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December 19, 2008

Saks Inc.

(Buy)

7.50% Senior Notes due 12/01/2010

Price: 83.0 **Yield:** 18.2% **Outstanding:** \$46 million **Rating:** B2/B

9.875% Senior Notes due 10/01/2011

Price: 60.0 **Yield:** 32.8% **Outstanding:** \$142 million **Rating:** B2/B

2.00% Convertible Notes due 3/15/2024

Price: 46.28 **Yield:** 8.3% **Outstanding:** \$230 million **Rating:** B2/B

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Investment Thesis

It has been a difficult year for all of Saks Inc.'s publicly traded securities, mainly as the market is concerned about the current macroeconomic environment and its impact on the retail industry. If economic conditions worsen, Saks revenues will likely continue to fall and its losses will deepen. That being said, the company has no debt maturities for another two years and it has remaining capacity of approximately \$335 million on its revolving credit line. That, in addition to the \$20 million in cash on Saks' balance sheet as of November 1, 2008, should allow the company to survive until the economy regains its footing. We note that cash balances at retailers are highly cyclical and the current level may represent a seasonal low as Saks had purchased inventory in anticipation of the Holiday season. On average over the past four quarters, Saks' cash balance has averaged \$77 million, so it is likely that it will increase over the next few months for seasonal reasons. That being said, employing the loss estimate of the most negative of the 11 analysts who cover Saks, as well as the most pessimistic of the analyst estimates of loss for the current quarter, Saks available funds over the next five quarters, adjusted to reflect capital expenditures, would diminish by about \$115 million, leaving it with over \$240 million in cash and credit line capacity. If the recession is over by the end of January 2010, Saks would likely be very well positioned to begin to expand its sales once again as many competitors may no longer be in business at that point.

While the retail environment is clearly the worst that it has been in decades, one could make an argument that Saks could actually be worth more than its current market valuation indicates if it were to liquidate its business. The reason for that is that Saks has a tangible book value of \$1.098 billion, the largest portion of which is real estate. If accumulated depreciation of almost \$900 million, is added back to book value, bearing in mind that much of this real estate, such as the flagship Fifth Avenue store, was originally acquired in the 1920s, adjusted book value would exceed \$2.0 billion. That one store could very well be worth some \$500 to \$750 million. By comparison, the market value of all of Saks outstanding debt is approximately \$239 million, given the discount to par, and its market capitalization is currently \$578 million. Consequently, from a debt holder's point of view, there clearly seems to be adequate protection in place, even if the economy will remain weak for some time.

Saks net profit margin has trailed its peers significantly over the past decade. In the late 1990s, Saks reported net profit margins of 3.7-3.8% but it has not recorded an annual net profit margin of more than 2.0% in the current decade. By comparison, its competitors such as Nordstrom's and Neiman Marcus have recorded net profit margins of 10% or more in the past few years (although not in the current retail environment). In the current fiscal year, Nordstrom's is expected to report a net profit margin of 5.0%, according to consensus forecasts. Were Saks to earn a 5.0% net profit margin on this year's expected revenues, if this may be considered 'normalized' earnings, it would have earned \$156 million. In an optimistic scenario, if Saks could earn an operating margin of perhaps 8% in 2011 and a net profit margin of 6% on revenues of around \$3.5 billion, it would generate \$210 million

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in earnings. However, while earnings are clearly volatile, a metric that is more consistent and normalized for inherent profitability would be revenues. During the past 12 years, Saks has traded at an average enterprise value-to-sales multiple that is almost double the current 0.31x, and private market acquisitions of like companies have taken place at more than 4x the current Saks revenue multiple.

Saks underperformance in terms of profit margins may be a function of a more inefficient model, or the fact that it offers a greater degree of personal attention to their shoppers, which reduces its profit margins. In either case, Saks will likely find a way to boost its margins to get more in line with those of its competitors, or it may be acquired by an entity that believes profit margins can be increased. At an enterprise value of around \$800 million, Saks would be a much more inexpensive acquisition compared to the \$5.1 billion acquisition of Neiman Marcus in 2005 and perhaps even more inexpensive than the \$942 million paid for Barneys last year.

One potential acquirer is Mexican investor Carlos Slim Helú, the company's largest shareholder. In recent weeks, Saks has established a poison pill in response to the 18% stake that has been accumulated by Mr. Slim, including 8 million shares acquired since early October. The terms of the poison pill appear designed not to dismiss an acquisition offer, but to ensure a strong bargaining position.

As difficult as the current conditions in the retail industry are, Saks survival does not appear to be threatened. It had access to \$355 million in cash and credit as of November 5th and its free cash flow will most likely be flat in 2009, despite the recession. In addition, if Saks were to experience unexpected liquidity issues, it should be able to enter a sale-lease back transaction of its flagship store which should free up \$500 million or more in cash, or sell any of the other 30 stores that it owns. At a substantial discount to what is likely a significantly understated tangible book value, there appears to exist significant margin of safety for its bond holders, and also significant appreciation potential, particularly for the convertible securities. Consequently, all Saks' debt securities are recommended for purchase.

The Current Situation

Saks has experienced five consecutive months of same-store sales declines, mainly as a result of the weakening economy and the difficulties of its customers to obtain credit. In addition, lay-offs at Wall Street firms and diminished returns on investment portfolios have affected Saks' primary clientele of wealthy shoppers. While high-end retailers have traditionally been relatively well insulated from trends such as rising oil prices, the industry is clearly sensitive to longer-term changes in economic cycles. In addition, high-end retailers tend to be more volatile than average retailers, growing faster in times of prosperity and contracting faster in recessionary times. As a result of the current downturn,

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Saks has been forced to discount its merchandise and offer attractive financing options to a greater degree than it normally does.

Saks' flagship store, which is clearly the company's most important asset, has benefitted significantly from strong tourism in New York City, but tourism has declined somewhat as overseas economies have been impacted and as the dollar has strengthened in recent months. While most of Saks' department stores are in tourist markets, its flagship store generates approximately 20% of the company's overall revenues. Saks also sells to "aspirational" shoppers, individuals who may buy clothing and other non-essential items beyond what they can afford. Those shoppers have sharply restricted their spending on these expensive items. As a result of these factors, same-store sales have declined significantly in the past few months as the table below indicates:

<u>Same-Store Sales</u>	
November	-5.2%
October	-16.6%
September	-10.9%
August	-5.9%
July	-5.3%
June	1.9%

The current Saks promotions, such as clearance sales and 'no interest - no payments for a year' deals (sponsored by HSBC) may have had a positive impact on sales and resulted in reduced inventory in the recent few weeks. Perhaps this was also a reason for the moderation in same-store sales declines in November. However, discounting to a large degree will most likely have a negative impact on the company's gross margin.

To preserve cash, Saks has announced plans to reduce its capital expenditures from an estimated \$125 million in 2008 to \$75 million in 2009. The company has canceled several store renovations and has announced that it is not opposed to shuttering certain underperforming outlets as even Saks' management does not claim that every store is cash flow positive. For example, the company closed its Fort Lauderdale store in the second quarter of the year. While Saks owns 31 of its retail stores, its 71 leased stores may be difficult to close without lease-break penalties. On the other hand, if it closes company-owned stores, Saks will most likely free up significant amounts of cash.

International Expansion

Saks is expanding its retail locations overseas, having opened or announced specific plans for Saks Fifth Avenue stores in Riyadh, Abu Dhabi, Dubai, Mexico City as well as a 300,000 square foot store in Shanghai. Success in China could become a very important growth driver for Saks as high-end consumption in China will most likely grow rapidly

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over the foreseeable future. If the Shanghai store is successful, additional Saks Fifth Avenue stores will likely open in places such as Macau, Beijing and Hong Kong to take advantage of the increasing wealth in the country. Currently, China is the third largest luxury goods market in the world, accounting for 12% of sales worldwide. However, at the rate of its current per capita income growth, China may surpass Japan in luxury consumption and become the world's second-largest purchaser of luxury goods by 2015. At the current time, international success could be said to represent a "free call option" in the valuation of the company. In other words, the market does not seem to assign any value to the potential of international success, even though it very well may materialize.

Real Estate

Saks owns the majority, or 31, of its 53 Saks Fifth Avenue stores, including its flagship store, while all of its Saks Fifth Avenue OFF 5TH stores are leased. The 31 owned stores have a total of 4.1 million square feet. Saks nine-story flagship store on Fifth Avenue and 50th Street, an official New York City landmark, is a 646,000-square-foot building, with approximately 340,000 square feet of selling space. This is without doubt Saks' most valuable asset. It is critical for the company's advertising campaigns and perceived status and it regularly accounts for approximately 20% of the company's overall sales, or approximately \$650 million per year. Considering that it has landmark status, is opposite Rockefeller Center and across the street from St. Patrick's Cathedral, there is no opportunity to add additional floors, so the store has to be highly efficient. Between 12,000 and 15,000 people visit the store on a typical day, although the count can be as high as 20,000 during busy shopping days. Despite the fact that it is almost 85 years old, the flagship store is said to be in better shape than most other buildings of similar vintage. Some major renovations have occurred in the last few years, including building a perimeter of designer accessory shops, a larger fine jewelry department on the main floor and an updating of designer sportswear with the addition of new shops for certain well-known designers.

Opened in 1924, the flagship store was later expanded into the 36-floor Swiss Tower located immediately behind it (closer to Madison Avenue), a move that increased its space by approximately 30%. The new building mirrors the Renaissance-style façade of the flagship store. Saks owns the land underneath the Tower and leased it for 100 years to the bank, which developed the building.

While it is very difficult to assign an appropriate market value to Saks flagship store, there are a few comparisons that can be used. For example, the site of the former Drake Hotel on Park Avenue between 56th and 57th streets is currently for sale and has reportedly six bidders, including Larry Silverstein and Apollo Real Estate Partners. Macklowe Properties had been assembling the site over the last decade, but now is facing foreclosure on the property. It is estimated that, at the height of the market, the land, which can support up to

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600,000 square feet, could have been purchased for \$1,300 a buildable foot, but industry experts now believe that it will sell for half of that price. This implies that, at the height of the market, the land would have been worth \$780 million and at the current time it is perhaps worth \$390 million. However, this price is for the land only and the costs of constructing the building, which are substantial, would be added. Be that as it may, if the same per-square-foot pricing is applied to Saks' flagship store, it would be worth approximately \$419 million (land only). However, top of the line buildings in Manhattan, such as this store, are generally priced around \$1,000 per square foot, which would equate to a \$646 million valuation for the flagship store.

In addition, earlier this year, developer Harry Macklowe sold the 50-story GM building on Fifth Avenue and 59th Street for an estimated \$2.9 billion. This tower has 1.9 million square feet, or approximately three times the square footage of Saks' flagship store. So assuming that the latter would be worth one-third of the price paid for the GM building, it would be worth close to \$1.0 billion.

Using another comparison, the Rockefeller Group Development Corporation recently paid \$62.5 million for a six-story garage at 148 West 48th Street, which is just three blocks away from Saks' flagship store. The approximately 48,700-square-foot garage, situated on a 75-foot by 100-foot lot. The garage site has a development potential of 90,373 square feet. Applying the same per-square foot valuation to Saks' flagship store results in a valuation of \$447 million to \$829 million, using the existing and potential square footage valuation, respectively.

Finally, in 2005, MetLife bought the 40-story 520,000 square foot building on 575 Fifth Avenue, which is located on 47th Street, for \$385 million. While commercial real estate prices may be declining at the current time, they are likely still above the 2005 level. Even so, the price paid implies \$740 per square foot, which applied to Saks' flagship building would result in a \$478 million valuation.

Using a different approach, if the flagship store, which is generally more profitable than the average store, produces revenues of \$650 million per year, and assuming a 5% net profit margin, it would generate earnings of \$32.5 million per year. At a 7% capitalization rate, the store would be worth \$464 million. However, one could easily argue that the building is worth more than its earnings potential as it also serves as an excellent advertising tool for its owner because of its highly exposed location.

While these comparisons are imprecise in that no other building is exactly the same and in that any valuation is subject to market swings, it seems that the flagship store could be valued at between \$500-\$700 million at the midpoint. In addition to its flagship store, the company also owns approximately 3.5 million square feet in other locations such as the 175,000 square foot Beverly Hills, California, location. So Saks clearly has significant flexibility with regard to its balance sheet. If the company were to experience financial distress as a result of a prolonged recession, it could enter a sale-lease back arrangement

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and potentially free up half a billion or more dollars for its flagship store alone. In addition, the company's long-term leases may have value as well. For example, Saks has been leasing a 75,000 square foot store on Greenwich Avenue in Connecticut since 1996. This is a 20-year lease and at the beginning of the lease term, rents on Greenwich Avenue ranged from \$40 to \$60 a square foot whereas recently, these rents have been as high as \$150 to \$200 per square foot. Even given a 5% rent escalation clause, if there is such a clause, Saks' rent would only increase to approximately half of the current market rent. As such, Saks may be able to rent this store to another company at market prices, if its contracts allows for that, for the eight years remaining on its existing lease. While we do not know the details of these leases, in general, the leases could be of significant value to Saks as the example of the Greenwich store demonstrates.

Liquidity and Capital Structure

At the end of the November quarter, Saks had approximately \$20 million in cash on its balance sheet and \$649 million in total debt. The debt amount included \$80.6 million in outstanding borrowings under its \$500 million revolving credit facility. Following the quarter's end, Saks used another \$84.1 million of its revolver to retire its 8.25% notes. As a result, approximately \$335 million remains available under the credit facility, an amount that should allow sufficient liquidity. In addition, the company is not subject to any covenants until only \$60 million remain on the revolver. Saks also had \$25.4 million in unfunded letters of credit, as of November 1. Even taking that into account, Saks would have to borrow another \$250 million before covenants even become an issue.

As dire as the economic forecasts may be, on a free cash flow basis, Saks will probably experience insignificant, if any, losses over the next year. The company should be able to slow its development and capital expenditure projects so that these expenses amount to less than its depreciation and amortization charges, which currently are \$130-\$140 million per year. Saks has already announced that it will cut its capital expenditures in FY2009 to \$75 million from \$125 million this year, mostly from delaying remodel projects and cooperative vendor shop construction. That will boost free cash flow by approximately \$50 million in 2009. In addition, if the company can trim inventory and improve its cash conversion, its free cash flow will likely be close to flat in 2009 under these assumptions, even though the company may report net losses of around \$80 million in 2009, which is widely expected.

Saks has \$192.3 million in senior notes outstanding, after taking its recent \$84.1 million maturity payment into account and a convertible note due in 2024. This debt matures on the following dates:

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Maturity	Amount	Coupon	Rating	Recent Price	Yield	Value
12/1/2010	\$46MM	7.5%	B	\$83.00	18.2%	\$38MM
10/1/2011	\$142MM	9.9%	B	\$61.00	32.8%	\$90MM
12/1/2013	\$3MM	7.0%	B	\$77.00	14.6%	\$2MM
12/15/2019	\$2MM	7.4%	B	\$62.00	13.7%	\$1MM
3/15/2024	<u>\$230MM</u>	2.0%	B	\$46.00	8.3%	<u>\$107MM</u>
	<u>\$423MM</u>					<u>\$238MM</u>

The conversion price of Saks' March 15, 2024 Convertible notes is a share price of \$11.97, and holders can convert their notes into shares once the company's share price is 20% above that level, or \$14.36 per share, for a certain trading period. It is likely that Saks' shares will reach this level well before 2024 and that these notes will be converted into shares. However, Saks can call its convertible debt on or after March 11, 2011 if its liquidity position allows it to do so. Furthermore, according to the terms of the debentures, Saks can settle a conversion with shares and/or cash and the holder is allowed to put the debt back to the company in 2014 or 2019. In addition to its outstanding debt, Saks also had \$62.2 million in capital leases covering various properties and pieces of equipment and Saks is required to make lease payments of around \$5 million and \$7 million per year on these leases.

The current market prices of Saks' debt securities are significantly below their respective par values as the table above indicates. As a result, the market value of all of its publicly traded debt is only \$239 million. Therefore, at these prices, it could make sense for Saks to buy back some of the debt on the open market, or through a Dutch Auction. To finance this transaction, it could enter into a sale-leaseback transaction for some of its 31 owned stores.

Company Overview

Saks Incorporated operates fashion retail stores under the brand names of Saks Fifth Avenue and Saks Fifth Avenue OFF 5TH, offering a range of high-end fashion apparel, shoes, accessories, jewelry, cosmetics, and gifts. Saks Fifth Avenue stores are usually free-standing stores in shopping destinations or anchor stores in upscale regional malls. Saks stores carry high-end merchandise from both new and emerging designers and well-known vendors including those made by Giorgio Armani, Chanel, Gucci, Prada, Louis Vuitton, St. John, Zegna, Theory, Juicy Couture, David Yurman, Hugo Boss, Elie Tahari, Ralph Lauren, Akris and Burberry, among others. While most of its stores are located in the US, the company also operates Saks Fifth Avenue stores in Riyadh, Saudi Arabia, Dubai, United Arab Emirates and Mexico City, Mexico. Saks also plans to open a store in Shanghai, China during 2009.

Saks Fifth Avenue OFF 5TH is intended to be a high-end off-price retailer in the United States. These stores are generally located in upscale mixed-use and off-price centers and

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offer high-end apparel, shoes, and accessories, targeting value-conscious consumers. As of November 1, Saks operated 53 Saks Fifth Avenue stores with 5.9 million square feet, 49 Saks Fifth Avenue OFF 5TH stores with 1.4 million square feet, and 98 Club Libby Lu specialty stores, which includes 78 standalone stores and 20 store-in-stores in the former Saks Department Store Group businesses, with 142 thousand square feet. However, a few weeks ago, Saks announced that it plans to close down its Club Libby Lu specialty store business by the end of April, 2009. This business line generated revenues of approximately \$60 million in FY2008. The company expects to record total charges of around \$55 million to close these stores. The company also sells its products through its catalog or its website; however, Saks does not break out the sales generated by its Saks Fifth Avenue, Off 5th and Internet/Catalog sales.

Saks has a credit card alliance with HSBC and there are approximately 800,000 proprietary credit accounts that have been active within the prior twelve months, and approximately 44% of the company's FY2007 sales were transacted on these HSBC's proprietary credit cards. Another interesting statistic is that Saks' flagship store traditionally accounts for 20% or more of the company's overall sales, despite the fact that it is just one of over 100 stores.

Saks' merchandise is dominated by apparel, which constitutes about 53% of the total assortment. While Saks operates the vast majority of the various departments in the Saks Fifth Avenue stores, a few departments are also leased to independent companies, primarily in areas for which specialization and expertise are critical. Examples of these departments include furs and certain designer handbags. Saks usually leases these departments under one- to seven-year agreements and generally requires the lessee to pay for a portion of the fixtures and provide its own employees. These leased departments make up slightly less than 1% of the company's total revenues. Excluding these leased departments, in FY2007, Saks generated the following sales by merchandise category:

Women's Apparel	36.9 %
Accessories	20.0 %
Cosmetics	15.3 %
Men's Apparel	14.3 %
Shoes	9.1 %
Intimate Apparel	1.7 %
Outerwear	1.3 %
Home and gifts	0.9 %
Children's Apparel	0.5 %
Total	100.0%

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Background

Saks's background can be traced back to Andrew Saks, who was born in Baltimore, Maryland in 1847, and later moved to Washington, D.C. where he established a clothing business in 1867 that grew to include stores in other cities. He moved to New York and opened Saks & Company in 1902 at Sixth Avenue and 34th Street with the help of his brother Isadore and his sons Horace and William. When Andrew died in 1912, he was succeeded by the Princeton-educated Horace.

In 1923 Saks & Co. merged with Gimbel Brothers, Inc., operating as a separate autonomous subsidiary. Looking for a higher class of clientele, Horace pushed his new associate, Bernard Gimbel, to open an upscale store on Fifth Avenue. Gimbel and Saks opened Saks Fifth Avenue on September 15, 1924. The beautiful building was awarded a Gold Medal from the Fifth Avenue Association and is now on the designation list of the New York Landmarks Preservation Commission. The company targeted upscale customers from the beginning. It was the first specialty store to expand across the nation. After Horace Saks died suddenly of septic poisoning in 1926, Bernard Gimbel's cousin Adam, who had been Horace's assistant, was named president of Saks Fifth Avenue. Adam Gimbel created small specialty shops within the store, which he had redecorated in the dramatic Art Moderne style. He filled Saks Fifth Avenue with exclusive merchandise from Europe and the US and established small boutiques that made custom men's shirts and ladies' made-to-order dresses. He built the fine shoe business and believed in a large stock, even in difficult economic times, so customers could have a large range of choices.

Adam also gave the company national aspirations. The first branch store opened in 1926 in the city of Palm Beach, Florida as a resort store, followed by a Southampton resort store in 1928. The first full-line year-round Saks store was opened in Chicago in 1929, followed by another resort store in Miami Beach, Florida. In 1938 Saks expanded to the West Coast, opening in Beverly Hills, California. By the end of the 1930s Saks Fifth Avenue had a total of 10 stores, including resort locations such as Sun Valley, Mount Stowe and Newport. More full-line stores followed with Detroit in 1940 and Pittsburgh in 1949. In downtown Pittsburgh, the company moved to its own freestanding location approximately one block from its former home on the fourth floor in the downtown Gimbel's flagship. The San Francisco location opened in 1952. More expansion followed from the 1960s through the 1990s including Texas, the Midwest, and the South.

Both chains prospered, with Gimbel's and Saks & Company supplying all income levels, while Saks Fifth Avenue appealed to the well-heeled. By 1969, the year Adam retired, there were 28 Saks Fifth Avenue stores in 16 states. In addition to the geographic expansion, Saks Fifth Avenue branched into direct mail sales in 1970. In 1973 the U.S. subsidiary of British American Tobacco (B.A.T.) offered to purchase Gimbel Bros. As the company was experiencing financial difficulties at the time, it was a welcome bid. The new owner renovated the Fifth Avenue store in 1978 and later closed the Gimbel chain in 1986. In 1990, Saks Fifth Avenue was sold for \$1.5 billion to Bahrain-based Investcorp S.A., an international investment group that also owned a 50% stake in Gucci Group and 3% of

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Tiffany & Co. at the time. After weathering the early 1990s recession, Investcorp took Saks public in 1996 as Saks Holdings, Inc.

Financial circumstances caused the firm to open Clearinghouse (now known as 'Saks Fifth Avenue OFF 5TH'), an outlet store for Saks Fifth Avenue merchandise in 1992. In an effort to enhance its West Coast presence, the chain acquired four I. Magnin stores in 1994, though the chain was phased out in 1995. Also in 1995, Saks Fifth Avenue opened the largest store in Beverly Hills, known as Saks West. The following year, 1996, the holding company, Saks Holdings, went public and opened more compact stores under the name 'Main Street' to address the demand of small but wealthy areas.

In 1998, Saks Holdings was purchased by Proffitt's, a company based in Birmingham, Alabama, for \$2.3 billion in an all-stock transaction. Proffitt, which already owned department store chains Carson, Pirie, Scott and Parisian, changed its name to Saks Incorporated to capitalize on the higher prestige of its new acquisition. Throughout this decade, the company has divested all of Proffitt's original store brands. What was known as the Saks Department Store Group, (which consisted of the Proffitt's and McRae's chains, each with approximately 22-25 stores) were sold to Belk, Inc. in July 2005. Saks also operated the Northern Department Store Group under the nameplates of Bergner's (14 stores), Boston Store (10), Carson Pirie Scott (31), Herberger's (40) and Younkers (47) and sold these operations to The Bon-Ton Stores, Inc. in March 2006. Furthermore, the company also sold its 38 stores operating under the Parisian name to Belk in October 2006. Recently, as stated above, Saks also decided to close its unprofitable Club Libby Lu stores, which specialize in young girls' clothing. Consequently, at the current time, Saks Inc. only operates Saks Fifth Avenue stores and Saks Fifth Avenue OFF 5TH outlet-styled stores, in addition to catalog and website sales.

Poison Pill

Just a few weeks ago, Saks adopted a poison pill strategy, most likely to defend itself from a takeover attempt by Mexican investor Carlos Slim Helú, who has accumulated an 18% stake in the company and is now its largest shareholder. Mr. Slim boosted his stake in Saks from 17.2 million shares to 25.3 million shares since October 8. It appears that Mr. Slim purchased his last 1.5 million shares approximately one month ago at prices ranging from \$2.76 to \$3 per share (average \$3.31) so he likely believes that the company is worth considerably more than that.

According to the poison pill strategy, Saks will distribute one preferred share purchase right for each of the company's common shares. The rights would become activated if a person or group acquires 20% or more of Saks' shares. At that point, other shareholders have the right to buy additional shares at a 50% discount, among other features. Saks will also impose a significant penalty upon any entity which acquires 20% or more of the company's outstanding common stock without the prior approval of the Board of

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Directors. However, it appears that a possible takeover attempt by Mr. Slim might not necessarily be rejected as long as it is a cash offer that is acceptable to the board of directors. Therefore, as long as the bidders/acquirers have obtained prior approval by the board of directors, the poison pill will not become activated.

Financial Performance

Saks sales declined by 12.3% year-over-year in the third quarter of FY2008, to \$698.0 million as compared to \$796.1 million in the 2007 period. Consolidated comparable store sales decreased \$89.2 million in the quarter, or 11.5%, from \$778.4 million in the year-earlier period to \$689.2 million in this year's third quarter. Saks' comparable store sales declined 5.9%, 10.9%, and 16.6% in August, September, and October, respectively, indicating that the trend is worsening. However, in November, the same store sales declined actually moderated to a negative 5.2%.

Saks experienced a progressive softening in the quarter across all geographies, merchandise categories and distribution channels. That being said, the declines were particularly impacting women's apparel and women's shoes and handbags. Some of the relatively better-performing merchandise categories for Saks Fifth Avenue during the quarter included cosmetics, fragrances, jewelry, men's contemporary sportswear, and men's shoes.

Saks Fifth Avenue OFF 5TH's comparable store sales performance in the third quarter was better than the company's average for the period, even though business trends were significantly below prior quarters. While Saks' same-store sales have declined every month since June, sales generated by its website are increasing. In the November quarter, these sales grew 10% compared to the third quarter of 2007. This growth rate was down from nearly 40% in the year prior. As Saks recently added the ability to ship merchandise to Canada from its website, its Internet sales may continue its strong growth rates. While Saks does not break out the Internet/catalog sales as a percentage of total, we know that Neiman Marcus generated 16.5% of its total sales in its August 2008 quarter from its Direct Marketing segment, which are its Internet/catalog sales. Assuming that Saks generates a similar percentage of its total sales from Internet/catalog sales and that it can grow these revenues another 10% in 2009, it would provide a positive contribution of 1.65% to the overall growth rate of the company. Under those circumstances, if its stores, which make up the remaining 83.5% of overall sales, experience same-store sales declines of 2.0%, the net result will be flat revenues in 2009.

Growth at the company's Fifth Avenue flagship store, which generates approximately 20% of the company's revenues, slowed considerably in October and this trend will likely continue based on the current economic outlook. As discussed above, the flagship store had also been fairly reliant on foreign tourist spending, which is declining rapidly as the

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dollar has appreciated and as the economic downturn overseas has intensified. During the Holiday season, the flagship store traditionally attracts wealthy clientele from the New York region who, in a time of economic crisis, rising unemployment and reduced Wall Street bonus payouts, will likely pull back on their spending considerably. As a result, it is likely that the Saks Fifth Avenue OFF 5TH outlet stores and the Saks online businesses will continue to outperform the retail stores.

Because of markdowns and other promotional activities, Saks gross margin fell by 6.4 percentage points in the third quarter to 35.6%, or \$248.3 million, compared to 42.0% or \$334.1 million generated in the third quarter of last year. Given the state of the economy, it is likely that the rate of decline will be even more dramatic in the fourth quarter as Saks will continue aggressive promotion, particularly as inventory is misaligned against recent comparable store sales trends (with comparable inventory up 4.4% year over year at the end of the third quarter). Approximately 450 basis points of the year-over-year deterioration was the result of an increase in markdowns, an increase in the percentage of business generated during promotional days as consumers continue to shift purchases to promotional events, and the inability to leverage a relatively fixed level of permanent markdowns during the quarter. The balance of the rate deterioration related to the acceleration of certain permanent markdowns from the fourth quarter last year into the third quarter this year and modest deleverage on buying and distribution costs. The fact that this much promotional activity took place so early in the fall season is troubling for Saks, although most retailers experienced the same pattern as luxury consumption is down sharply across the board because of the decrease in consumer confidence and the ongoing recession. With comparable inventory still expected to be up at the end of the fourth quarter, gross margin pressure will likely continue into 2009.

Consolidated inventories at November 1, 2008 totaled \$1.02 billion, an approximate 4.0% increase over the prior year. Inventories increased approximately 4.4% on a comparable stores basis. The reason for this is that Saks had planned for holiday sales to rise in the low single digits. With the recent economic downturn and resulting declines in same store sales, Saks had too much inventory, which should result in lower gross margins over the next few quarters. The company is working with its vendors to trim receipts and cancel orders, and has ordered 15% less merchandise for the spring. The company also plans a substantial decrease in capital spending next year. This should allow margins to stabilize in the second half of 2009 from the precipitous second half drop in 2008. Consequently, Saks' gross margin may improve in the second half of 2009 as the company will by then have cut inventories significantly and will benefit from easy comparisons against 2008's weak results.

Selling, General & Administrative expenses were \$183.0 million, or 26.2% of Sales, in the third quarter compared to \$206.0 million, or 25.9% of Sales, in the same period in the prior year. While these expenses declined sharply on an absolute basis, Saks should still be able to reduce these expenses further in the fourth quarter and into FY2009 as approximately one-third of SG&A expenses is variable based on sales. However, while these expenses

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most likely will decline in dollar terms, as a result of declining sales, SG&A expenses will likely increase slightly in as a percentage of sales 2009. However, these savings, to the extent that they can materialize, will most likely be partially offset by an expected increase in pension expenses of \$12-\$14 million in 2009. For the third quarter, other operating expenses (rents, depreciation, taxes other than income taxes and store pre-opening costs), including store pre-opening costs, were \$83.2 million, or 11.9% of sales, compared to \$82.2 million, or 10.3% of sales, for the three months ended November 3, 2007. As a percent of sales, other operating expenses increased 160 basis points in 2008, reflecting the rate deleverage caused by the 11.5% comparable store sales decline in the current year third quarter. If fewer stores are opened in the next year, which seems likely, these expense may decline accordingly.

The year-over-year third quarter operating loss totaled \$18.0 million this year compared to operating income of \$51.3 million last year. Saks has set a target of 8% operating margins, but this goal will likely not be achievable in the near term. The company recorded a net loss of \$42.8 million, or \$0.31 per share in this year's third quarter compared with a profit of \$21.6 million, or \$0.14 in the year-ago period. The third quarter of the current fiscal year included after-tax items totaling \$24.5 million, or \$0.18 per share including expenses of \$10.6 million related to the closing of it Club Libby Lu operations, and the write-off and adjustment of \$14.6 million of deferred tax assets. Saks expects to complete the majority of the Club Libby Lu closings by the end of its fourth quarter, ending January 31. The company expects to record further after-tax impairment charges of approximately \$18 million to \$27 million in the fourth quarter. In addition, Saks expects to record approximately \$3 million of one-time severance costs, and approximately \$15 million to \$24 million related to inventory liquidation, store closure and lease termination costs.

Expected inventory reductions over the next few quarters should have a positive impact on the company's cash flow. Saks is also reducing its capital expenditures to \$75 million in 2009 from \$125 million anticipated in 2008. With management's intense focus on the company's cash position we expect disciplined oversight of working capital in the coming year, which should allow the company to generate positive or breakeven free cash flow in 2009. Operating EBITDA for the first three quarters declined by 48% to \$78 million from \$150 million in the comparable year ago period,

In the third quarter, Saks did not repurchase any shares of common stock. However, on a year-to-date basis, the company has repurchased approximately 2.9 million shares (or around 2% of the shares outstanding) at an average price of \$11.83. It has remaining availability of approximately 32.7 million shares under its existing repurchase authorization programs.

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Valuation

There is little doubt that the next few quarters will be difficult for Saks as over-stretched consumers are pulling back their spending habits, or simply do not have access to the same credit they had enjoyed up until recently. As a result of the current macroeconomic and unprecedented retail environment, it is impossible to predict Saks revenues, but these are widely expected to decline in the current fiscal year as well as in the upcoming FY2009. With declining sales and, at least up until recently, rising inventories, Saks will likely have to discount a larger percentage of its inventory as compared to the prior year and, everything else being equal, the company should report worsening gross margins, operating margins and net profit over the next year at least.

However, even though Saks is experiencing the worst recession in decades and the first consumer-led recession in four decades, it will most likely report flat or slightly positive free cash flow, even in this challenging environment. With \$20 million in cash and \$335 million left in its revolving credit line, Saks should easily survive the current economic crisis. In fact, even the most negative analyst of the 11 analysts who cover Saks expects the company to lose 'only' \$1.00 per share in upcoming fiscal year 2009 (ending January 31, 2010). This would equate to a loss of approximately \$138 million. Adding in another \$40 million loss for the current quarter, which is the most pessimistic forecast at this time, would result in total losses up until January 31, 2010 of approximately \$178 million. However, because of its significant non-cash amortization and depreciation charges, on a free cash flow basis, the impact will be far less. Over the next five quarters, Saks should record approximately \$165 million in non-cash amortization and depreciation charges at the current run rate, an amount that reduces reported earnings. That being said, Saks will most likely incur capital expenditures of approximately \$100 million over the next five quarters. Consequently, in this worst case scenario, Saks' available funds would diminish by approximately \$113 million (\$178 million - \$165 million + 100 million). That would leave Saks with a full \$242 million in cash and remaining credit line capacity.

Furthermore, the assets are most likely worth considerably more than the book value indicates as Saks is not allowed to mark up the value of its real estate to reflect current market prices, but instead records annual depreciation and amortization charges of approximately \$135 million. As a result, Saks' accumulated depreciation accounts for almost \$900 million and this reduces the cost basis of its long-lived assets to \$1.1 billion from \$2.0 billion. As such, assuming that the properties have not declined in value from the time they initially appeared on Saks' balance sheet, the company's tangible book value would be approximately \$2.0 billion as well, or almost \$14 per share. Even this calculation could be conservative as it only assumes that the value of Saks' properties have remained at cost and not increased in value. As some properties have been on the books for decades, they have likely increased significantly in value. For example, Saks' flagship store on Manhattan's Fifth Avenue opened in 1924 and is most likely on the books for a nominal amount at this point, even though one can make a strong case that the building could be worth \$500-\$750 million if sold.

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However, most experts are currently predicting declines in commercial real estate of 10%-20% before the recession is over. In addition, assuming that the current value all of Saks' long-lived assets are the fully depreciated value currently on its balance sheet, or \$1.07 billion, and not the gross value of \$2.0 billion as we argue above, under such a scenario Saks' real estate value would be only \$858 million following a 20% decline in commercial real estate values. Assuming further that the company's free cash flow between now and the end of the recession will not be flat, as we estimate above, or even just a negative \$113 million, which is derived using the most pessimistic assumptions, but in this draconian scenario we will assume that Saks will lose \$300 million on a free cash flow basis before the recession is over. Even in this case, the company's tangible book value would decline from \$1.1 billion to \$583 million, indicating that there should still be significant equity value and that there should be more than enough assets remaining for Saks to continue to service its debt and remain solvent.

Consequently, the bonds seem to have more than adequate protection, and with yields from 14%-32% on its senior notes, the risk/reward appears to be favorable. The convertible notes, although yielding less at only 8.3%, could become very valuable once the company gets through the recession. We note that Neiman Marcus, a fairly comparable company as it operates both high-end and a website/catalog business, was acquired in 2005 by Texas Pacific Group and Warburg Pincus for \$5.1 billion. At that time, the company operated 35 Neiman Marcus full-line stores at prime retail locations in major US markets and two Bergdorf Goodman stores on Fifth Avenue in New York City. Based on its FY2005 sales of \$3.82 billion and \$241 million in earnings, the purchase price represented 1.34x sales and 21x earnings.

Similarly, in September 2007, Istithmar, an investment firm based in Dubai, acquired Barneys for \$942 million. Barneys, much like Saks, operates both high-end stores and outlet stores and it is very dependent on its New York flagship store. While Istithmar does not announce sales and earnings for Barneys we know that it generated 2007 sales of \$452 million and operating income of \$11 million up until September 6th, 2007. Annualizing these numbers, Barneys' 2007 revenues might have been close to \$600 million and its operating income closer to \$15 million. However, by annualizing these numbers we exclude the effect of the holiday season. By comparison, in 2006, Barneys generated \$29 million in operating earnings on \$656 million in sales. Assuming a modest growth rate in 2007, Barneys might have generated sales of approximately \$700 million in 2007 and operating earnings of \$32 million. If so, Istithmar's purchase price represents 1.34x sales and 29x operating earnings.

Applying these valuations to Saks, at 1.34x sales, the company would be worth \$4.2 billion based on its estimated 2008 sales of \$3.12 billion. Also, to calculate Saks normalized operating earnings, we use the average operating margin during the past ten years, as outlined in the table below:

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<u>Saks Operating Margin</u>										
2007	2006	2005	2004	2003	2002	2001	2000	1999	1998	<u>9.6%</u>
7.1%	6.9%	11.1%	12.8%	7.5%	8.1%	6.4%	8.7%	13.4%	13.5%	

If Saks can generate 9.6% in operating margin in, say 2011, it would earn approximately \$300 million in operating earnings, assuming revenues remain constant at \$3.12 billion. If the operating earnings multiple paid by Istithmar for Barneys is applied, Saks would be worth \$8.7 billion. Assuming a 35% tax rate, Saks' normalized net earnings would be \$195 million in this scenario, and applying the 21x earnings multiple paid by TPG and Warburg Pincus for Neiman Marcus would result in a \$4.1 billion valuation for Saks. On a per-share basis, these valuations represent \$27 - \$63 per share for Saks. However, multiples such as these are generally only awarded during good times and not in the middle of a recession, such as that which we are experiencing at the current time. Even so, for long term investors, the convertible can provide reasonable safety and an 8.3% yield to maturity at the current time, while also providing excellent long-term return if Saks' shares were to potentially gain 10-fold over the next few years.

Investment Summary

If Saks operating business were to continue to weaken, as a result of the on-going recession, the company may attract buyout offers from investment companies that are more interested in real estate than retailing. While it could be argued that, at the current time, Saks is worth more dead than alive - in other words, the value of its real estate seems to easily eclipse its current enterprise valuation - the brand name of Saks Fifth Avenue clearly has significant value in and of itself and patient investors will likely experience significantly better returns if the company continues to operate as opposed to if it liquidates its business. However, whether Saks were to liquidate its business or not, it appears that its debt securities are well protected and provide attractive yields. Consequently, all series of Saks' debt securities are recommended for purchase.

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SAKS INCORPORATED and SUBSIDIARIES
CONDENSED CONSOLIDATED BALANCE SHEETS
(Dollar amounts in thousands)
(Unaudited)

	November 1, 2008	February 2, 2008	November 3, 2007
ASSETS			
Current Assets			
Cash and cash equivalents	\$ 20,008	\$ 101,162	\$ 63,464
Merchandise inventories	1,016,192	857,173	976,880
Other current assets	119,917	124,973	102,172
Deferred income taxes, net	35,954	42,827	23,509
Total current assets	<u>1,192,071</u>	<u>1,126,135</u>	<u>1,166,025</u>
Property and Equipment, net	1,072,990	1,092,004	1,091,196
Intangibles, net	277	297	304
Deferred Income Taxes, net	100,758	97,108	144,224
Other Assets	50,537	55,480	35,862
TOTAL ASSETS	<u>\$2,416,633</u>	<u>\$2,371,024</u>	<u>\$2,437,611</u>
LIABILITIES AND SHAREHOLDERS' EQUITY			
Current Liabilities			
Trade accounts payable	\$ 250,353	\$ 176,844	\$ 264,450
Accrued expenses and other current liabilities	258,384	282,311	278,025
Dividend payable	1,421	2,641	2,653
Current portion of long-term debt	169,429	319,242	260,433
Total current liabilities	<u>679,587</u>	<u>781,038</u>	<u>805,561</u>
Long-Term Debt	479,831	253,346	338,554
Other Long-Term Liabilities	159,377	161,034	166,031
Total liabilities	<u>1,318,795</u>	<u>1,195,418</u>	<u>1,310,146</u>
Commitments and Contingencies	—	—	—
Shareholders' Equity	<u>1,097,838</u>	<u>1,175,606</u>	<u>1,127,465</u>
TOTAL LIABILITIES AND SHAREHOLDERS' EQUITY	<u>\$2,416,633</u>	<u>\$2,371,024</u>	<u>\$2,437,611</u>

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SAKS INCORPORATED and SUBSIDIARIES
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(In thousands, except per share amounts)
(Unaudited)

	Three Months Ended		Nine Months Ended	
	November 1, 2008	November 3, 2007	November 1, 2008	November 3, 2007
NET SALES	\$ 698,037	\$ 796,063	\$2,229,622	\$2,282,916
Cost of sales (excluding depreciation and amortization)	449,741	462,001	1,418,230	1,373,808
Gross margin	248,296	334,062	811,392	909,108
Selling, general and administrative expenses	183,040	205,981	581,891	613,084
Other operating expenses:				
Property and equipment rentals	28,551	28,086	85,779	83,635
Depreciation and amortization	32,904	33,555	98,446	100,081
Taxes other than income taxes	20,928	20,137	64,619	62,106
Store pre-opening costs	848	436	1,436	697
Impairments and dispositions	17,134	413	18,493	4,111
OPERATING INCOME (LOSS)	(35,109)	45,454	(39,272)	45,394
Interest expense	(9,961)	(10,199)	(29,970)	(32,100)
Loss on extinguishment of debt	—	—	—	(5,634)
Other income, net	1,487	2,333	3,174	6,903
INCOME (LOSS) BEFORE INCOME TAXES	(43,583)	37,588	(66,068)	14,563
Provision (benefit) for income taxes	(828)	15,998	(9,881)	6,562
NET INCOME (LOSS)	\$ (42,755)	\$ 21,590	\$ (56,187)	\$ 8,001
Net Income (Loss) per share - Basic	\$ (0.31)	\$ 0.15	\$ (0.41)	\$ 0.06
Net Income (Loss) per share - Diluted	\$ (0.31)	\$ 0.14	\$ (0.41)	\$ 0.05
Weighted average common shares:				
Basic	137,715	141,102	138,713	141,077
Diluted	137,715	153,049	138,713	153,853