Consensus estimates. Additionally, the analysts contributing to this report certify that the views expressed herein accurately reflect the analysts' personal views as to the subject securities and issuers. Zacks certifies that no part of the analysts' compensation was, is, or will be, directly or indirectly, related to the specific recommendation or views expressed by the analyst in the report. Additional information on the securities mentioned in this report is available upon request. This report is based on data obtained from sources we believe to be reliable, but is not guaranteed as to accuracy and does not purport to be complete. Because of individual objectives, the report should not be construed as advice designed to meet the particular investment needs of any investor. Any opinions expressed herein are subject to change. This report is not to be construed as an offer or the solicitation of an offer to buy or sell the securities herein mentioned. Zacks or its officers, employees or customers may have a position long or short in the securities mentioned and buy or sell the securities from time to time. Zacks uses the following rating system for the securities it covers. 

**Outperform** - Zacks expects that the subject company will outperform the broader U.S. equity market over the next six to twelve months. 

**Neutral** - Zacks expects that the company will perform in line with the broader U.S. equity market over the next six to twelve months. 

**Underperform** - Zacks expects the company will underperform the broader U.S. Equity market over the next six to twelve months. The current distribution of Zacks Ratings is as follows on the 1133 companies covered: Outperform - 15.2%, Neutral - 75.0%, Underperform – 9.0%. Data is as of midnight on the business day immediately prior to this publication.

Our recommendation for each stock is closely linked to the **Zacks Rank**, which results from a proprietary quantitative model using trends in earnings estimate revisions. This model is proven most effective for judging the timeliness of a stock over the next 1 to 3 months. The model assigns each stock a rank from 1 through 5. Zacks Rank 1 = Strong Buy. Zacks Rank 2 = Buy. Zacks Rank 3 = Hold. Zacks Rank 4 = Sell. Zacks Rank 5 = Strong Sell. We also provide a **Zacks Industry Rank** for each company which provides an idea of the near-term attractiveness of a company's industry group. We have 264 industry groups in total. Thus, the Zacks Industry Rank is a number between 1 and 264. In terms of investment attractiveness, the higher the rank the better. Historically, the top half of the industries has outperformed the general market. In determining **Risk Level**, we rely on a proprietary quantitative model that divides the entire universe of stocks into five groups, based on each stock's historical price volatility. The first group has stocks with the lowest values and are deemed **Low Risk**, while the 5th group has the highest values and are designated **High Risk**. Designations of **Below-Average Risk**, **Average Risk**, and **Above-Average Risk** correspond to the second, third, and fourth groups of stocks, respectively.