Urban Outfitters Inc is offering a deal to investors

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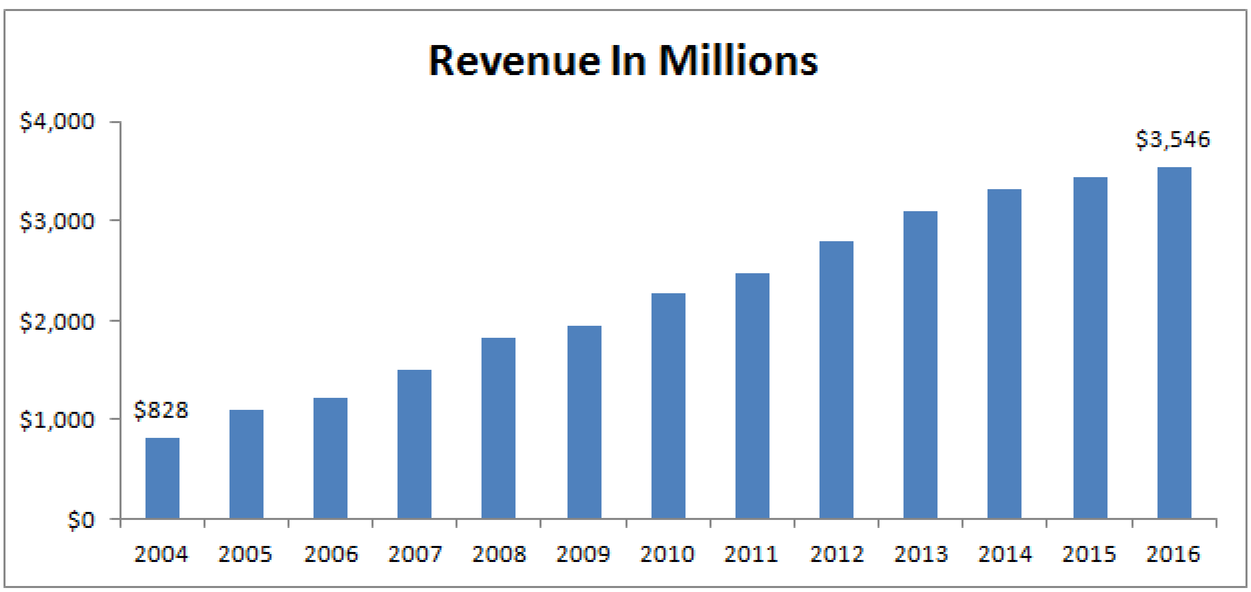
Recently, Anthropologie's apparels are not exciting customers, so investors are punishing the parent company, Urban Outfitters Inc's (NASDAQ: URBN) stock. Despite its recent challenges, the company's financial performances are one of the best in the industry. When the company doesn't meet its expectation, management takes accountability and doesn't blame the weather or a weak retail environment. The company is adapting to the evolving retail environment, and due to its disciplined approach, it is not frantically closing stores. It has a strong balance sheet and will survive this downturn. As the retail environment is transforming, investors are concerned about retailers' ability to successfully adapt, so they are pessimistic about the retail segment. So, we believe the company is undervalued.

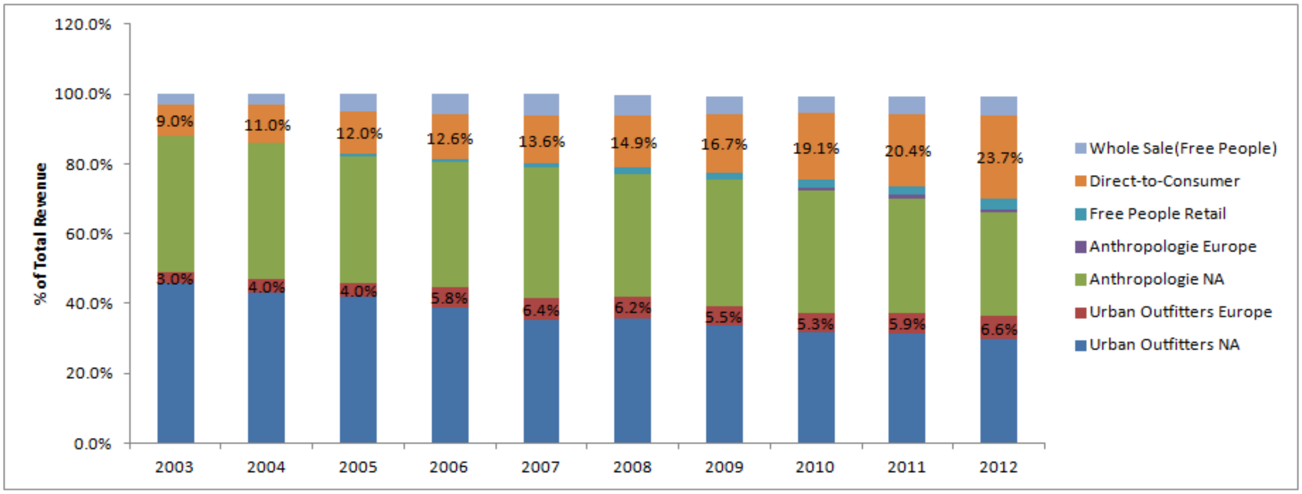
To distinguish between the company and the Urban Outfitters brand, this article will refer to the company as URBN.

The key to success is gradual expansion



(Source: SEC filings and Author's analysis)

The company has experienced consistent growth over the years. It has fueled its growth by successfully developing multiple brands, gradually expanding its store base, product categories, and geographic reach.



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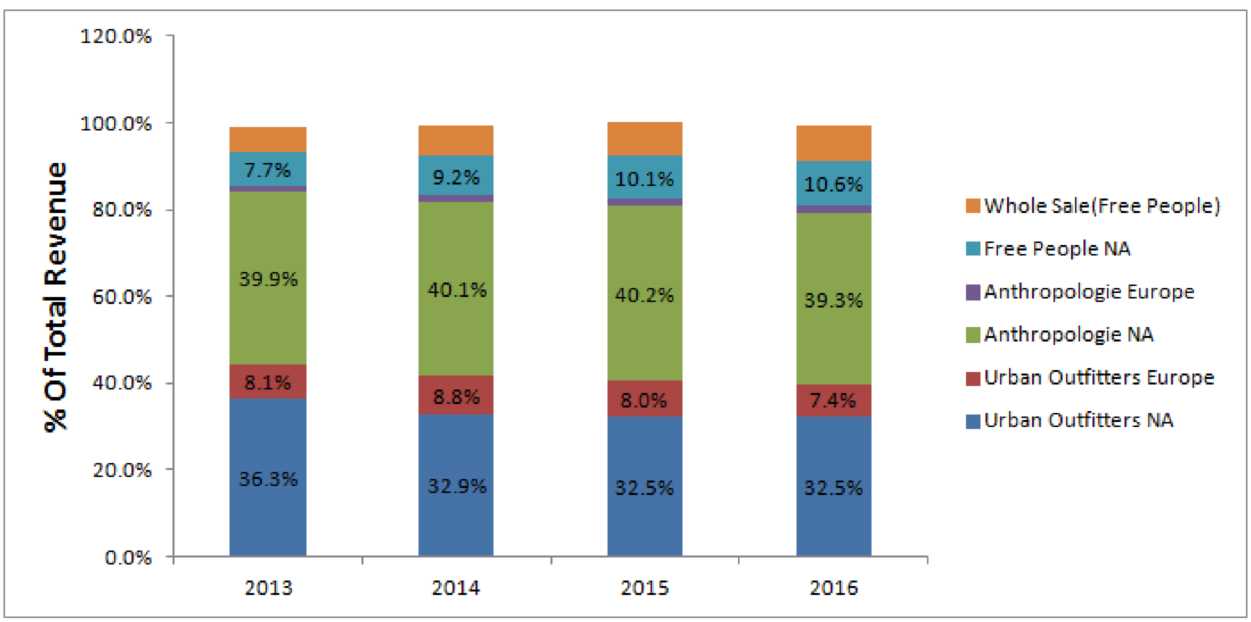


(Source: SEC filings and Author's analysis)

(Note: Brand revenue includes direct-to-consumer revenue)

Every company's goal is to attain profitable growth. The growth can be obtained by expanding product categories, market, geography, etc. Some retailers launch a new brand while others expand the existing brand, but success is never guaranteed. For example, Kate Spade unsuccessfully tried to broaden its target demographics by creating a new brand, 'Saturday by Kate Spade.' Vera Bradley, a relatively small women cotton handbags and accessory provider decided to increase its target market by introducing new fabrics including leather. Vera Bradley's strength was its loyal customer base who took pride in carrying the brand's colorful, floral pattern cotton products. Even though it is yet to be seen, to date, Vera Bradley is struggling to acquire new customers, and its expansion strategy has resulted in alienating its core customer base. As consumer brands' success depends on companies' ability to create an emotional connection with customers, it depends on several factors. So, successful expansion requires a well-thought-out strategy, the right business model, and disciplined execution. URBN's ability to successfully launch new brands, expand, and continue to grow them profitably is worth noting.

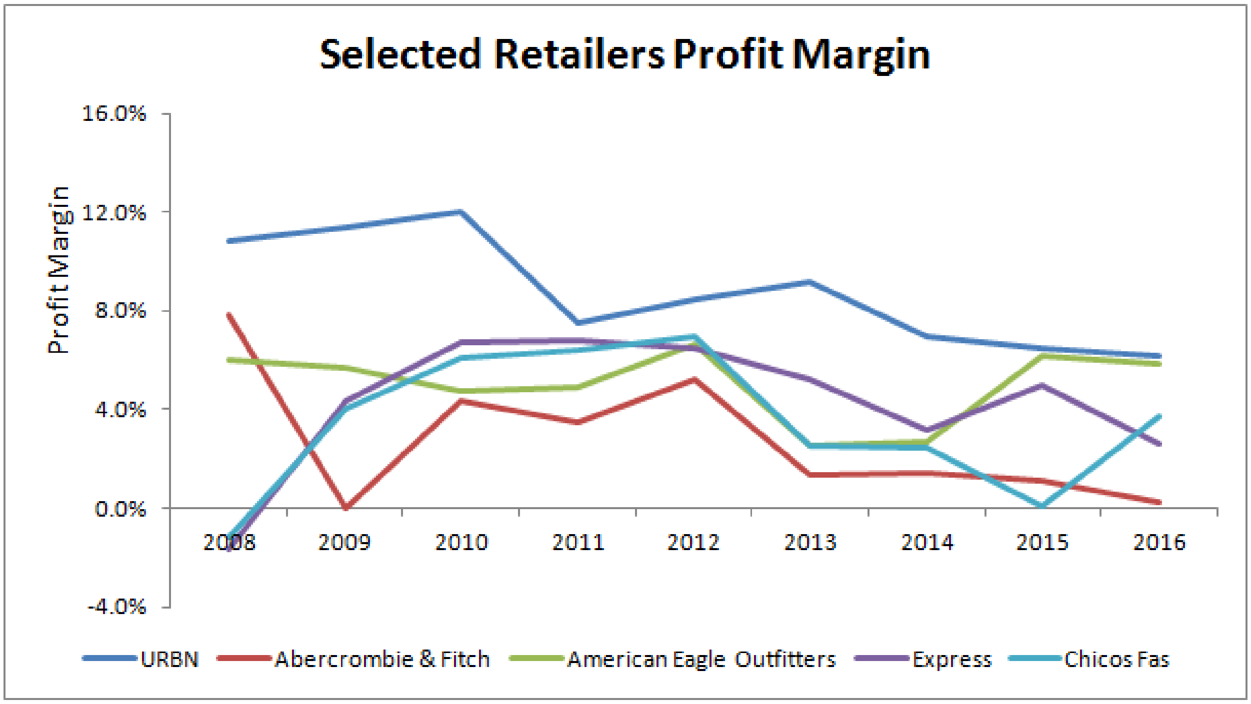
Industry Challenges

In general, the retail industry is impacted by consumer spending, which is influenced by the macroeconomic environment and the unemployment rate. For the last few years, despite a low unemployment rate, mall traffic is on the decline and the retail environment has been promotional and challenging. This trend can be blamed on changing consumers' shopping habits such as consumers' desire to shop whenever, wherever, and whatever, the shift in fashion trends, and increased consumers' desire to hunt for bargain prices.

Desire to shop frugally

After the 2008 financial crisis, US consumers' desire to hunt for bargains has increased. During that time, their personal debt reached a record high, and as many faced tough times, maybe they learned a hard lesson. Another reason might be that millennials started entering adulthood during that period and they value bargains. Now comparing prices and looking for deals is just one click away. Many factors have contributed to the shift in consumers' desire to hunt for bargains.

In recent years, low priced fast-fashion retailers such as H&M, Zara, Forever 2, etc. have expanded their presence and gaining market shares from traditional retailers. So, the incumbents have decided to compete on prices and that has led to a prolonged promotional retail environment. Consequently, retailers' margins have suffered. After competing on prices for a few years, some retailers such as American Eagle Outfitters (NYSE:AEO) have decided to rather focus on quality and appeal to the customer base who value quality. So, American Eagle Outfitters has invested in innovating higher quality materials and is trying to set itself apart. Even during this period, rather than competing on prices, URBN has focused on delivering its value proposition. That doesn't imply that the company has never offered promotions. Hits and misses are part of the fashion business and offering promotions to clear excess inventory is part of running a retail business. Despite not competing on prices, the promotional environment and omnichannel have impacted URBN's margins, but its financial performances are one of the best in the industry.



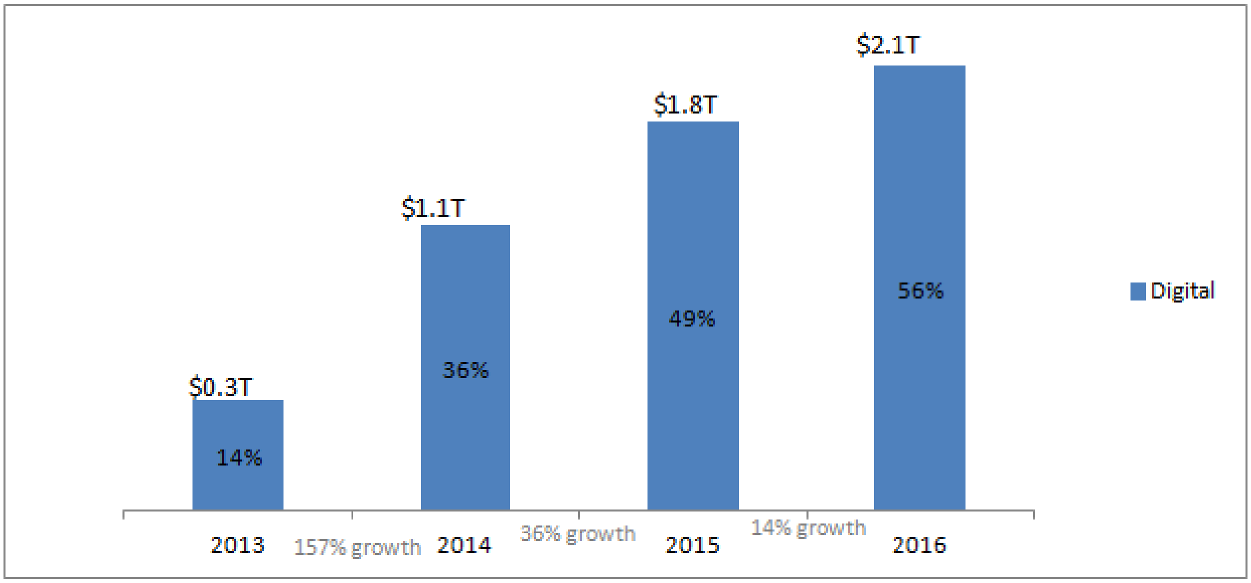
(Source: SEC filings and Author's analysis)

TTM Comparable Operating Statistics							
	Gross Margin %	EBIT Margin %	Net Income Margin %	FCF % Sales	Revenue Growth %	Comparable Sales %	Revenue (in millions)
URBN	34.5%	8.7%	5.7%	7.7%	(0.2%)	(3.1%)	3,544
American Eagle OutFltters	37.3%	8.5%	5.4%	5.7%	1.7%	2.0%	3,622
Abecrombie & Fitch	60.6%	0.0%	(0.5%)	1.4%	(3.6%)	(3.0%)	3,303
Express	28.9%	2.9%	3.0%	4.0%	(7.1%)	(10.0%)	2,157
Chico Fas	38.1%	6.0%	3.9%	7.4%	(9.2%)	(8.7%)	2,417
GAP	37.0%	7.9%	4.5%	7.7%	0.1%	2.0%	15,518

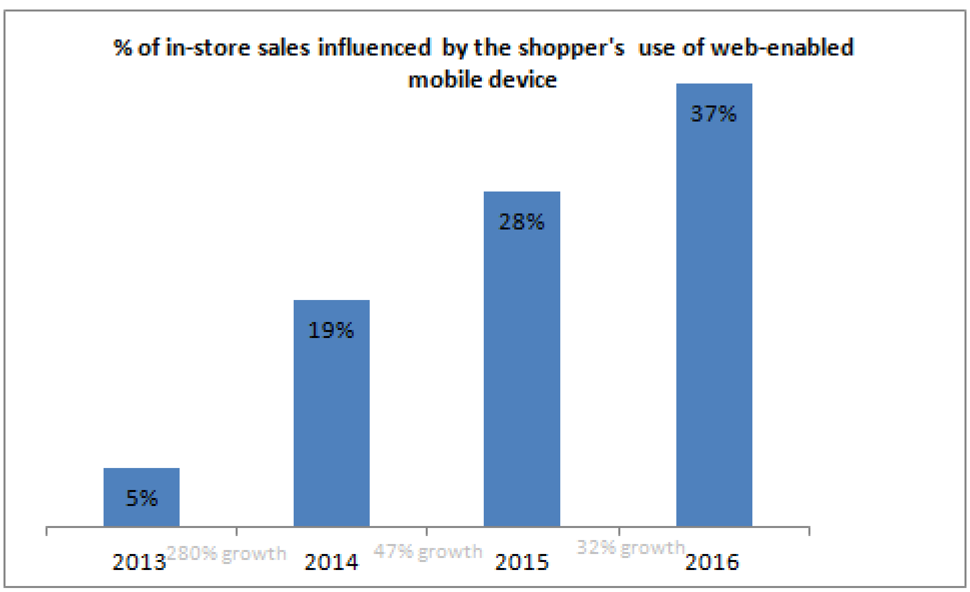
(Source: SEC filings and Author's analysis)

Omnichannel is more than a buzz word

Digital has reshaped consumer shopping behavior forever. Eighty percent of the US consumers own a smartphone. Smartphones and social networks have made it easier for consumers to share their opinions about products and services. Not only is mall traffic on the decline, digital as well as mobile influence on in-store purchases is also on the rise. According to Deloitte research, today 56% of in-store shopping decisions are influenced by digital, and 37% are influenced by mobile. Companies are trying to meet consumers' rising expectations for being able to buy what they want, and also when and how they want —which means providing a seamless omnichannel experience.



(Source: Deloitte research)



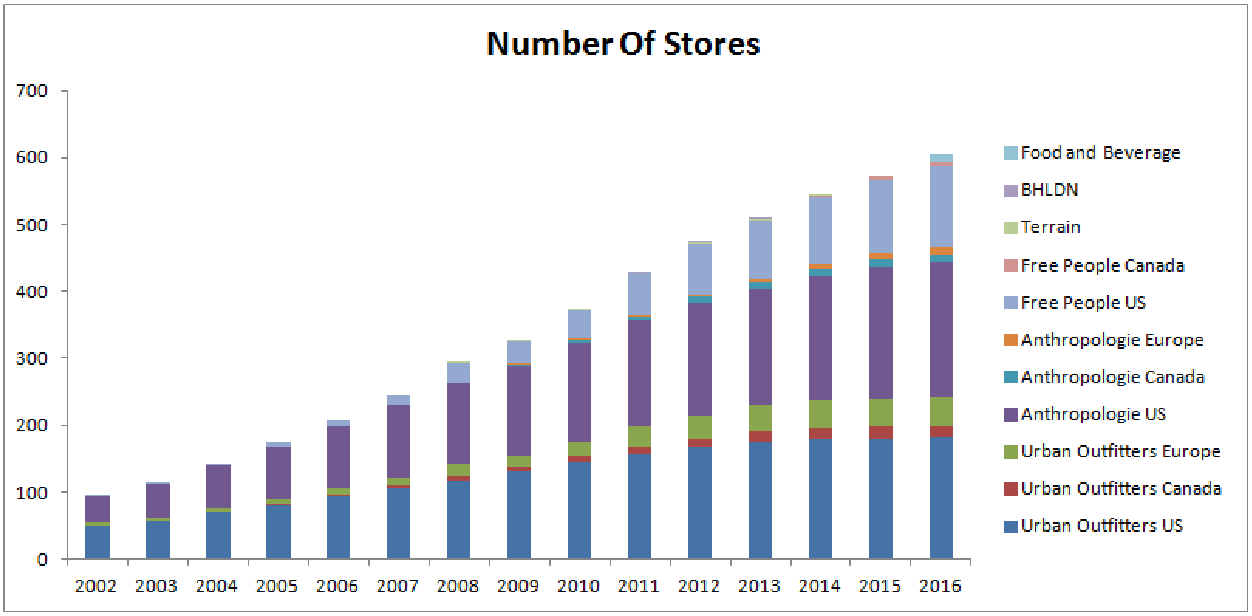
(Source: Deloitte research)

To be a successful omnichannel retailer, URBN needs to maintain a consistent brand image across different channels and use appropriate means to acquire customers. Traditionally, fashion retailers' brand image depends on products offered, quality, price points, store experience, etc. Store experience depends on the look and feel of the store, customer service, products placement, etc. But the online shopping experience depends on products offered, quality, price points, ease of navigation and responsiveness of the website, social media presence and content, shipping and transportation efficiency, customer service, consumer reviews, etc. While there are similarities between online and brick and mortar, creating a consistent brand image across channels is a bit more complicated than replicating brick and mortar stores. Even the customer acquisition and creating brand awareness are different. Traditionally, consumers came in contact with brands through catalogs, magazines, TV and radio ads, discover stores while walking through a mall, etc. In today's digital world, customers come in contact with the brand through social media, online advertising, email, etc. For fashion retailers, the switching cost is low; they build a loyal customer base by forming an emotional connection with consumers.

URBN started direct consumer channel through catalogs and websites in the late 90s, and over the years, it has maintained its disciplined approach to grow that channel. However, in recent years as consumers' shopping habits are swiftly changing, the company has increased investment in technology and is adapting more rapidly. It is trying to ensure that consumers have every opportunity to interact with the brand, be it through online or offline channels. It is using social media, email and online advertising to strengthen its online presence and build an emotional connection with customers. It has a strong social media presence. For example, the Urban Outfitters brand has more than 7M Instagram followers. The company is trying to offer a seamless omnichannel experience to consumers. Customers can buy products not just in stores and on the web, but also on a mobile app and they can track orders, pick up, return, and exchange their online purchases at stores. It is also trying to personalize the online shopping experience. A few years ago, the company set a goal to generate 50% of its revenue from online sales. It already generates 50% of its Free People brand revenue from direct business and around 35% of Urban Outfitters and Anthropologie revenue from direct business. So it has a relatively strong online business, and the company is planning to double its online revenue within the next five years.

Disciplined approach to expand store base is paying off

Many retailers have expanded store base aggressively, and now they are frantically closing doors. URBN has always taken a very conservative, disciplined approach to expanding its store base. So, while the company is investing in omnichannel, it is not frantically closing stores. However, periodically closing a few underperforming stores is part of doing business. The company's disciplined approach to open new stores also boosts management's credibility regarding its goal to double its online revenue within the next five years.



(Source: SEC filings and Author's analysis)

Experience matters to millennials

Even though online shopping and social media are on the rise, millennials value experiences. So, retailers are looking for more innovative approaches to attract consumers to their stores and providing enhanced store experiences. For example, American Eagle Outfitters opened a new Aerie pop-up store in New York which offers workout classes, personalized shopping session, flower wall, etc. and that store is performing very well, according to the company. To improve the customer shopping experience, last year URBN acquired a small, family owned pizza company. URBN is experimenting with an idea of turning its stores into a place to hang out as well as eat and shop. While URBN's pizza stores have good customer reviews, it is yet to be seen whether it will be a success. However, the company's conservative management is not going to expand rapidly and will be in a situation where it needs to close many underperforming stores. While it is hard to predict if and when margins will improve, it is a well-managed company with diversified brands and is evolving with the industry.

Innovation

Retailers' sales and profitability can be summed up with a simple formula: if something is selling, accelerate production. If it's not selling, cut the losses and stop producing it, because it's cheaper to cancel production than sell a product at a markdown. When goods are marked down, companies not only loose profit, they also take away floor space from goods that could be sold at full price.

To achieve this, a retailer needs to have a shorter lead time, preferably just in time inventory, ability to connect and analyze sales data, inventory management system, and efficient distribution system. URBN is trying to improve its lead time, has invested in data analytics and improving the supply chain

Strong balance sheet

The company has no debt and a strong balance sheet. It generates positive free cash flow and periodically repurchases shares. The company doesn't have a strong record of repurchasing shares only when the company is undervalued. Rarely companies repurchase shares only when they are undervalued. In general, companies will have excess cash when they are performing well, and during uncertainty periods, they prefer to hold on to the cash. Apart from that, companies' management believes in its strategy, so yet times they might be over optimistic about the future.

Current Situation

URBN's Selected Financials

	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016
Revenue (in millions)	$828	$1,092	$1,225	$1,508	$1,835	$1,938	$2,274	$2,474	$2,795	$3,087	$3,323	$3,445	$3,546
EPS	0.54	0.77	0.69	0.94	1.17	1.28	1.60	1.19	1.62	1.89	1.68	1.78	1.86
Revenue Growth %		32%	12%	23%	22%	6%	17%	9%	13%	10%	8%	4%	3%
Profit Margin	10.9%	12.0%	9.5%	10.6%	10.9%	11.3%	12.0%	7.5%	8.5%	9.1%	7.0%	6.5%	6.2%
Operating Margin %	17.9%	19.0%	13.4%	14.9%	16.3%	17.5%	18.2%	11.5%	13.4%	13.8%	11.0%	10.3%	9.5%
Gross Margin %	40.9%	41.1%	36.9%	38.3%	38.9%	40.6%	41.2%	34.8%	36.9%	37.6%	35.4%	34.9%	35.1%
SGA ratio %	23.0%	22.1%	23.5%	23.3%	22.6%	23.1%	23.0%	23.3%	23.5%	23.8%	24.4%	24.6%	25.6%
FCF % Sale	9.0%	2.0%	(2.0%)	9.2%	7.6%	11.2%	10.6%	3.7%	8.1%	7.7%	2.8%	7.8%	7.6%
Asset Turnover	1.5	1.4	1.4	1.3	1.4	1.2	1.3	1.67	1.6	1.4	1.8	1.9	1.9
Debt to Asset	-	-	-	-	-	-	-	-	-	-	-	-	-

(Source: SEC filings and Author's analysis)

Currently the company's Anthropologie and Urban Outfitters apparels are not resonating with customers. Its second quarter estimates are disappointing, it expects margins to suffer and have negative comp sales. The company's forecast has clouded investors' enthusiasm. The recent quarterly results are not only the reasons for investors' pessimism. As we mentioned earlier, its margins are shrinking and growth has hit a speed bump.

While one shouldn't focus too much on a quarterly result and hits and misses are part of the fashion business, if a company continuously misses, then there is a possibility of losing its loyal customer base. Bringing back the lost customer base is a challenging task. However, both brands offer diverse product categories and its other categories; especially Anthropologie's home is performing well. So customers are visiting both brands, and when the company offers relevant fashion, they will notice. The company is also reducing lead time, trying to introduce products in smaller batches, replenish what is selling and stop producing what is not selling. Apart from that, even in this challenging environment, the Free People brand is performing well due to its brand equity and emotionally compelling connections with its customer base. The company credits that to its creative team. However, creative team doesn't imply that brand is never going to miss.

The Free People brand has no presence in Europe, and the company is planning to expand. While it is a strong brand in the US, it is yet to be seen whether it will be a success in Europe. However, the brand offers quality products, and the company will cautiously expand. It is also expanding product categories in all three brands.

Valuation

One can't assume a company is undervalued just because its current valuation is low. However, in URBN's case, we do believe the company is undervalued considering all things we have mentioned so far such as its ability to offer quality products, omnichannel capabilities, growing online business, diversified brands, etc. We believe its challenges are short-term.

Selected URBN's Ratios										
	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017 TTM
Comparable Sales Growth %	7.8%	(2.6%)	4.0%	3.8%	6.9%	6.0%	1.6%	1.6%	0.8%	(3.1%)
Market Cap (in millions)	2,502	5,714	4,923	4,313	6,391	6,469	2,870	3,131	3,102	2,144
Market Cap - Low (in millions)	2,467	2,375	4,840	3,307	3,694	5,184	2,733	2,505	2,337	
Market Cap - High (in millions)	6,086	5,714	6,676	6,161	6,391	6,610	6,423	5,009	4,675	
TEV/REV	1.08	2.56	1.81	1.60	2.06	1.81	0.75	0.80	0.76	0.49
Low - TEV/REV	1.06	0.84	1.77	1.19	1.10	1.39	0.71	0.62	0.55	
High - TEV/REV	3.03	2.56	2.58	2.34	2.06	1.85	1.82	1.35	1.20	
TEV/EBIT	6.61	14.66	9.94	13.88	15.41	13.07	6.86	7.83	7.97	5.62
Low - TEV/EBIT	6.50	4.81	9.74	10.34	8.20	10.06	6.49	6.06	5.71	
High - TEV/EBIT	18.59	14.66	14.17	20.37	15.41	13.40	16.58	13.14	12.62	
P/S	1.40	3.00	2.21	1.77	2.31	2.13	0.87	0.91	0.88	0.6
Low -P/S	1.38	1.25	2.17	1.36	1.33	1.70	0.83	0.73	0.66	
High -P/S	3.40	3.00	3.00	2.53	2.31	2.17	1.95	1.46	1.32	
P/E	12.86	26.48	18.41	23.61	27.19	23.25	12.49	14.03	14.27	10.84
Low -P/E	12.68	11.00	18.10	18.10	15.72	18.63	11.89	11.23	10.75	
High -P/E	31.27	26.48	24.96	33.73	27.19	23.76	27.94	22.45	21.51	
P/B	2.37	4.41	3.49	4.04	4.72	3.82	2.16	2.75	2.36	1.61
Low P/B	2.34	1.83	3.43	3.10	2.73	3.06	2.06	2.20	1.78	
High P/B	5.78	4.41	4.73	5.78	4.72	3.90	4.84	4.40	3.56	
P/FCF	18.44	26.94	20.81	47.18	28.45	27.70	31.37	11.69	11.48	
Low P/FCF	18.18	11.19	20.46	36.18	16.44	22.20	29.87	9.35	8.65	
High P/FCF	44.85	26.94	28.22	67.40	28.45	28.30	70.20	18.70	17.30	
	Stock price on July 25th 2017 is used for TTM calculations									
	TTM comp sales is 2017 1Q sales									

(Source: SEC filings and Author's analysis)

Risks

Right now, the retail is challenging despite economic growth, low unemployment rate, and low gas prices. The Economic slowdown, rising gas prices will further deteriorate the retail environment.

Even though the current political situation has shifted the focus away from border tax, concern regarding the border tax negatively impacting retailers is still valid. Border tax might adversely affect international consumers' appetite for the US brands.

Conclusion

While the way consumers shop is transforming, their need for apparel, beauty, home products, furniture, etc. are not vanishing. URBN is adapting to the evolving retail environment, and it will be one of the winners. Unlike its competitors, the company is not frantically closing doors. Its financial performances are one of the best in the industry. It has a strong balance sheet and a relatively low valuation. Creativity and disciplined approaches are its strength, and the company still possesses them. It has diversified brands and product categories, and it is expanding product categories in all three brands, so it is worth considering.