



# VRA

# Snapshot



NEGATIVE

## EarningsQuality

ANALYTICS

14 NOVEMBER 2011

### Vera Bradley Inc.

www.verabradley.com

Industry	Apparel, Accessories, & Luxury Goods
Price	\$42.25 (11/11/11)
Market Cap	1.71 billion
Enterprise Value	1.78 billion
P-E Ratio	30.35
EV/Revenue	4.39
Debt/EBITDA	0.92
Short Interest	50.3%
Days to Cover	16.5

**Considerations:** ❶ Indirect sales growth has been inconsistent of late, while gross margin declined in the latest quarter. ❷ A sharp rise in accruals may indicate an increase in earnings quality-related risks relative to prior periods. ❸ Abnormal increases in AR and inventory may signal an elevated risk of a potential sales or earnings miss.

### Company Description

- Vera Bradley Inc. (VRA), through its subsidiary, Vera Bradley Designs Inc., engages in the design, production, marketing, and retail of functional accessories for women under the “Vera Bradley” brand. Its products include a range of handbags, accessories, and travel and leisure items. The company sells its products to independent and national retailers and third-party e-commerce sites through its indirect reporting segment. VRA also sells through its direct reporting segment consisting of 43 full-price stores, six outlet stores, three pop-up shops in Japan, and its e-commerce sites: verabradley.com and verabradley.co.jp. The company was founded in 1982 and is based in Fort Wayne, Ind.
- **Note regarding data constraints of this analysis:** VRA recently completed its initial public offering on 10/21/10. The following analysis is built on the financial statements provided in VRA’s prospectus; a 10K filing for fiscal year 2011; 10Q filings for Q3 FY2011, Q1 FY2012, and Q2 FY2012; and related earnings announcements. As a result, we have limited balance-sheet and cash-flow statement data for prior years.

1

### Key Fundamental Trends

- Three-month (12-month) total revenue for Q2 FY2012 totaled \$103.8 million (\$406.2 million), up 29.6% (25.8%) YOY. Most of this growth came from the company’s direct segment, where revenues increased 46.3% (54.2%) YOY to \$47.9 million (\$179.6 million) for the three months (12 months) ended 07/30/11. Direct (store) revenue has benefited from expansion of the company’s store base. Current plans call for the addition of 14 to 20 stores annually to an estimated 300 total units in the United States.
- Though indirect segment revenue rose 18.1% (9.7%) YOY to \$55.9 million (\$226.6 million) in FQ2 (the TTM period), revenue growth for the segment generally has been decelerating. In this context, YOY growth in quarterly indirect revenue declined for three consecutive quarters through Q1 FY2012. During this period, quarterly revenue growth fell from a high of 17.0% in Q2 FY2011 to 5.7% in Q1 FY2012. Additionally, the sudden upturn seen in Q2



2012 was accompanied by a surge in accounts receivable. As such, it may indicate that demand was pulled forward relative to normative seasonal sales trends.

- Three-month (12-month) gross margin was 57.5% (56.5%) for Q2 FY2012, down 102 (flat) basis points YOY from 58.5% (56.5%) in Q2 FY2011. Management attributed this decline to an increase in input costs, in particular for cotton and Chinese labor (Q2 FY2012 analyst call). Despite planned price increases, management is guiding for a 50 bps decline in gross margin for the fiscal year.

**Table 1. Quarterly Revenue and Margin Trends**  
(\$ in millions)

3M Ended:	07/30/11	04/30/11	01/29/11	10/30/10	07/31/10
Total direct revenue	\$47.9	\$44.1	\$55.7	\$31.8	\$32.7
Indirect revenue	\$55.9	\$57.2	\$53.7	\$59.8	\$47.4
Total revenue	\$103.8	\$101.4	\$109.4	\$91.6	\$80.1
Gross margin %	57.5%	55.7%	56.5%	56.4%	58.5%
Operating margin %	22.1%	18.8%	24.3%	-0.2%	12.1%
<u>Change YOY</u>					
Total direct revenue	46.3%	43.2%	61.1%	74.1%	70.5%
Indirect revenue	18.1%	5.7%	6.2%	9.7%	17.0%
Total revenue	29.6%	19.3%	28.5%	25.9%	34.2%
Gross margin (bps)	(102)	(176)	128	160	893
Operating margin (bps)	1,002	(155)	313	(1,840)	141

**Table 2. Trailing 12M Revenue and Margin Trends**  
(\$ in millions)

12M Ended:	07/30/11	04/30/11	01/29/11	10/30/10	07/31/10
Total direct revenue	\$179.6	\$164.4	\$151.1	\$130.0	\$116.4
Indirect revenue	\$226.6	\$218.0	\$214.9	\$211.8	\$206.5
Total revenue	\$406.2	\$382.4	\$366.1	\$341.8	\$322.9
Gross margin %	56.5%	56.7%	57.1%	56.9%	56.5%
Operating margin %	16.8%	14.4%	14.6%	13.1%	18.0%
<u>Change YOY</u>					
Total direct revenue	54.2%	59.8%	57.2%	NA	NA
Indirect revenue	9.7%	9.2%	11.5%	NA	NA
Total revenue	25.8%	26.4%	26.7%	NA	NA
Gross margin (bps)	0	205	483	NA	NA
Operating margin (bps)	(119)	(374)	(126)	NA	NA



2

### Growth in Accruals May Indicate Elevated Earnings Quality-Related Risks

- Operating accruals surged to 45.6% of average current assets in Q2 FY2012, up 1,588 basis points from 29.8% a year ago. The jump in operating accruals was driven by increases in both inventory and accounts receivable, both of which are discussed in more detail in the final section of our analysis.
- Total accruals rose sharply to 17.4% of average total assets in Q2 2012, compared to -0.1%, -0.5%, and 9.6% in Q1 FY2012, Q4 FY2011, and Q3 FY2011, respectively. However, the Q2 FY2012 total accruals are not as high as the 18.1% recorded a year ago. In addition to the trends in AR and inventory noted below, the increase in total accruals is also explained in part by growth in CapEx relative to depreciation. We are less concerned about the divergence between CapEx and depreciation, as it appears to be adequately explained by the expansion of the firm's retail store base.

**Table 3. Cash-Flow and Accruals Trends**  
(\$ in millions)

12M Ended:	07/30/11	04/30/11	01/29/11	10/30/10	07/31/10
Net income	\$45.1	\$40.6	\$46.2	\$49.3	\$56.0
EBITDAS	\$93.5	\$79.7	\$77.6	\$70.5	\$68.6
CFOA	\$23.6	\$52.8	\$58.5	\$42.1	\$36.5
CapEx	\$13.1	\$11.9	\$11.4	\$8.3	\$8.2
Free cash flow	\$10.5	\$40.8	\$47.1	\$33.9	\$28.3
Operating accruals/Avg. CA	45.6%	19.2%	14.6%	24.5%	29.8%
Total accruals/Avg. TA	17.4%	-0.1%	-0.5%	9.6%	18.1%
<b>Change YOY</b>					
Net income	-19.5%	-22.8%	6.9%	NA	NA
EBITDAS	36.4%	21.8%	37.7%	NA	NA
CFOA	-35.3%	7.1%	-11.4%	NA	NA
CapEx	58.9%	60.2%	94.5%	NA	NA
Free cash flow	-62.7%	-2.4%	-21.7%	NA	NA
Operating accruals/Avg. CA (bps)	1,588	NA	NA	NA	NA
Total accruals/Avg. TA (bps)	(72)	NA	NA	NA	NA

3

### Abnormal Growth in AR and Inventory

- Inventory rose 39.3% YOY to \$118.1 million, versus a 29.6% (25.8%) increase in three-month (12-month) total revenue. As a result, inventory to three-month (12-month) total revenue was 113.8% (29.1%) in Q2 FY2012, compared to 100.5% (26.6%) in Q1 FY2012 and 105.9% (26.3%) in Q2 FY2011. According to management, the build in inventory is related to the recent expansion of the firm's store base and anticipated new store openings.
- AR rose 73.5% YOY to \$44.7 million in Q2 FY2012, versus three-month revenue growth of 29.6% YOY. Consequently, AR to three-month indirect (total) revenue surged to 80.0% (43.1%), compared to 62.0% (35.0%) in Q1



FY2012 and 54.4% (32.2%) a year ago. Management stated that the increase in accounts receivable was related the timing of shipments, and that the balance had declined as of the date of the Q2 FY2012 conference call. However, we remain concerned that the timing of shipments/billings may also indicate a shift in the timing of revenues relative to normal seasonal patterns for the firm. If so, FQ3 revenue may face headwinds that could jeopardize the company's ability to meet expectations.

**Table 4. Inventory-Performance Trends**  
(\$ in millions)

	Period Ended:	07/30/11	04/30/11	01/29/11	10/30/10	07/31/10
Inventory		\$118.1	\$101.9	\$96.7	\$83.7	\$84.8
Inventory/3M total revenue		113.8%	100.5%	88.4%	91.4%	105.9%
3M DSI		227	202	173	193	216
Inventory/12M total revenue		29.1%	26.6%	26.4%	24.5%	26.3%
12M DSI		201	194	188	178	NA
<u>Change YOY</u>						
Inventory		39.3%	40.1%	45.4%	64.6%	NA
Inventory/3M total revenue (bps)		790	1,492	1,024	2,149	NA
3M DSI		5.1%	14.8%	23.1%	NA	NA
Inventory /12M total revenue (bps)		282	260	339	NA	NA
12M DSI		NA	NA	NA	NA	NA

**Table 5. Accounts-Receiveable-Performance Trends**  
(\$ in millions)

	Period Ended:	07/30/11	04/30/11	01/29/11	10/30/10	07/31/10
Accounts receivable		\$44.7	\$35.5	\$34.3	\$28.8	\$25.8
AR/3M indirect revenue		80.0%	62.0%	63.9%	48.3%	54.4%
AR/3M total revenue		43.1%	35.0%	31.4%	31.5%	32.2%
3M DSO – Indirect revenue		65	56	54	42	61
3M DSO – Total revenue		35	31	26	27	36
<u>Change YOY</u>						
Accounts receivable		73.5%	-5.8%	10.6%	14.8%	NA
AR/3M indirect revenue (bps)		2,553	(753)	252	213	NA
AR/3M total revenue (bps)		1,089	(930)	(509)	(305)	NA
3M DSO – Indirect revenue		7.1%	-3.8%	5.9%	NA	NA
3M DSO – Total revenue		-2.5%	-14.8%	-12.5%	NA	NA



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