TAG® TELSEY ADVISORY GROUP

FOOTWEAR

COMPANY UPDATE

APRIL 4, 2016

DSW - $27.59 **MARKET PERFORM**

Price Target (Current) $29.00

Price Target (Previous) Same

Market Statistics	04/01/2016
Market Capitalization ($MM):	$2,380.9
Enterprise Value (MM):	$2,286.2
Shares Outstanding (MM):	78.9
Avg. Daily Trading Volume (Shrs, 000s):	1,792.2
Short Interest/Float:	9.6%
Insider Ownership (% of Total Shrs Out):	11.3%
Dividend Yield:	2.9%
Stock Exchange:	NYSE

Price Performance	04/01/2016
52-Week Range:	$21.23 - $39.58
YTD % Change:	15.2%
YTD % Change Relative to Index:	16.4%
Implied Return to Price Target:	5.1%

Valuation Metrics (FYE Jan)	2015	2016E	2017E
P/E Ratio	18.4x	17.5x	15.7x
PEG Ratio (using 5-Yr GR)	1.9x	1.7x	1.6x
EV/Sales	0.9x	0.8x	0.8x
EV/EBITDA	8.0x	7.8x	7.2x
FCF Yield	3.5%	5.2%	4.1%

Balance Sheet and Growth Metrics	2015	2016E	2017E
Book Value/Share	11.42	12.71	13.43
Debt/Capitalization	0.0%	12.4%	11.9%
Debt/EBITDA	0.0x	0.5x	0.5x
Adjusted Debt/EBITDAR	3.3x	3.7x	3.6x
ROIC	0.0%	9.3%	9.5%

Same-Store Sales			EPS (Operating)		
Period	**Current**	***Previous***	**Period**	**Current**	***Previous***
1Q15	5.1%	-	1Q15	$0.53	-
2Q15	1.8%	-	2Q15	$0.42	-
3Q15	(3.9)%	-	3Q15	$0.44	-
4Q15	0.7%	-	4Q15	$0.14	-
2015	0.8%	-	2015	$1.54	-
1Q16E	0.4%	-	1Q16E	$0.50	-
2Q16E	1.0%	-	2Q16E	$0.39	-
3Q16E	3.4%	-	3Q16E	$0.53	-
4Q16E	3.0%	-	4Q16E	$0.20	-
2016E	2.0%	-	2016E	$1.62	-
1Q17E	3.4%	-	1Q17E	$0.56	-
2Q17E	3.4%	-	2Q17E	$0.44	-
3Q17E	3.0%	-	3Q17E	$0.58	-
4Q17E	3.0%	-	4Q17E	$0.23	-
2017E	3.2%	-	2017E	$1.81	-

Source: FactSet, company reports, and TAG estimates.

Kelly Chen, CFA
212.584.4609 / kchen@telseygroup.com

Joseph Feldman
212.584.4605 / jfeldman@telseygroup.com

DSW, INC.

DSW: Highlights from Management Meetings

We hosted investor meetings with DSW's senior management team, including CEO Roger Rawlins, CFO Mary Meixelsperger, and Senior Director of IR Christina Cheng in New York last week. Overall, we thought the tone of the meetings was determined and upbeat. 2016 is all about execution as the company focuses on improving the product/value proposition and gaining share.

Heading into 2016, DSW has reassessed its priorities and is committed to execution – focusing on improving the product assortment and value proposition, and leveraging the core of DSW to gain market share. In order to do so, management highlighted its strategic plan, which is built on Focus, Tempo, and Disruption. In this note, we offer some key highlights from our investor meetings. A more in-depth note will follow after we reassess the model.

Focus: Improving the Product/Value Proposition and Gaining Share. In order to improve the product assortment, the company is working on the following initiatives (some are a continuation of the initiatives implemented in 2014).

> **Increasing the penetration of close-out/opportunistic buys.**
> **Adding More Exclusives.**
> **Turning Private Label into Private Brands.**
> **Collaborations.**

Tempo: Reacting More Quickly to the Changing Landscape. Retail is always evolving, and while our companies have all embraced the idea of "omni-channel," companies are struggling to keep pace with the ever-changing demands of the consumer. While we've always viewed DSW as one of the best-in-class players in the footwear space, we were encouraged to hear Mr. Rawlins' message, which seemed to have a greater sense of urgency and a desire to more quickly change and adapt. In our meetings, the company noted that it has eliminated over 30,000 hours within the organization in order to free up time and increase responsiveness.

Disruption: Not Afraid to Try New Categories, Regions, and Channels. In addition to better focus and tempo, the company pledged to be more disruptive in the market place, citing opportunities in Kids, Canada, and regions outside of North America.

TAG VIEW: 4Q15 came in better-than-expected and we were surprised to see the comp in positive territory and encouraged by how quickly the company was able to take action to drive sales and market share gains. We were also encouraged by the company's swift actions in cutting back on tall shaft boots, which helped DSW enter Spring with clean inventory.

Our meetings with management reaffirmed that 4Q15 was a step in the right direction, and it seems like the company is approaching 2016 with renewed vigor and a clear set of priorities aimed at improving the product/value proposition. We are encouraged by the plan but believe the team still needs to execute and show more consistency on the comp. In addition, given the investments in the business, we are also assessing the model to get a better understanding of the company's long-term earnings power.

We left the meetings feeling more upbeat and reiterate our price target of $29, which is based on a P/E multiple of 16x our 2017 EPS estimate of $1.81, which reflects a ~15% discount vs. its historical P/E average of ~19x over the past three to five years.

Key Takeaways from Management Meetings

We hosted investor meetings with DSW's senior management team, including CEO Roger Rawlins, CFO Mary Meixelsperger, and Senior Director of IR Christina Cheng in New York last week. Overall, we thought the tone of the meetings was determined and upbeat. 2016 is all about execution as the company focuses on improving the product/value proposition and gaining share.

2016: It's All About Execution

CEO Roger Rawlins took the helm at the beginning of the year following a roller coaster 2014/2015 that started with negative comps in early 2014 (impacted by unfavorable weather/lack of fashion trends), a strong acceleration by year-end and into early 2015 (fueled by merchant changes and the company's efforts to sharpen the value proposition), which decelerated and took a surprise turn into negative territory in 3Q15, before leveling to a modest positive in 4Q15.

Heading into 2016, DSW has reassessed its priorities and is committed to execution – focusing on improving the product assortment and value proposition, and leveraging the core of DSW to gain market share. In order to do so, management highlighted its strategic plan, which is built on Focus, Tempo, and Disruption.

Focus: Improving the Product/Value Proposition and Gaining Share

Over the past few years, DSW has been working to implement numerous systems initiatives and changes to drive better processes and efficiencies. However, at its core, DSW's business model is built around delivering great products and great brands at a great value, and in hindsight, the company believes that it took its eye off the ball. Mr. Rawlins believes that DSW needs to refocus its attention on product and differentiating the DSW value proposition.

Although the company started to course correct a bit in 2014 when it implemented several merchant changes, sharpened its price points, and focused on driving up the percentage of close-out/opportunistic buys, these were all symptoms of a deeper and broader issue, product, which the company is now completely focused on.

In order to improve the product assortment, the company is working on the following initiatives (some are a continuation of the initiatives implemented in 2014).

> **Increasing the penetration of close-out/opportunistic buys.** Opportunistic (typically closeout) buys have historically accounted for 10%-15% of the company's assortment. Merchandise acquired under these circumstances are usually designated in stores as a "Big Deal," and are over 40% off MSRP, which helps drive home DSW's value proposition.

  In 2013, the penetration of opportunistic buys slid down into the low-HSD range when the process of closeout buys was decentralized following the retirement of the company's previous closeout buyer. In late 2014, the company reinstated the closeout buyer position, and ended the year with closeout penetration in the 8% range. In 2015, the penetration improved to 10%, and going forward, the company is targeting a penetration rate closer to 15%, which should help push the value part of the consumer proposition.

  While the availability of closeout inventory is typically more favorable following periods of retail choppiness (such as the holiday season we just witnessed in 4Q15), we think it's important to note that the company is being strategic and deliberate about its opportunistic buys. On the 4Q15 call, for example, Chief Merchandising Officer Debbie Ferree noted that given some potential newness in the boot category, the best investment for the boot category would be in go-forward merchandise instead of over-allocating spend in closeout buys that may not resonate as strongly with consumers.

> **Adding More Exclusives.** Looking ahead, merchants will be charged with building a differentiated assortment through exclusive vendor offerings. That means that the company will work with brands to take specific SKUs that are only sold at DSW. So far,

the company is seeing great reception from its vendors who appreciate the opportunity to get better exposure for the brand.

> **Turning Private Label into Private Brands.** The team is also being tasked with transitioning private labels into private brands. Currently, DSW offers a slate of private label products that are being well-received – so well, in fact, that consumers don't realize that it is a private label product and are searching for it outside of DSW. As a result, management believes that there is an opportunity to further invest in these products and to create stronger brands that will further drive demand.

Importantly, the company is cognizant of not over-assorting to the private brands and plans to limit the penetration to 15%-20% in any given category up from a LDD penetration in 2015. We see the potential for the investment to drive stronger sell-throughs, which we believe will help bolster the gross margin over the long-term since private label product can carry margin rates significantly above average.

> **Collaborations.** In an attempt to further differentiate and offer exclusive product, the company is also making a more active effort to engage in collaborations that are more outside the box. For example, the company recently worked with tattoo artists to create and customize Chuck Taylors that were unique to DSW.

Tempo: Reacting More Quickly to the Changing Landscape

Retail is always evolving, and while our companies have all embraced the idea of "omni-channel," companies are struggling to keep pace with the ever-changing demands of the consumer. While we've always viewed DSW as one of the best-in-class players in the footwear space, we were encouraged to hear Mr. Rawlins' message, which seemed to have a greater sense of urgency and a desire to more quickly change and adapt. In our discussions, the company noted that it has eliminated over 30,000 meeting hours within the organization in order to free up time and increase responsiveness.

> **Going on the Offensive to Tell DSW's Value Proposition.** In 4Q15, the company intensified its marketing offensive with weekly deals and compelling offers for the holiday. This compares to the previous year when the company would run a campaign for two to three weeks at a time. DSW saw immediate results and was able to drive positive store traffic and market share gains. While some of the events were in response to the sluggish holiday environment in 4Q15, the company is utilizing a test-and-control methodology so that it can evaluate all of the actions to determine which drive the appropriate returns and in order to see which are appropriate for the brand longer-term.

Therefore, while weekly deals and promotions may not become the norm, we believe that the idea of reacting faster and being more nimble is part of the company's culture that will be emphasized when Mr. Rawlins talks about keeping an elevated tempo of business going into 2016.

– **Being More Timely and Relevant with Campaigns.** So far in 2016, we've already seen instances of how DSW has been quick to react to changes in the environment. For example, following a hyped-up half-time show with Beyonce at the Super Bowl that spawned tons of media coverage, DSW got in on the fray and ran a campaign featuring footwear fashions inspired by the show. Another example is when the company highlighted UGG boots when it first got cold.

> **Implementing more Omni-Capabilities that Consumers Want.** In reaction to the changing landscape, the company implemented Buy Online, Pick-Up in Store (BOPUS) and Buy Online, Ship to Store (BOSTS) in September 2015 at an accelerated tempo of six weeks. The capabilities are being well-received and helped drive an acceleration in digital sales, which grew over 35% in 4Q15 vs. 22% for the full year. Management noted that BOPUS and BOSTS collectively accounted for 20%-25% of digitally demanded sales and we believe the penetration will continue to grow as customers learn about the capabilities.

As for its impact, we expect some of that to be reflected in the gross margin as the company deleverages on its Rewards program (~20 bps for 2016) and also expect marketing expenses to tick up (~10 bps).

Disruption: Not Afraid to Try New Categories, Regions, and Channels

In addition to better focus and tempo, the company pledged to be more disruptive in the market place, citing opportunities in Kids, Canada, and regions outside of North America.

> **Launching Children's Footwear to Drive Incremental Sales and Attract New Customer.** DSW previously offered a kids assortment online (since 2010), but chose not to offer kids products in its stores in fear of detracting from its core shopper that may prefer a kid-free shopping environment.

However, the company's internal research showed that while DSW has a high market share with single adults aged 20-25, DSW's market share drops significantly – almost in half – for married couples with kids. As a result, the company now feels that it may have been walking some of its customers away by not providing a children's assortment.

In 2015, DSW tested a limited offering of kids products in 22 of its stores with around 100 SKUs (vs. an average in-store SKU count of ~2,500). Encouragingly, results from the test were positive and did not seem to disrupt the core DSW shopper, and as a result, the company will now expand the program and launch a kids assortment in 220 stores, in time for Back-to-School season.

The assortment will feature around 200-250 styles and will have a wide range of athletic and non-athletic footwear for boys, girls, youth and toddler. DSW believes that it can add the kids assortment to this first batch of stores pretty seamlessly, while the remaining stores might require additional fixtures to add in the assortment without disrupting the adult assortment. Over time, the company hopes that kids can grow to be 3%-5% of total sales, and that the assortment not only adds incremental sales, but also draws in a new customer to help drive sales in its adult footwear business.

> **Canada: 10 More DSW Stores to Open in 2016.** On May 12, 2014, DSW finished its initial acquisition of Town Shoes, purchasing a 49.2% interest for CAD $75.5MM (USD $68.7MM) in cash. Town Shoes, the largest footwear and accessories retailer in Canada, is primarily owned by Alberta investment Management Corporation (AIMCo) and Callisto Capital. The current stake was purchased from AIMCo and other minority shareholders. DSW will have the right to purchase the balance of Town Shoes at a pre-determined EBITDA multiple after four years. We estimate that there were roughly 13 stores in Canada under the DSW banner at year-end, and the company plans to open up another 10 new DSW stores in 2016.

> **Ebuys = Entrance into New Channels and New Regions.** On February 17, before the market open, DSW announced an agreement to acquire Ebuys, Inc., an e-commerce retailer of off-price footwear and accessories with a presence in North America, Europe, Australia, and Asia. The transaction closed on March 4 with a purchase price of $61MM at closing, with deferred payments contingent on Ebuys' future performance over the next three years.

In 2016, Ebuys is expected to contribute roughly $100MM in sales and $0.04-$0.06 in EPS. From a margin perspective, Ebuys has a lower gross margin than DSW, but has a substantially higher operating margin due to a lower SG&A structure (less employees, marketing etc.).

We believe that DSW's acquisition of Ebuys is complementary from a strategic point of view and helps support growth because: 1) the potential for both organizations to leverage each other's competitive strengths, develop economies of scale, and to benefit from synergies; 2) the acquisition provides an entrance and expertise into new channels; and 3) the acquisition provides an entrance and expertise into new International markets (recall that DSW currently operates in the US and Canada). In addition, we believe there is a unique opportunity for Ebuys to serve as an additional channel for DSW's excess inventory, such as with DSW's clearance product (currently not digitally available), which would also provide better visibility of sales and sell-throughs.

2016 Goal is to Rejuvenate Comps; Margins will be the Next Step

In 2016, the company is focused on execution and management's priority is getting the product/value proposition right and rejuvenating comps/gaining share. Therefore, while 2015 was a down year for margins, the company anticipates another year of operating margin deterioration in 2016 as it resets the organization, invests in the business, and builds a strong foundation for growth in the future.

Assuming that the company executes on the top line, management believes that the next step will be to leverage expenses and rebuild the margin. Recall that DSW was once within striking distance of a 12% operating margin, reaching 11.7% in 2013, though that was prior to the increased investments in price and higher shipping costs associated with e-commerce sales.

We believe that under the new CEO, the team is in the process of reassessing its long-term margin potential and that there will be more visibility on the company's thoughts later this year.

Below, we highlight the 2016 guidance that DSW issued on its 4Q15 call in March, calling for comps of 1%-2%, total sales growth of 8%-10%, and EPS of $1.54-$1.64. The guidance includes Ebuys, which will contribute ~$100MM in sales and $0.04-$0.06 in EPS. Excluding Ebuys, we estimate that the implied outlook for core DSW would be 4%-6% sales growth and EPS growth of (3%)-3%.

Also embedded in the company's 2016 guidance are the following:

- 32 net new stores (34 new stores and 2 store closures), including 4-5 small format stores
- Gross Margin roughly flattish
- SG&A Expense growth of ~10% excluding EBuys, driven by higher compensation expense, higher marketing, IT, store expenses, and depreciation. SG&A growth is expected to increase in the low teens including EBuys.
- Tax rate of ~39%
- Share count of ~83MM shares
- CapEx of ~$95MM

Moving in the Right Direction; Reiterate Price Target of $29

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ADDENDUM
Important Disclosures:

Valuation Method for Target Price: Price-to-Earnings, enterprise-value-to-EBITDA, P/E to growth, price to free cash flow, and discounted cash flow analysis.

Investment Risks: Telsey Advisory Group's (TAG's) equity research department covers consumer-focused sectors including advertising, apparel manufacturers, children's and teen retailers, consumer electronics retailers, cosmetics, department stores, discounters, footwear, gaming and lodging, home furnishings retailers, home improvement retailers, luxury goods, office supply retailers, off-price retailers, pay TV companies, restaurants, specialty apparel retailers, sporting goods retailers, and supermarkets. Risks across or specific to one or more of these sectors include volatility of commodity costs, consumer spending, currency, rising interest rates, weaker consumer confidence and unemployment rates. Additionally, access to capital, supply chain disruptions, commodity costs, private label distribution, currency, geopolitical uncertainly, unfavorable government regulations, lack of appropriate real estate sites, and the use of the World Wide Web to sell merchandise represent unique industry risks.

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The Research Analysts, Kelly Chen, CFA and Joseph Feldman, who prepared the research report hereby certify that the views expressed in this report accurately reflect the Analyst(s) personal views about the subject companies and their securities. The Research Analyst(s) also certify that the Analyst(s) have not been, are not, and will not be receiving direct or indirect compensation for expressing the specific recommendation(s) or view(s) in this report.

Company Specific Disclosures

DSW, Inc. Rating History as of 04/02/2016

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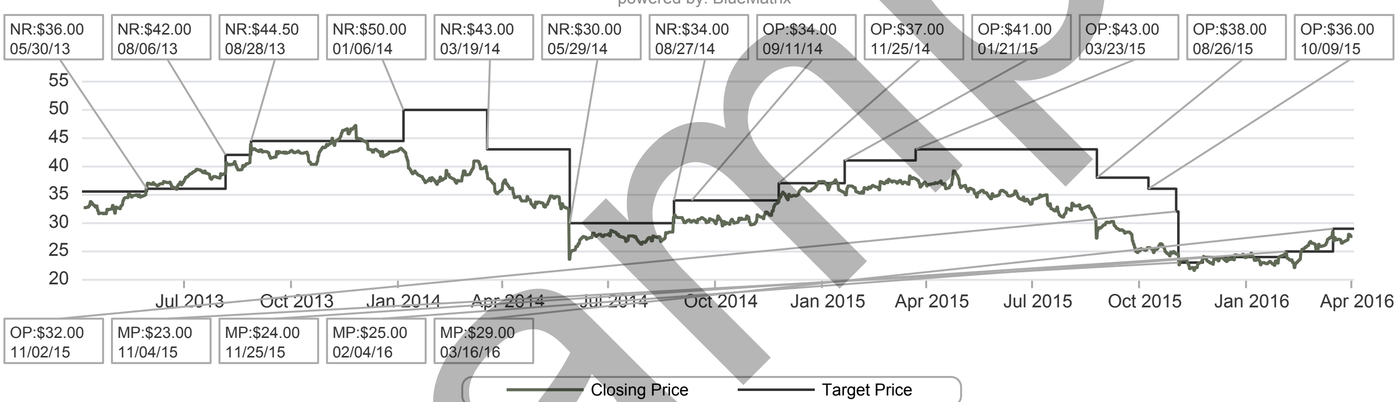

On September 16, 2012 TAG completed a transition from price target ranges to specific price targets. All price target changes prior to September 16, 2012, are displayed as price target averages.

* Telsey with ratings are effective as of 09/11/14

Ratings Distribution & Investment Banking Disclosure

Rating	Count	Ratings Distribution	Count	*Investment Banking
OUTPERFORM	67	48.91%	1	1.49%
MARKET PERFORM	65	47.45%	1	1.54%
UNDERPERFORM	5	3.65%	0	0.00%

On 09-11-2014 TAG launched a three-tiered rating system of Outperform, Market Perform, and Underperform to evaluate its stocks under coverage. Price targets continue to be used in conjunction with the new rating system.

Ratings Definition and Distribution

Our recommendation system is based on a stock's expected total return relative to the industry universe over the next 12 months.

We divide stocks under coverage into three categories, each defined by a prospective rate of return:

Outperform – the stock is expected to outperform the average total return of the industry universe over the next 12 months.

Market Perform – the stock is expected to perform in line with the average total return of the industry universe over the next 12 months.

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