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VOSS CAPITAL

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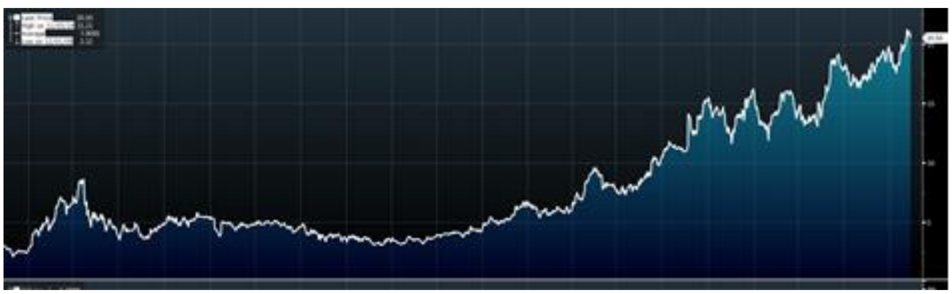
TUES Tuesday Morning Corp. $21.50

Tuesday Morning
SEEK THE UNIQUE

A high conviction short on Tuesday mornings or any morning of the week with a price over $21.50.

Market Capitalization	$928,198,407
- Cash & Equivalents	8,537,000
+ Total Debt	0
Enterprise Value	$919,661,407



Executive Summary of Short Thesis:

- Stock is overvalued even if we assume miracle in profitability improvement over the next few years.
- When taking an objective look at history, faith in management and their turnaround prowess is unwarranted.
- Sell-side is over estimating gross margin expansion and drastically underestimating cap-ex needs.
- Activist investor Steven Becker has sold his position down aggressively starting at prices over 40% lower.
- Investors have a misguided myopic focus on TUES' manipulated positive SSS numbers.
    - Company's strategy of shifting to larger, nicer stores is not a panacea. It is boosting SSS in the near term, but only at the expense of gross margin compression and continued operating losses.
- Given the discretionary nature of their merchandise, the stock is extremely susceptible to economic weakness.
- Competition is intensifying and as soon as they start to miss guidance or disappoint relative to lofty expectations the stock has >50% downside.

"**Q - Mark K. Montagna**: Okay. And then just last quick follow-up. Michael, when you're looking out to the future years, I know you want to hit singles and doubles at the most. When you look at comps, what is your general accepted comp you think that if you can achieve 4% to 6%, that's what you're looking for and you're happy with that or could it be more high single digits?

A - R. Michael Rouleau: I would only say it this way; I think that we have tremendous opportunity in all departments and on all fronts. So, and that's, I'm so excited about that. I can hardly even stand it. But the point is that that would be my answer. I mean, I don't know where the ceiling is but we have – we've underperformed for so long and we have such upside potential that it's going to be probably significant, but beyond that, I don't know what to say." Source: TUES Q3 2014 Earnings Conference Call

I'm so excited about the TUES short I can hardly even stand it. There is tremendous opportunity and the downside potential is going to be probably significant. Beyond that, I have a lot to say.

Pulling threads on this unlikely story stock quickly reveals that the business model is frayed and the bull thesis unravels under any objective scrutiny. TUES is at a point where I think it will be abandoned by both value investors and so-called growth investors. The only ones left holding or actively buying (firms like Gilder Gagnon whose top ten holdings include momo favorites NFLX/AMZN/FB/GMCR/TWTR) seem to be focused on share price momentum and little else.

TUES Profile from Bloomberg: Tuesday Morning Corporation is a closeout retailer of upscale home furnishings, gifts, and related items. The Company sells a variety of brand name merchandise such as Ralph Lauren bed linens, Waterman pens, and Royal Dalton china and giftware at a discount. Taglines: "*seek the unique*" and "*famous brand names at deep discounts!*"

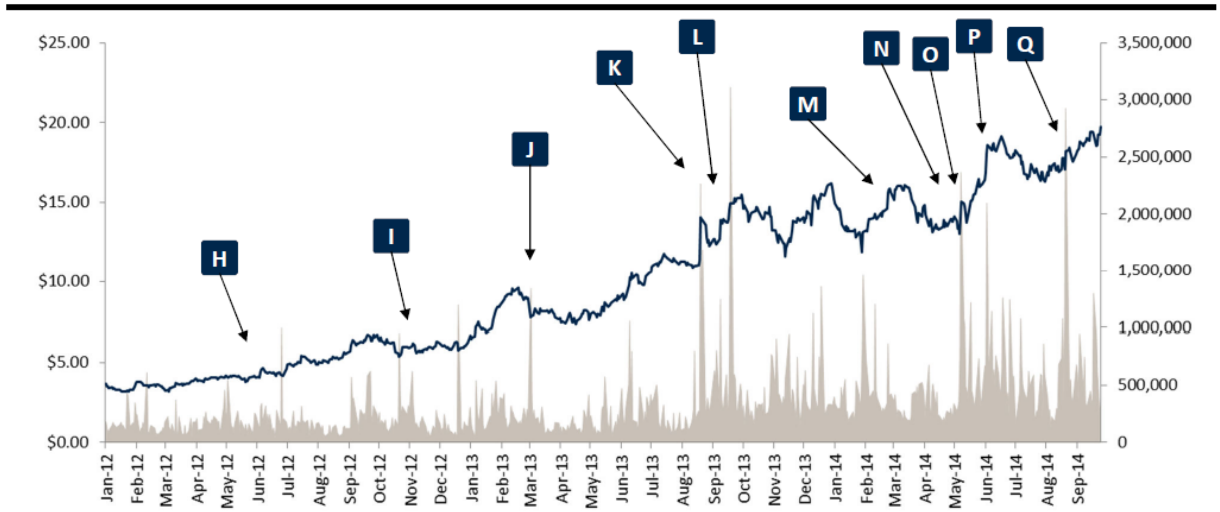
From TUES Investor Relations' website: "Tuesday Morning is an upscale, deep discount, off-price retailer specializing in domestic and international, designer and name-brand closeout merchandise. With stores across the country and decades of experience in closeout retailing, we haven't strayed from our original concept. Our mission is to deliver fresh and exciting assortments that are constantly being updated." In my opinion they are not an upscale retailer, they are a retailer of up-scale, off-price goods.

Tuesday Morning sticks out to me as an asymmetric short given the stock is years ahead of the potential improvement in fundamentals and the upside is seemingly capped even if the fundamentals do improve by the unrealistic magnitude that Wall Street expects. Investors continue to enthusiastically kneel down and worship at the altar of CEO Michael Rouleau, giving him the benefit of the doubt when there has been little fundamental improvement in the first 20 months of his tenure. We will demonstrate that in reality Rouleau has not done very much at all in midst of his turnaround effort and that even if he turns the profitability around very quickly that the miracle has already been priced into the stock. Rouleau's comments on the conference calls are quite entertaining as he religiously adheres many of Voss' top Laws of Hype, such as give non-answer answers, ignore and omit empirical details, and excessively repeat and re-iterate how excited you are no matter what in reference to. We'll take a deep dive into the history of Tuesday Morning, its competitive positioning, management's turnaround plan, operating performance and financials as well as various potential valuation scenarios.

Short Thesis Summary: In the case of TUES there is no "there" there…the there being a turnaround. TUES is a supposed turnaround that hasn't turned around and is unlikely to. Despite SSS comping very positively, TUES has shown no improvement in operating profit due to lower initial mark-ups and their new real estate strategy of shifting the store base into locations that are 50-200% larger and in nicer, more expensive A and B-type locations. On November 12th for the first time in months I flipped on CNBC's Squawk Box and Jim Cramer immediately reminded me why he is poisonous for investors, stating that he never holds or will hold a retailer or restaurant that is comping negatively. When pressed as to why, his illogic was that "why, when others are comping positively?" There was no mention of valuation or cash flow or margins, etc. Taking his illogic to the extreme one would own TUES at any price and not own BBBY even if it were available at 1x FCF yet comping negatively. We frequently find ourselves liking specialty retailers or restaurants that are comping down but cheap and cash flow positive with a credible turnaround in place. TUES as a short is kind of the exact inverse of this long strategy—they're comping positively but are overvalued, not cash generative and have a quite tenuous turnaround plan in place. In this momo-market revenue and hocking hope are still preferred price-drivers and metrics emphasized by the blind-capital.

We think TUES' strategy to try and move "up-market" to more expensive real estate will eventually prove an expensive strategic mistake. The competitive dynamics in the off-price retailer space have greatly intensified over the last decade, making it nearly impossible for TUES to re-attain the previously attractive profitability metrics it had in the mid-2000s. Despite its "no-frills" approach to in-store merchandising display, TUES is dramatically underspending on cap-ex relative to its own history and its peers and even more when considering the company is going through an all-out turnaround and thus Wall Street's FCF forecasts in future periods is badly overstated. The stock has priced in an incredibly optimistic operating improvement (something akin to one of the best retailers, BBBY) and we struggle to come up with upside in the stock even in a generous bull case, or even in a theoretical take-out scenario using the most relevant transaction comps. Additionally, upon scrutiny CEO Michael Rouleau's credit for a turnaround during his tenure at Michael's Stores is misguided. We can easily compute 60% or more downside in a base case scenario that is grounded in empirical data and economic realism.

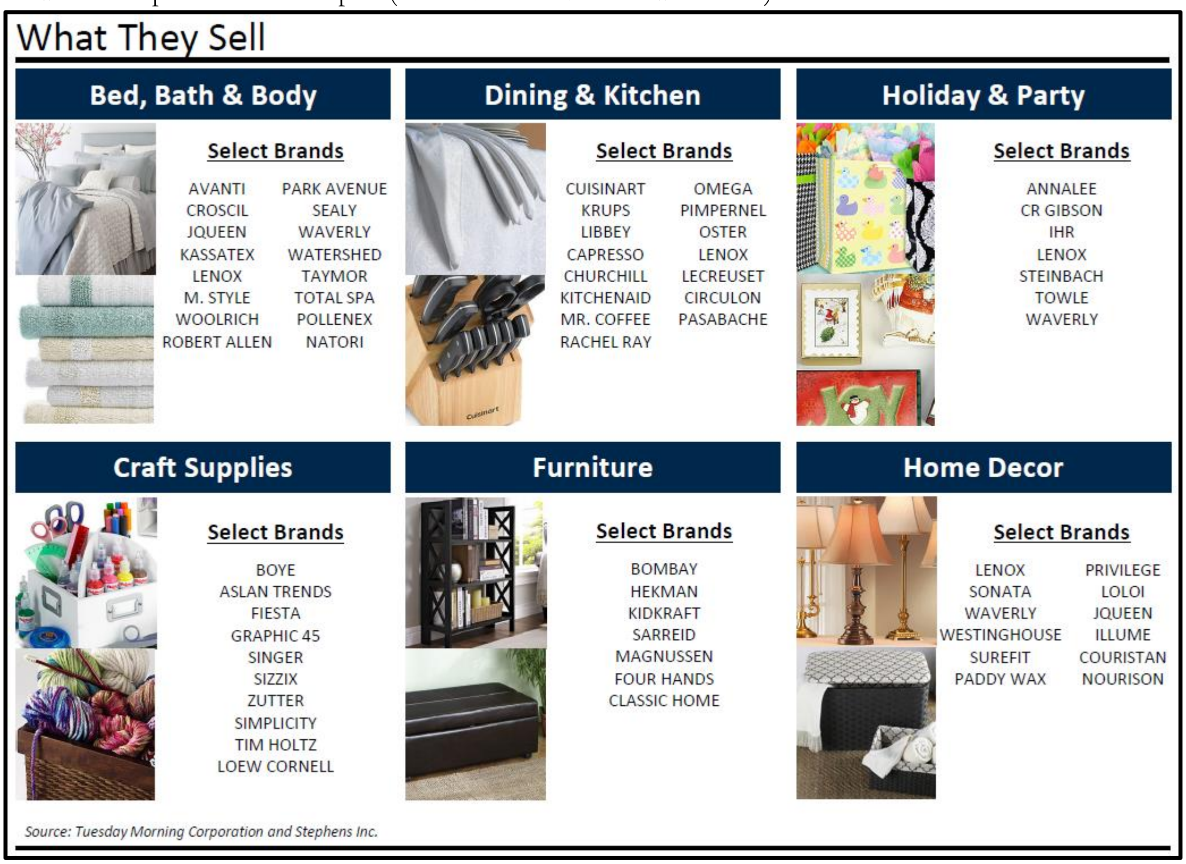
TUES: Two-Year Annotated Stock Price Chart

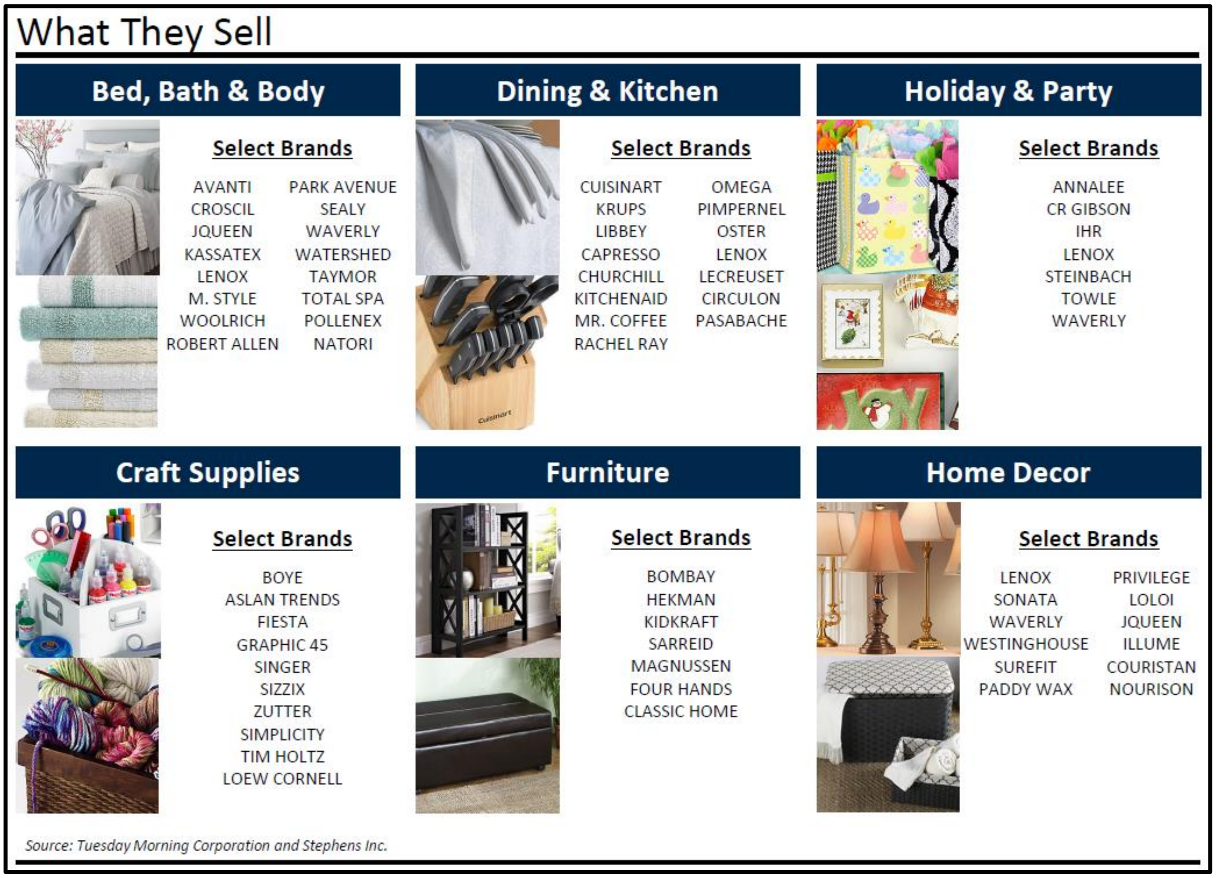


H	6/6/2012	Kathleen Mason, President & Chief Executive Officer, is relieved of her duties	M	2/24/2014	Doug Sullivan is named as SVP of Real Estate Michael Jones is named as SVP & Chief Information Officer
I	11/2012	Michael Rouleau joins Board of Directors	N	4/22/2014	Melissa Phillips is named as EVP, General Merchandise Manager
J	3/4/2013	Michael Rouleau is named interim Chief Executive Officer	O	5/9/2014	TUES reports 3Q14 earnings with SSS growth exceeding expectations
K	8/20/2013	Michael Rouleau is named as full-time Chief Executive Officer	P	6/3/2014	Susan Davidson is named as SVP, Marketing
L	9/9/2013	Jeff Boyer is named as EVP, Chief Administrative Officer & Chief Financial Officer	Q	8/22/2014	TUES reports 4Q14 earnings with SSS growth exceeding expectations

Source: Tuesday Morning Corporation, FactSet Research Systems and Stephens Inc.

Above and below from Stephens initiation report (no need to re-invent the wheel here).





Firstly, according to management the turnaround is over. “We have just exited a successful turnaround plan and have now entered what we call a rebuilding phase.” – CEO, Q1 2015 earnings conference call. According to the sell side the turnaround is in the early stages, to wit from Citi on October 1st: “TUES is in the early stages of a multi-year turnaround…” So with the turnover done and Mr. EBITDA yet to arrive to the party the bull case has become all about Voss Law of Hype #5: Condition Investors to Focus on non-value creating and non-fundamental metrics/ratios, or in this case same-store-sales comps.

“We're getting out of the 5,000, 6,000, 7,000, 8,000 square foot stores, we're going into 12,000 to 15,000 square foot stores. Net-net the square footage that we're going to have next year, the total square footage for the stores is going to be pretty comparable. I think we've finished this year with about 8.6 million square feet. We're going to be pretty darn close to that next year even with some contraction in the store base.” – CEO Q4 2014 conference call (period end June 2014). With no material improvement in gross margins or operating margins yet the stock hitting fresh highs, it is clear the focus has been squarely on large positive SSS comps and faith in management to manifest a cash cow.

Crux of bull thesis: Have faith in CEO Michael Rouleau and Chairman Steven Becker.

Steven Becker got on the Board in July 2012 and has since sold his stake in the company down to less than 0.5% from a high of 8.7%, so we will start our discussion with Michael Rouleau, who has day-to-day control.

Michael Rouleau got on the Board at the same time as Becker and took over as full time CEO in August of 2013—FQ1’14 (interim CEO March 2013—FQ3’13). So 20 months in what has happened during their turnaround? They’ve generated positive same store sales comps in each quarter, expanded gross margins by 40 bps on a TTM basis since Rouleau took over, and increased adjusted operating margins by 10 bps to 0.2% (still -0.9% in FY 2014 on a GAAP basis). All told there has been a ~$1.2 million positive swing in operating profit over Rouleau’s first full year and the enterprise value is up $633 million over that time. We are baffled by the market’s faith in the management team as they continue to struggle turning the business around and hint that gross margins are pretty much normalized at the current level.

Michael Rouleau's career history[1]:

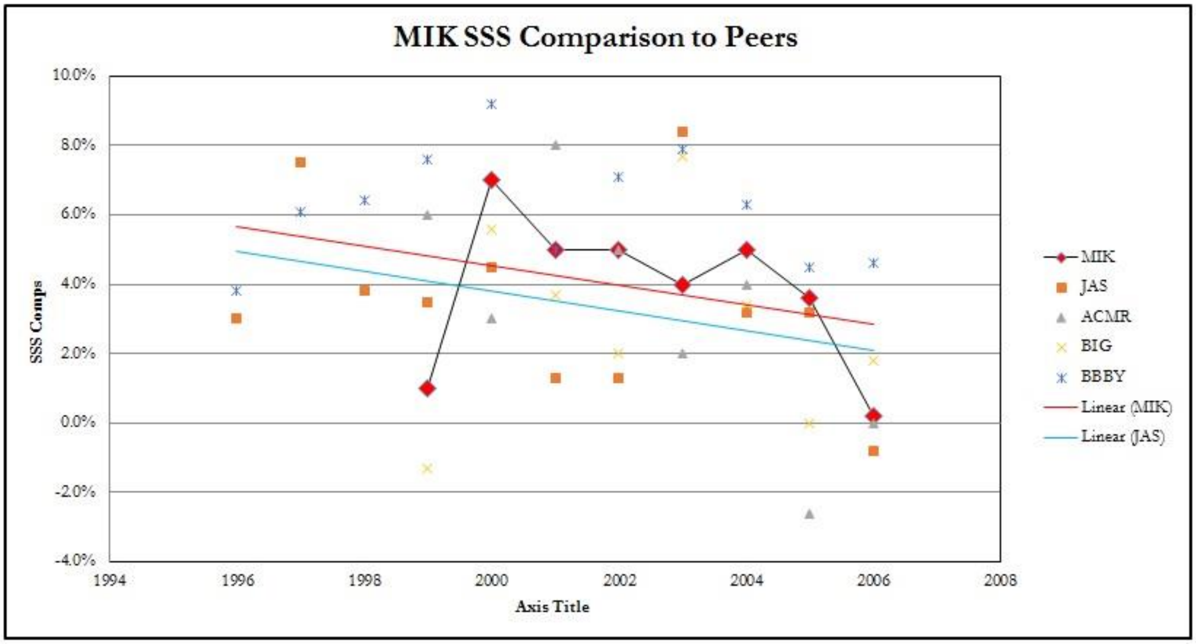
- Started career as one of the first 25 employees of Target in 1962, rising to become VP of Merchandising and Logistics/Supply Chain
- In 1988 co-founded one of the nation's first office supply stores called Office Warehouse
    1. Went public in 1991 and was acquired by OfficeMax in 1992
- Went on to become VP of Retail Operations at Lowe's from 1992-1996
- President and CEO of Michael's Stores from 1996-2006
    2. Unanimously credited with turning around MIK
    3. Michael's grew sales and profits for 10 consecutive years before its sale in 2006
        - Bought by a PE consortium led by Blackstone for \$5.52 billion. Other investors were Bain Capital and Highfields Capital
            - 15.6% premium to previous closing price
            - TEV/Revenue multiple of 0.74x
            - TEV/EBIT of 11.96x
            - TEV/EBITDA of 10.48x
    4. Michael's Stores also owned Aaron's framing stores

<u>Voss Variant View on Rouleau's MIK experience:</u>

- It would appear to me that he was in the right place at the right time, likely entirely by chance.
- His major strategic initiative at MIK was to shift more SKUs to "perpetual inventory" tracking, using technology to track inventory and replenish low inventory more quickly instead of using the past method of relying on a store manager to put in a request (more likely to run out of stock in key seasonal items); more detailed inventory replenishment methodology, e.g. knowing which color of a certain item is the best selling color)
    - MIK inventory turns actually declined significantly under Rouleau
- MIK's entire comp group posted positive comps for an extremely long time period—Rouleau got caught in a nice secular ride along with every arts & crafts retailer and home décor related stores
    - Comparing MIK's strong comps to its peers during the periods that Rouleau was CEO puts them at best in-line with peer group performance on nearly every metric
    - MIK stock went nowhere for 4-5 years after Rouleau took over. It was not until the scrapbooking/housing bubbles kicked into high gear that things took off.
- Michael's, Jo-Ann Fabrics, and A.C. Moore collectively grew sales from 02-04 at a 3-year CAGR of 9.6%.
    - MIK grew only slightly more quickly at 11.1% CAGR from 2002-2004, this due solely to more aggressive store openings and square footage growth.
    - MIK comps actually underperformed its peer group from 1999-2006
        - Peer group includes: BIG, BBBY, AMCR, JAS
            - Peers chosen for mix of similar merchandise and category/theme exposures
            - MIK Comped on average 0.1% lower from 1999-2006
            - Comped on average only 0.81% higher if excluding BBBY (the best) from group

Annual SSS Comps Comparison

Year	MIK	JAS	ACMR	BIG	BBBY	Avergage Ex-MIK	Difference MIK - Peers
1996		3.0%			3.8%	3.4%	n/a
1997		7.5%			6.1%	6.8%	n/a
1998		3.8%			6.4%	5.1%	n/a
1999	1.0%	3.5%	6.0%	-1.3%	7.6%	4.0%	-3.0%
2000	7.0%	4.5%	3.0%	5.6%	9.2%	5.6%	1.4%
2001	5.0%	1.3%	8.0%	3.7%	5.0%	4.5%	0.5%
2002	5.0%	1.3%	5.0%	2.0%	7.1%	3.9%	1.2%
2003	4.0%	8.4%	2.0%	7.7%	7.9%	6.5%	-2.5%
2004	5.0%	3.2%	4.0%	3.4%	6.3%	4.2%	0.8%
2005	3.6%	3.2%	-2.6%	0.0%	4.5%	1.3%	2.3%
2006	0.2%	-0.8%	0.0%	1.8%	4.6%	1.4%	-1.2%
MIK Avg SSS Comp Outperformance (with BBBY excluded)							**0.81%**
MIK Avg SSS Comp Outperformance (with BBBY included)							**-0.1%**

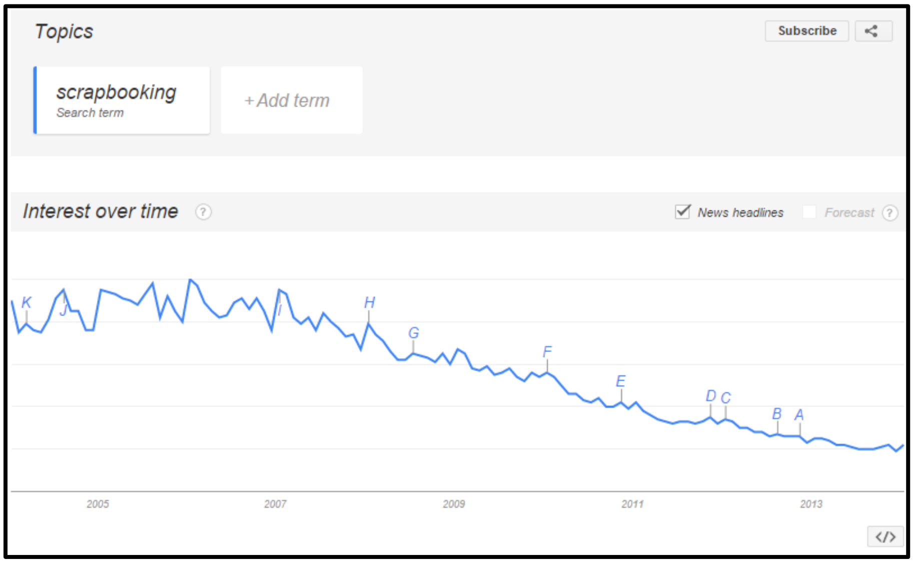


The chart above shows the same data that is presented in the table right above it but in scatterplot format. MIK's SSS comps are emphasized in red diamonds along with a red trend line tracing their progression. I included the light blue trend line that shows Jo-Ann stores' comp trend line to demonstrate that MIK basically just tracked its most direct peer with an identically sloped trend line (hence the tight grouping of only a 10 basis point difference in comps over the seven year period shown). The main point is to show that Michael Rouleau is a false idol, worshipped as a retail legend but mostly just rode the wave up and down along with everyone else in his niche.

To further explain and elaborate on what I mean:

- Starting in the early 2000s scrapbooking went through a very trendy phase/craze/bubble which greatly benefitted the arts & crafts stores for the bulk of Rouleau's tenure (think of Pinterest, Tumblr & Instagram as the modern day version or continuation of the scrapbooking bubble, just virtual).
    - "In mid-1990s, with the explosion of scrapbook idea publications, scrapbooking picked up speed in becoming one of the fastest growing hobbies in America."[2]
    - "The Craft & Hobby Association reports sales of scrapbook materials and supplies nationwide more than doubled from $1 billion in 2001 to more than $2.5 billion in 2003."[3]
    - "General crafts make up about 43% of industry sales with the rest of the industry breaking out as follows: needlecrafts: 29%; painting and finishing: 18%; and floral crafts: 10%. Michael's sales break down along much the same lines, with general crafts accounting for 26% of sales, art supplies 21%, framing 19%, floral crafts, 14% and seasonal and other 20%. MIK`s category mix has not changed substantially over the past few years and we expect it to remain relatively constant. **Scrapbooking is probably the most interesting trend. The category, included in general sales, grew 30% over the past few years**, to sales of $2.6 billion in 2003 from $2.0 billion in 2001, according to a survey conducted by Creating Keepsakes. Over the past year, the percentage of households with a consumer who has `scrapped` rose to 24.5% from 21%." – sell side report Smith Barney Citigroup, 6/22/04
    - Scrapbooking related merchandise as a sales driver was so important to MIK that they started opening smaller scrapbook-focused stores called ReCollections in 2003
        - SKUs overlapped 40% with MIK but favored paper, accessories, books, and stickers geared towards scrapbooking
    - TUES is extremely unlikely to benefit in the way that Rouleau did while at MIK from any kind of single-product category bubble, as no merchandise/category or large amount of SKUs is exclusive to them in the way that arts & crafts was dominated by MIK during the great scrapbooking bubble.

    - For example, if there is a tremendous area rug bubble from 2016-2018, TUES is not going to disproportionately benefit compared to any rug seller.



The chart above shows the Google search volume trend for scrapbooking. Available data starts only in 2004, but you can obviously see the steady decline over time. The flattening and declining trend coincides with MIK's SSS comps.

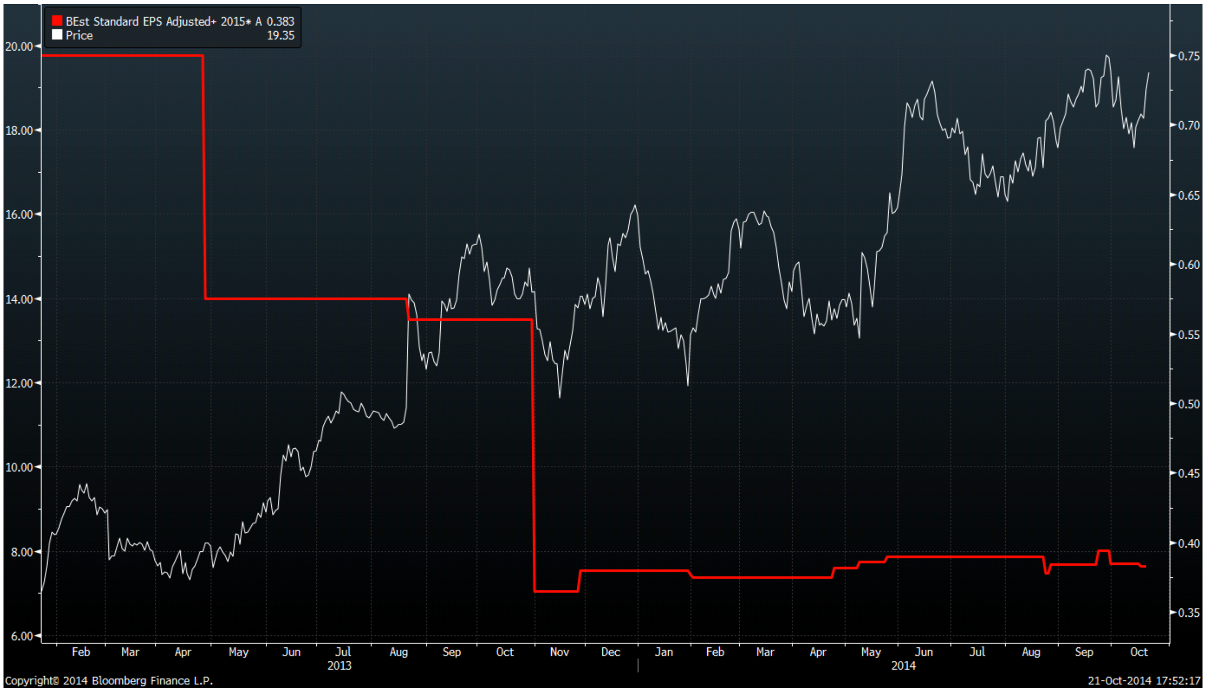
- Like most hardline retailers in the mid-2000s, MIK greatly benefitted from the housing and HELOC bubble.
  - MIK was the beneficiary of the housing bubble as in reviewing the historical data and commentary from the mid-2000s it is repeatedly emphasized that housing-related product merchandise was the strongest growth area within the stores.
  - The SSS comp rollover from 2006-2008 coincided with housing bubble peak.
- MIK stores' average four-wall ROIC was 14%. Returns in year one for a new store were 10% and this rose to 14-16% by year five as the stores matured and average unit sales rose from $3.0mm for year one stores to $3.7mm on average by year five.
  - TUES can get some ROIC bump from new stores and relocations, but so far given that rent expense is rising commensurately with sales they are not generating good ROIC on store relocations.
- MIK had a subsidiary called Artistree that manufactured frames and moulding, this boosted overall company gross margins
  - MIK has benefitted over time from an increasing shift towards selling higher margin private label products (all the way up to 48% of private label brand penetration by 2013),
    - This is a strategy that would be the exact opposite of what TUES' business model aims to accomplish, which is selling off-price brand name goods
- MIK had a large wholesale operation that served interior decorators, party and event planners, civic organizations, and "professional crafters"

Quick Overview of the rest of the TUES Management Team:

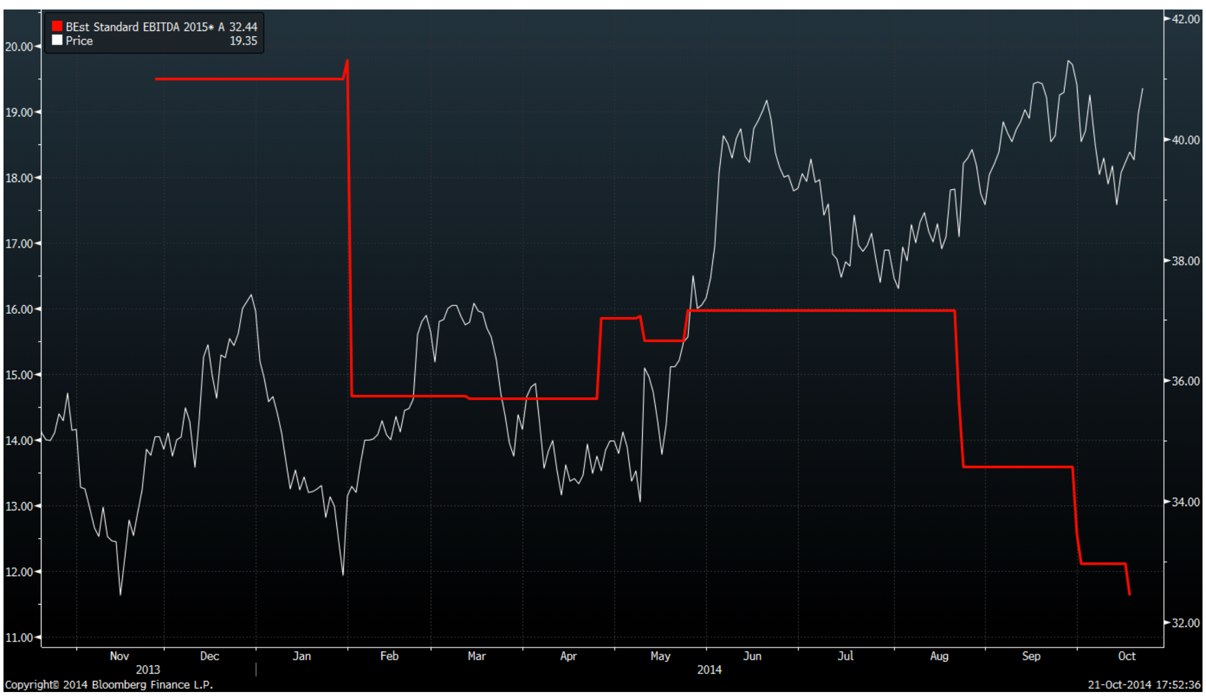
- Jeff Boyer, previously CFO of Michael's Stores
- Douglas Sullivan, Senior VP of Real Estate, previously worked with Rouleau at Michael's Stores
- Michael Jones, VP and Chief Information Officer, came from Systemax (TigerDirect), previously CIO of Michael's

To their credit, TUES has manifested an impressively healthy bump in store foot traffic, perhaps from improved merchandising, but most likely from lower initial mark-ups which has kept a cap on gross margins for the time being.

To show how far off overly optimistic estimates for the company have been so far since Rouleau took over:



Michael Rouleau was named interim CEO in March 2013 (Fiscal Q3 2013) and full-time CEO in August 2013. The stock was under $8 at the time and 2015 adjusted EPS estimates were at $0.75. Now the stock is $21.50 and the EPS estimate is at $0.37. The P/E multiple expanded 5.5x—not 5.5x turns, but 5.5x from 10.6x to 59x (48.4 turns).



2015 EBITDA estimates have also come down substantially while the stock has doubled.

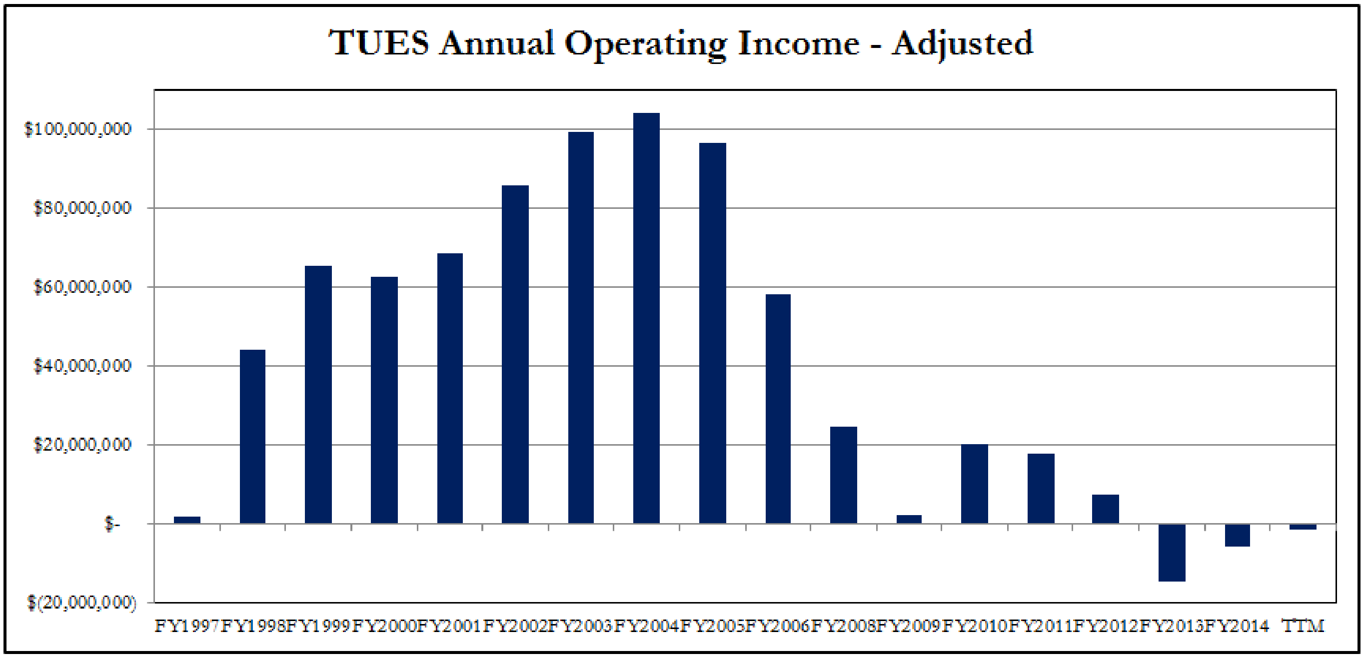
Surprisingly (or not), even 2014 sales estimates came down slightly from the start of the year and slowly lock-stepped downwards, yet the stock has marched higher to the beat of its own optimistic drummer. Big deal! These charts showing diverging stock prices and earnings/cash flow estimates are the norm in 2014, rather than the exception. TUES is closing stores on a net basis, revenue should come down slightly, as long as profits rise, but…okay, okay, but fiscal 2014 is already in the books it does not matter. What about the long term potential? What about 2016 sales estimates? The magnitude of estimate decline there gets worse.

Intermediate term…say, 2015 EBIT estimates? Same story but the magnitude of the drop is greater.

2015 EBITDA estimates started the year at over $41 million and that has come down to $32.5 million as of mid-October, all the while the stock is up >60% since the estimates were last above $40 million. Sales, EBITDA, and EPS estimates have all come down just in the last few weeks but the stock relentlessly marches higher on a daily basis. Okay, let's dive in to what has happened and is slated to happen.

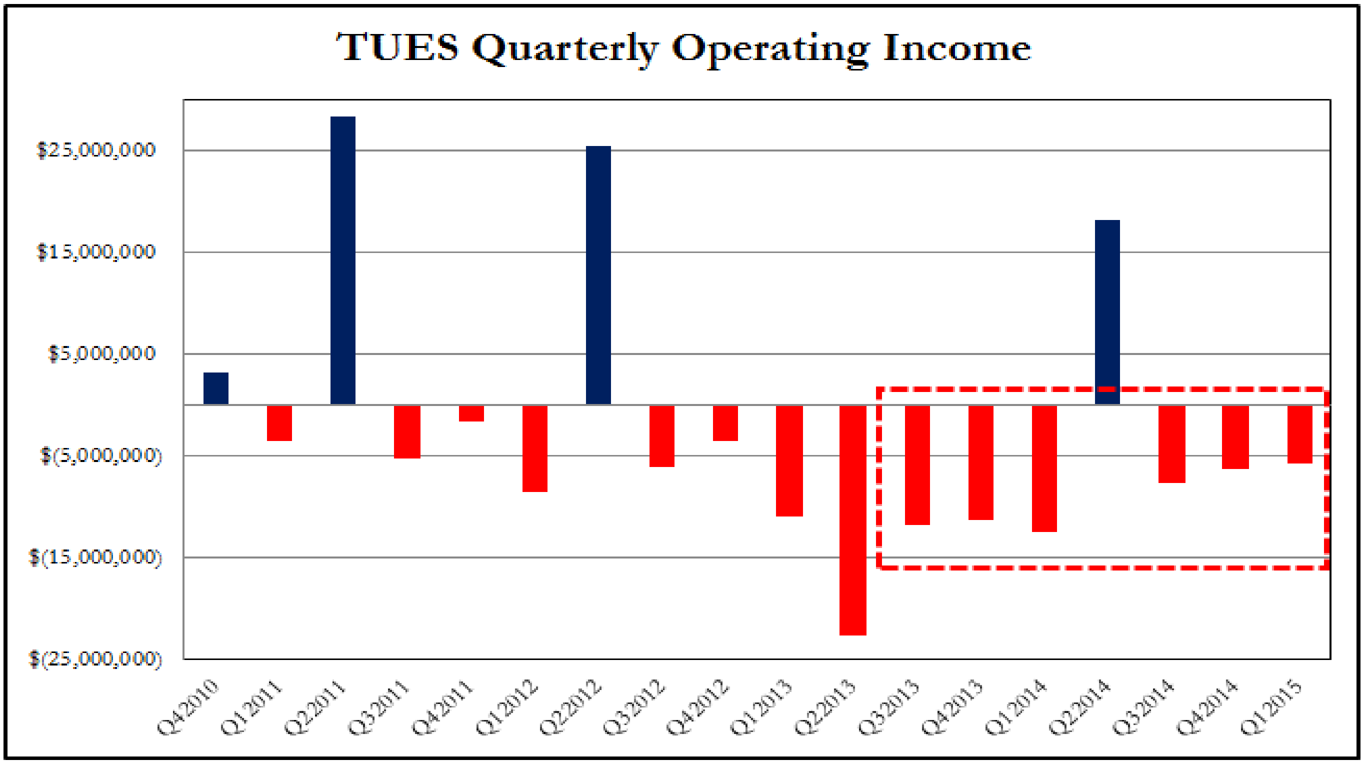
Turnaround Progress So Far:

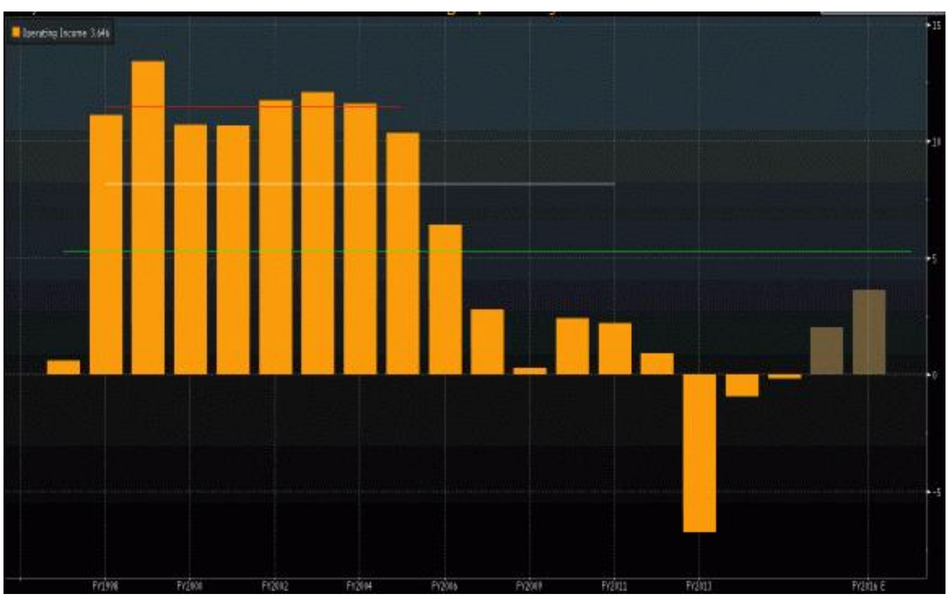
Here we are in November 2014 and we're 20-months into Rouleau and his team taking over since March 2013. Things must be looking pretty darn good. What have they done? Quarterly SG&A is flat. On a trailing twelve month basis SG&A is essentially flat compared to the TTM period when Rouleau took over ($310.2 million versus $314.8 million, or -1.5%). Operating Loss for the year was $8.1 million. 2013 Operating Loss was $56.5 million, which included a $41.8 million inventory write-down.



CEO Michael Rouleau said the company is finishing up the final phase of its turnaround. "We have had remarkable progress in a very short period of time," he said, adding that the turnaround will be considered complete by Sept. 1. "We are expecting to return to profitability this year."

It appears to me that aside from the fortuitous timing of taking over after a blood-bath of a quarter there has little tangible operating improvement for TUES on a sequential basis compared to the pre-inventory write-down quarter. In the second fiscal quarter of 2013 (period ended December 31, 2012), they took a $41.8 million pre-tax inventory write-down and EBIT loss exceeded $22.5 million (Annual Operating Income is adjusted to exclude this and other one-time turnaround related expenses). Usually during the typical holiday season the company earned in excess of $20 million in EBIT. Since then there has been minimal tangible operating improvement. So far there is no "there" there.

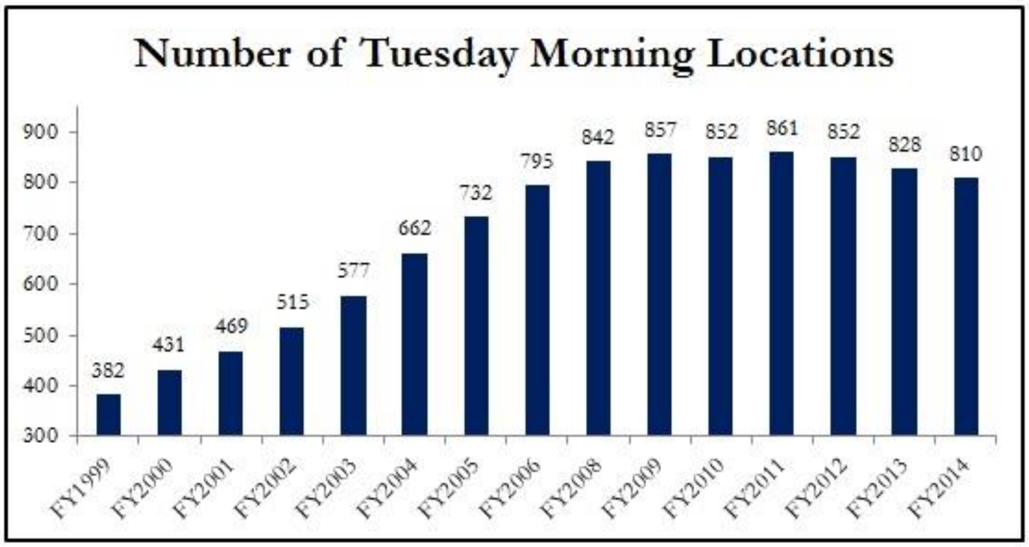


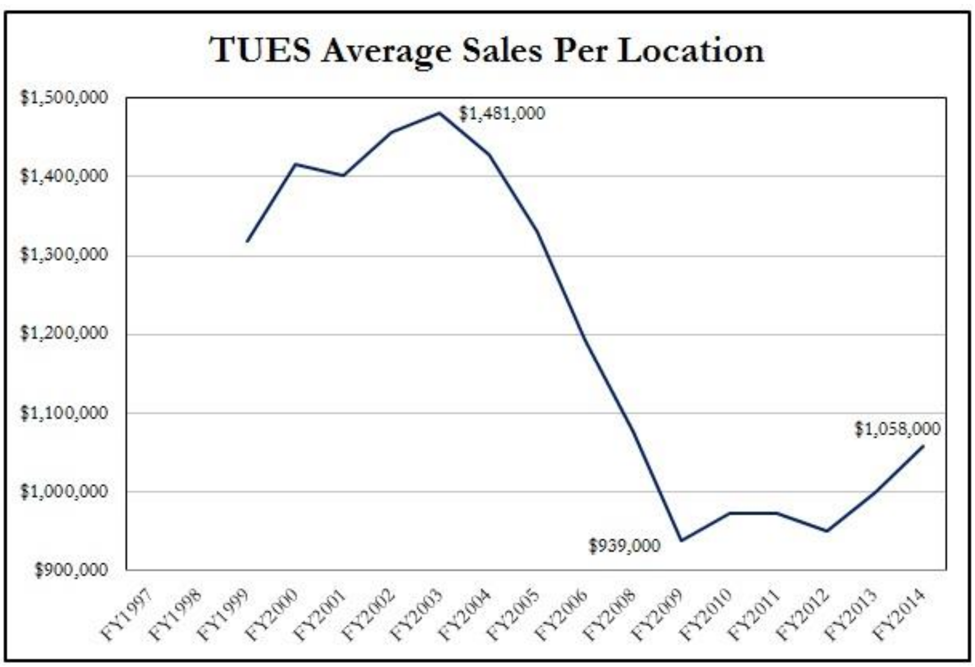


The red line shows the Operating Margin average from 1998-2005 of 11.46%. This was Tuesday Morning's hey-day in the middle of the biggest housing bubble in a generation. The white line shows the average operating margin from 1998-2011 was 8.24%. The green line shows the average from 1997-2016E at 5.3%.

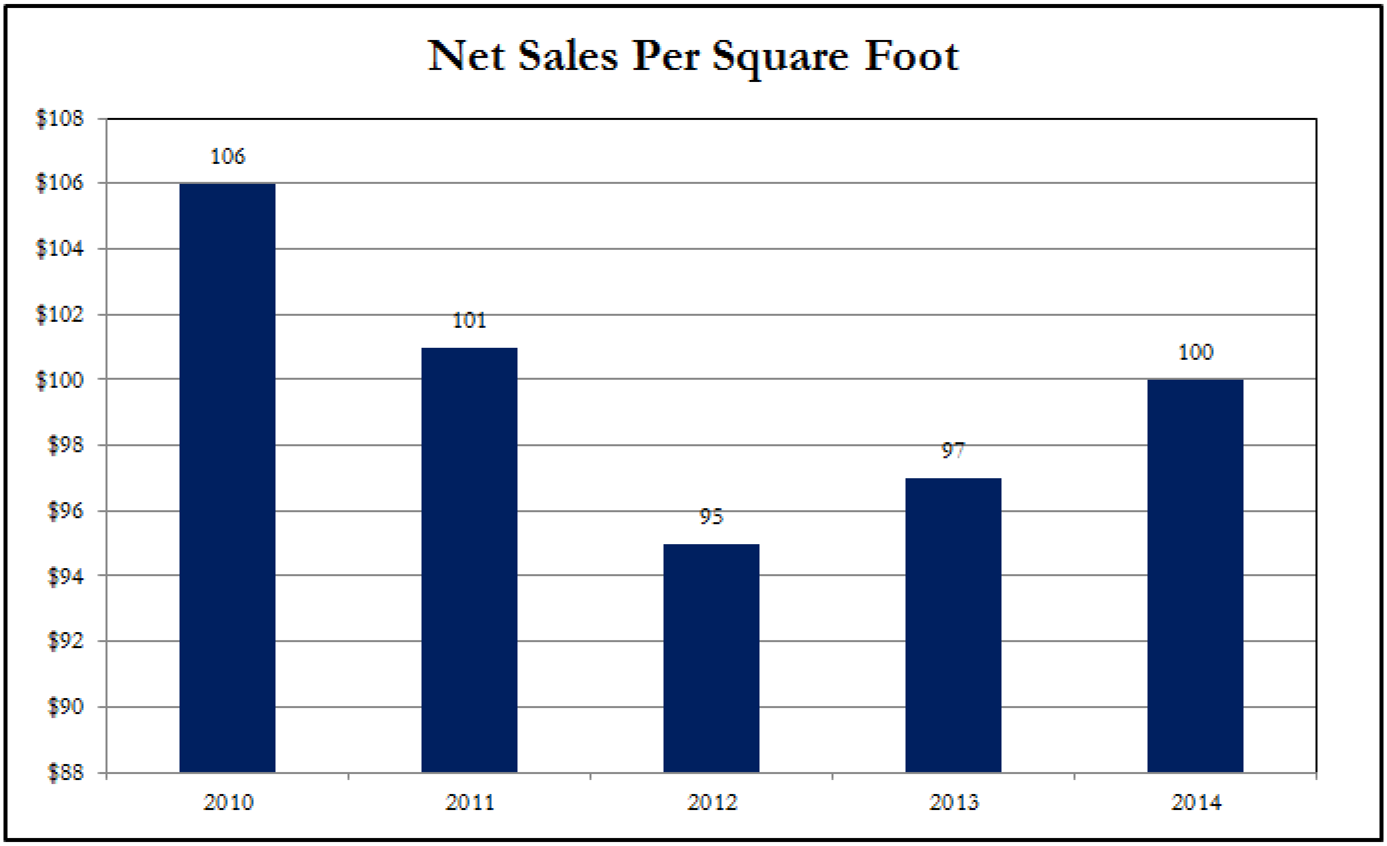
Store economics

- Square footage ranges from 5,000-31,800, averaging 10,700 as of June 30th, 2014. The company takes a "no-frills" approach with "less emphasis upon fixtures and leasehold aesthetics."
- Sales per store is rising, sales per square foot is falling as they quickly shift into larger stores.
- "Relocations will continue to be an important element of the company's strategy. Relocated stores are seeing sales lifts of greater than 50% and relocations that are in place for at least one year are still delivering high single-digit same-store sales growth. 40% of the total existing store base are still candidates for relocations, and management is focused on longer-term rent agreements (10 years) that have higher rent, but put TUES in better locations." – recent Stephens initiation.



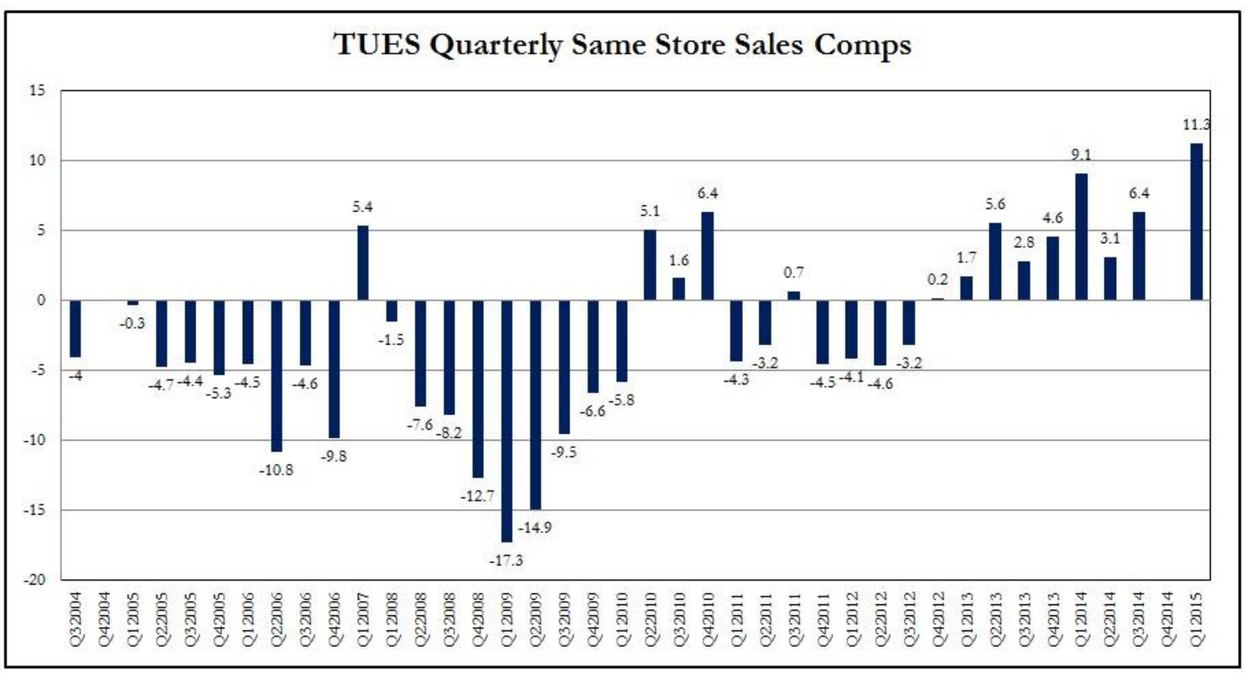


Average sales per location is rising meaningfully off the 2009/2010 low, while the sales per square foot remains ~6% below the 2009 level. It doesn't take a genius to figure out what is going on here.



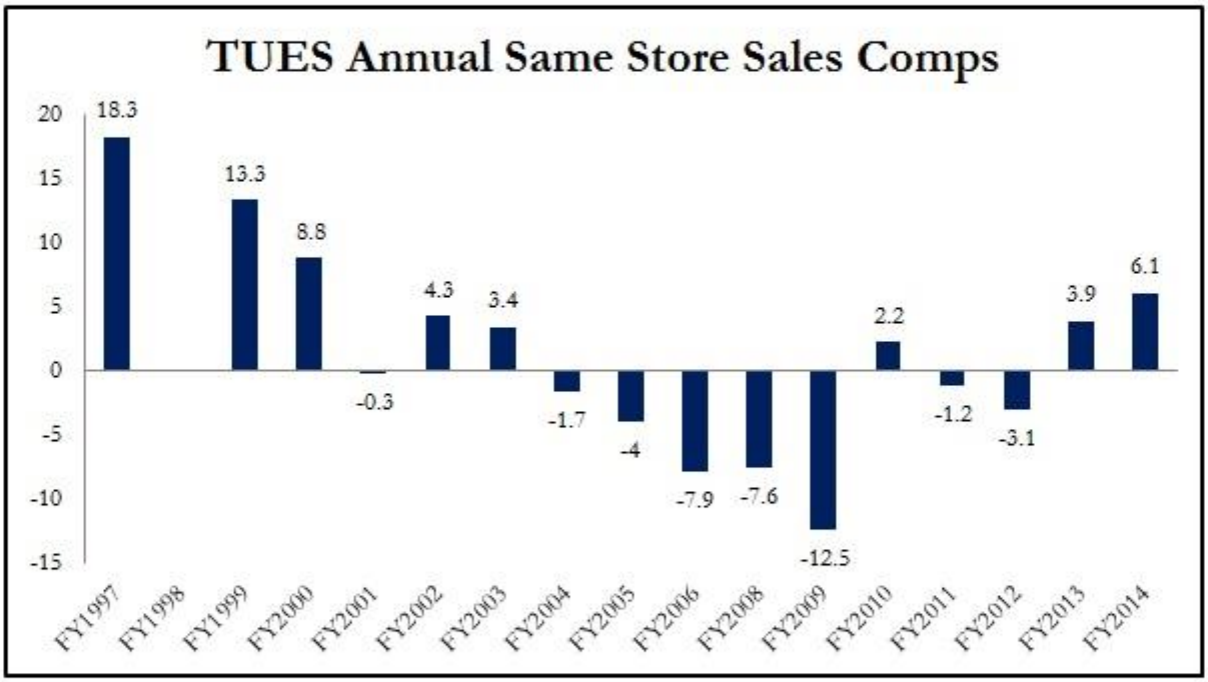
Increase in net sales per square foot has been directly offset with a ~3% YoY increase in rent per square foot.

SSS Comps:



- Management likes to cite the 50% SSS comps for relocated stores then conveniently neglects to mention in the same breath that the new stores formats **are at a very minimum 50% larger than previous stores** (from at least 8,000 square feet to at least 12,000 square feet). The Sales per square growth is only trending at half the rate of comps due to the outsized impact from the ongoing shift to larger stores.

- From a footnote in the K: "A store that relocates within the same geographic market or modifies its available retail space is still considered the same store for purpose of this computation."
- Net sales per average square foot was up 3.0% YoY for Fy2014 while SSS Comps were +6.1% for the year.
  - Rent per square also up roughly 3%, which explains the flat operating margins/profits even though comps were up 6%.
- The store format shift explains a lot of why they are comping up massively yet not seeing improvement in Operating Income. They are simply moving to more expensive, larger, nicer real estate.
- SSS boost has also clearly come at the expense of gross margin compression (simply liquidating old inventory or lowering price, which is not a sustainable business strategy).



Apart from Elon Musk and Tesla who get credit for every ridiculous press release and every utterance of their future Utopia, this one of the few management teams that gets rewarded for everything they mention they plan to do yet do not show detectable results.

"Three phases of the turnaround plan we put in place a year ago. Phase 1: clean-up of very poor condition of stores and warehouses and exit apparel business. Phase 2: two months later, prepare for Christmas. Phase 3: which we are finishing up just now, is what we call the final phase of the turnaround, which we said on prior calls we expect it to complete by September 1. And while everything may not be perfect, we are basically done. The last four to five months leading up to the September 1 were spent on making the final conversion from the old to the new, selling off the remaining discontinued merchandise, cleaning up a few lumps, bringing in the replacement merchandise, making some modifications to our store layouts so that all 800 plus stores look similar. And now that it is all complete, we are finally looking forward, getting ready for the exciting fall and Christmas selling season. We are now in a position to focus on improving our financial performance both in sales and profit." – CEO on Q4 2014 conference call.
"We have just exited a successful turnaround plan."- CEO on Q1 2015 earnings conference call.

Sell-side statements immediately following entirely at odds with what CEO states about turnaround being done: "We continue to believe that **TUES is in the early stages of a multi-year turnaround** under a very high-quality management team, with a potential upside case that includes high single or even **double-digit comps and double-digit margins**." – Credit Suisse report on TUES, October 1st, 2014. CS goes on to call it conservative **to *not* assume double-digit comps for the**

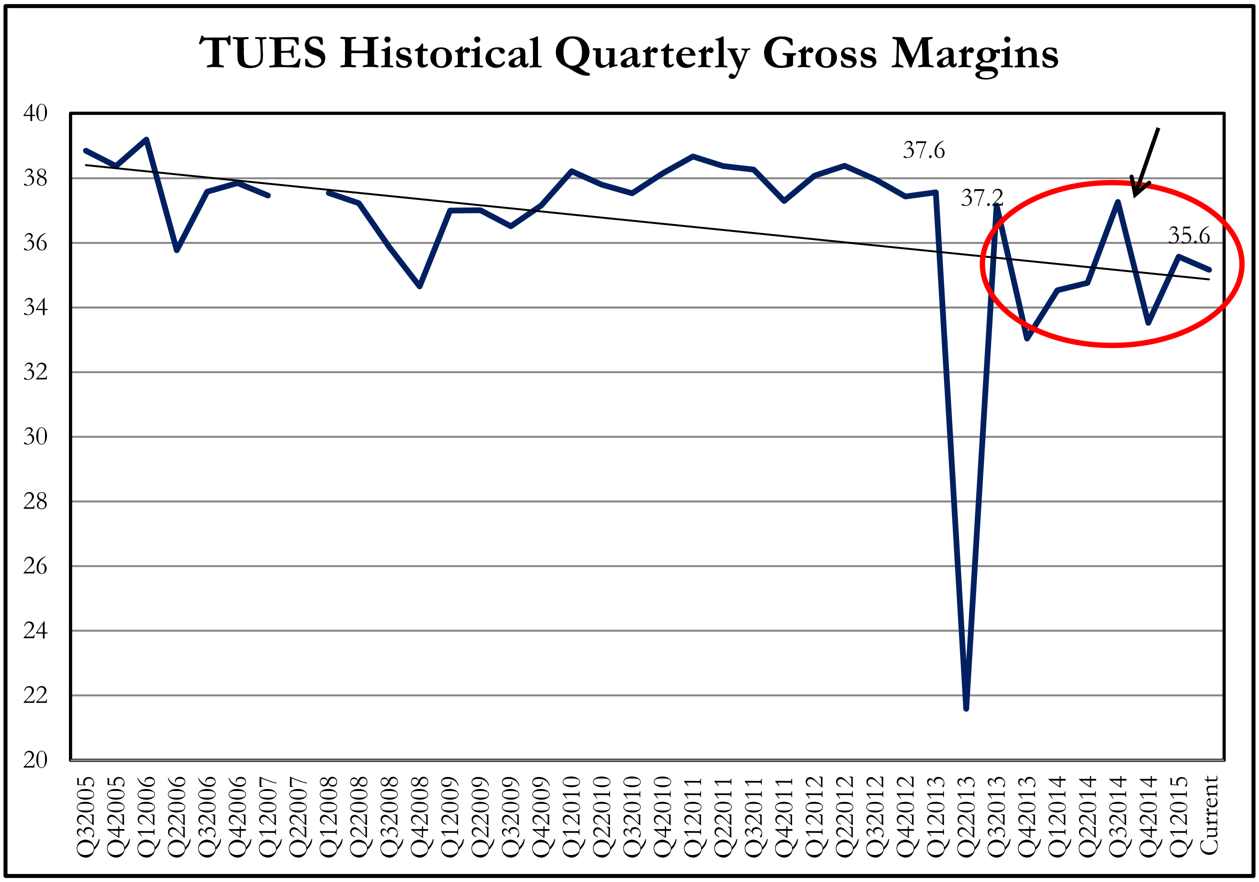
foreseeable future as the company's "core categories" comped up ~13% in FQ4. "Long term, our model does not assume double-digit comps continue, which may be conservative based on the current growth rates (e.g. ~13% "core" comps in FQ4)." This is very dangerous extrapolation and sets TUES up for a great disappointment. As another sign of the bizarre optimism surrounding the name, Stephens research used the phrase "**overly opportunistic**" instead of a more apt "**undisciplined**" to describe real estate decisions that nearly bankrupted the company. In the future I may attribute some of my inevitably bad quarters in the Fund to my being overly opportunistic with our trades.

Turnaround Plans:

- Supply Chain
    - Previous guidance was to open 4-5 new strategically located regional distribution centers by the end of 21014, save on freight
- Growth in comps: SG&A expense leverage as sales per square foot grows faster than square footage and SG&A grows ½ as quickly, so far this has been a big failure
- Merchandise: Rouleau repeatedly states that success is ultimately dependent on merchandise.
    - Exited a few categories that amounted to 7-8% of SKUs,
        - Exited categories include women's apparel and shoes
    - Buy a broader assortment at decreased levels to keep its products fresh and reduce dependence on markdowns
    - "…getting new products in here, that's probably the biggest area of low hanging fruit we have…" – CEO on Q1 2015 call
        - I find this a potential traffic driver, but also a potential risk if the new products/categories flop. They provide precisely zero detail on what areas these include, although one new emphasis has been on pet-related products.
    - TUES has no eCommerce presence. As part of their turnaround strategy TUES has entirely exited eCommerce. This is at odds with the way the world is moving given online sales are taking market share at a rapid clip.

- Marketing: "get more out of less."
    - New hire Susan Davidson, former VP of merchandising at Sally Beauty supply.
        - "Susan is diving in to better understand our customer base and determine how to most effectively use our marketing dollars. We expect that rebuilding our marketing program from the bottom up will take a little time, but we should be able to share our update marketing efforts with you on our next call."
        - It is never a good sign when a retailer has to hire consultants or someone to evaluate who their core customer is.
    - Aim to improve advertising circular for a more focused emphasis on a few items.
    - Sharpening focus on social media presence.
        - I've spent a lot of time in multiple stores and rarely seen a women under the age of 50 in any stores, so I'm not sure how much a new focus on social media will help.
            - Not that I am reading into this too much nor emphasizing it, but to give one a sense of the level of social media "engagement" TUES has 107k "Likes" on FB while HomeGoods has 2.23 million. (21x as many for HomeGoods).
            - TUES = 4,849 followers on Twitter (as of 11/14/14) versus HomeGoods 199k followers (41x as many for HomeGoods).
        - This increased social media focus is also interesting given they completely threw in towel on offering online sales. Technologically speaking, TUES is moving the opposite direction of the consumer.
- Real Estate
    - Guidance is for net closure of 15-30 stores in FY 2015.
        - Guidance is for total square footage to stay constant as they shift to larger stores
    - Consisting of 10-15 new locations, 30-40 closures, 30 relocations (no change in count).
    - Re-locate to more prime locations, larger locations 12,000-15,000 sq ft versus old store base at 7-9k.
        - 13 done in 2014.
        - Guide for 30 in 2015, with 10 already done in Q1 (hence store comp boost front-end loaded on the year).
            - Guide for 50-60 in FY2016.

- Relocated stores also get a "grand-opening" type of boost yet are still included in the comp base
    - Square footage is at a minimum 50% larger for relocated stores (from
- Relocated stores in place for at least a year are seeing "high single digit" SSS growth, which would at best put them in-line with current stores, or given 11% comps in Q1 2015 would put them below existing stores
- Management states that the longer term store opportunity is 1,200 stores
    - 850 clearly proved to be too many and every other off-price brick and mortar retailer has been growing square footage 5-10% a year.



TUES gross margins for the latest quarter (Q1 2015) were up 1.04% year-over-year, but still -1.58% from when Rouleau took over as CEO. On the Q1 conference call Mark Montagna of Avondale ask them about how many basis points gross margins got hit on a final "sweep through clearing out the last bit of discontinued items" for the quarter. The CFO replies "Well, really didn't have…we were pretty cleaned up by the end of June on everything. I think that was really related to that apparel clearance. When we took markdowns in December of 2013 that really kind of reserved for that and that took care of all that penalties. So really in the fourth quarter we were through it all with no net impact. And right in the first quarter, there was no hangover or legacy issues on it. So, really didn't have a drag on the gross margin for that reason, Mark." So there you have management admitting that the current gross margin is pretty much the new standard/normal and nothing was unusual about Q1 2015 with a gross margin rate of 35.2%, 1.6% lower than when the turnaround began. The struggle of gross margins to perk up continues to be completely at-odds with sell-side and management commentary. They keep talking a big game while not delivering results. They guide for only 50-60 basis points of gross margin improvement in FY 2015 over FY2014, which would put the full year at 36.0-36.1%. Sell-side consensus is for a 70 bps improvement in 2015. To put this into historical context, the company's forward guidance is still lower than any TTM period in the company's history prior to Rouleau taking over, including slightly below the 36.13% from the Great Recession period of Q3 2008- Q2 2009.

Stephens (sell-side) modeling on progression of gross margins looks like this: +70 bps in 2015, +125 bps in 2016, +100 bps each year thereafter through 2019. This GM improvement would put them at 40.8% in 2019. This table has historical gross margins and will help put their prediction in proper context:

	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Net Sales	$ 396,095	$ 488,866	$ 586,867	$ 642,398	$ 728,846	$ 822,646	$ 897,841	$ 931,827	$ 911,107	$ 924,199	$ 885,281
COGS	257,037	312,106	389,967	421,703	461,317	513,097	556,623	574,546	568,594	578,881	562,578
Gross Profit	$ 139,058	$ 176,760	$ 196,900	$ 220,695	$ 267,529	$ 309,549	$ 341,218	$ 357,281	$ 342,513	$ 345,318	$ 322,703
Gross Margin	*35.1%*	*36.2%*	*33.6%*	*34.4%*	*36.7%*	*37.6%*	*38.0%*	*38.3%*	*37.6%*	*37.4%*	*36.5%*

After just even casually glancing at this table you will recognize how optimistic the 40.8% is that the sell-side is modeling in.

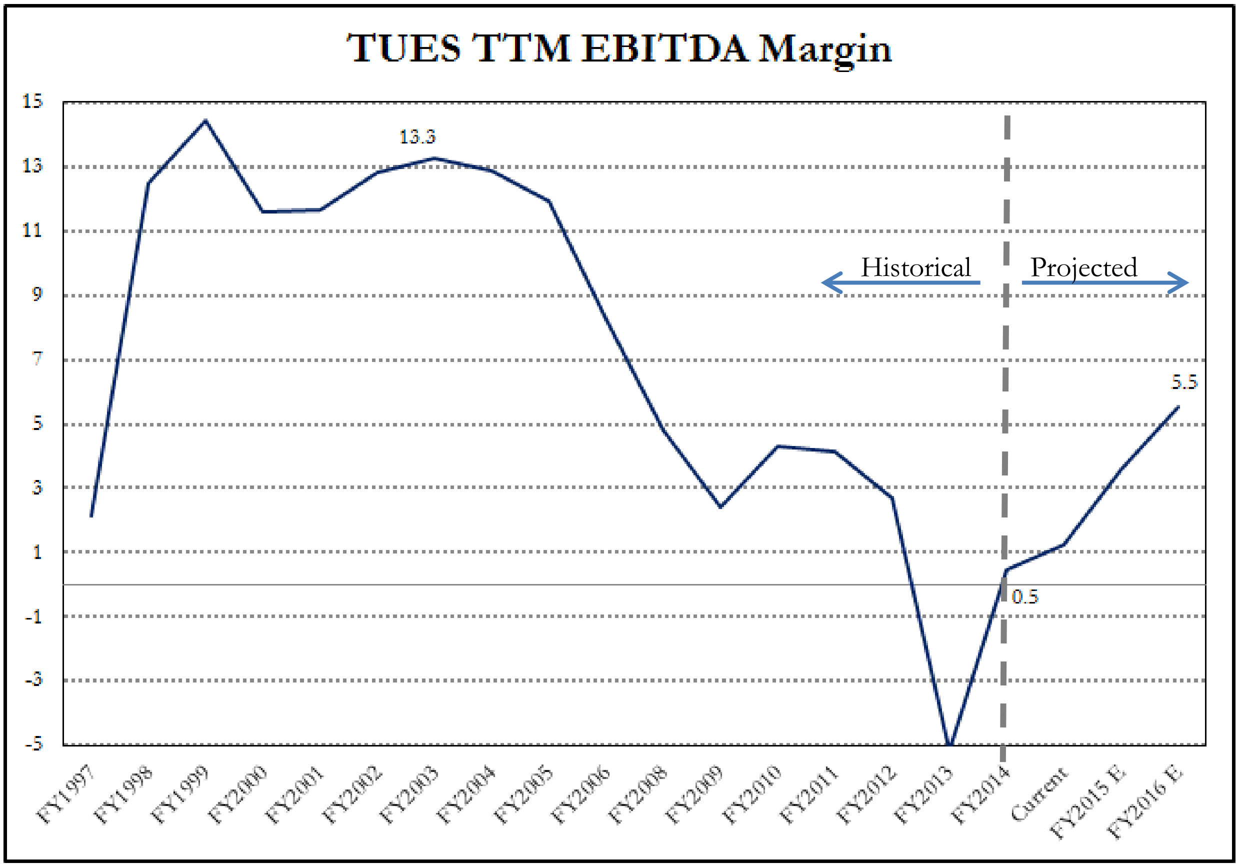
- 40.8% is 4.57% higher than the company's long term average.
- 40.8% is 2.5% better than any year in the company's history.
- 40.8% is 1.95% than they've done on any rolling 4-quarter period.
- 40.8% is 1.61% better than they've ever done in a single quarter in the company's history.
- In the period shown TUES benefitted from the largest housing bubble and consumer debt binge in history.

With the likes of mature eCommerce channels and a saturated off-price brick and mortar space, I don't know how in the world TUES would be able to march gross margins up by 5% over the next few years when Rouleau is struggling mightily to even keep them from collapsing now. Even with these aggressive and unobtainable margins assumptions Stephens only gets to $1.61 in EPS by 2019, putting the stock currently at a, errr, not cheap multiple 13.5x 2019 EPS estimates. If we use Stephens' other revenue and op-ex assumptions but take 2019 gross margins down to TUES' previous peak of 38.3%, we get to 2019 EPS of $1.20, or 17.9x 2019 EPS at current prices. I wouldn't pay more than maybe 12x forward earnings for this business, much less 18x earnings estimates five years from now that assume lock-step improvement in comps and margins each year. We will evaluate valuation more in depth from multiple angles below.

Given the stair step improvements Wall Street has modeled in for every operating and financial metrics, it should also be obvious to you that everyone appears to assume there will be no recession between now and 2019. We are five years into an economic expansion already. The fact that Wall Street hockey-sticks projections is nothing new or unique to TUES. What is important though is that if you look at how TUES comped during the Great Recession, they did not exactly hold up like BBBY. TUES is much more susceptible to recession than a FDO or even BIG, as essentially 100% of the purchases are purely discretionary (no consumer staple type of items. For example at Cost Plus World Market ~35% of sales are consumables/food/beverage). TUES is not a destination store that women must go to buy necessities, but is more of a treasure-hunt impulse shopping experience you go to look for bargains and maybe walk out with some toys for your grandchildren and a new dog bed for Coco or Sparky.

Quick look at valuation scenarios:

- LTM EBITDA margins are 0.5%, while operating margin is still negative 20 months into the turnaround. SG&A is flat since the turnaround began at the end of 2012 despite store count being 5% lower now.
- Operating margins have turned from slightly positive to slightly negative.
- Upside valuation stress test:
    - If we assume TUES can achieve BBBY's industry leading EBITDA margins of 15.1% (2.5% higher than TUES achieved in the golden years from 1999-2004) and slap that on consensus FY2016 Sales estimates of $989 million, which assume a generous two year growth rate of 7%, then TUES could achieve $149mm of EBITDA.
        - Just taking current EV of $930mm that puts them at 6.25x, which is about what PIR, KIRK, and HVT are at now.



  - BBBY is at 7.4x, so giving TUES BBBY's margin profile and multiple on FY2 sales, which would give them their best all time EBITDA, the stock would have only 16% upside.

- Looking out two years, assuming they can achieve a 12x increase in EBITDA to get $50mm, their EV/FY2 EBITDA would still be 18.6x. Using comp group KIRK, PIR, SMRT, FDO, TJX, BBBY, BIG forward Enterprise Multiples and no growth in 2016 over 2015 (that's no growth for the peer group), TUES would still be at a 135% premium to its comp group.

	EV/EBITDA (FY1)	EV/FY2 EBITDA
BIG	7.4x	
KIRK	6.0x	
BBBY	7.4x	
PIR	6.8x	
FDO	11.2x	
SMRT	6.5x	
TJX	9.9x	
TUES		**18.6x**
Comp Average	**7.9x**	
TUES FY2 Premium over Comps FY1		**135.3%**

- TUES is pricing in several years of successful turnaround including either massive positive comps for several years in a row, a return to decent unit growth, all while getting EBITDA margins more in line with peers within ~2 years.
- At PIR's 11% EBITDA margins (assumes 1,200 bps of expansion immediately) on 2015 sales the stock is still at 8.5x.
- The problem with all of these assumptions is management tells you that the turnaround is complete--there is not really any more low hanging fruit. They're done.

Here is another valuation scenario analysis based on future theoretical FCF. I am being very conservative here (from a bearish POV) as I am confident FCF will be overestimated in the near term and I assume 10% sales growth from 2016-2020 using consensus 2016 sales estimates as the baseline for revenue. These assumptions still result in a Price-to-theoretical-2020 FCF multiple of 11.4x. BBBY is available now at a 13.0x P/trailing FCF multiple. 11x is actually higher than the entire weighted average of our current long portfolio and this wouldn't even occur for another six years if everything went swimmingly.

Year	Theoretical Sales		FCF at 5.7% Margin	P/FCF
2016	$989.40	Consensus Estimate	$32.50	28.9x
2017	$1,088.34	10% Sales Growth	$36.95	25.4x
2018	$1,197.17	10% Sales Growth	$51.85	18.1x
2019	$1,316.89	10% Sales Growth	$56.96	16.5x
2020	$1,448.57	10% Sales Growth	$82.43	11.4x
Current Market Cap	$ 938.70			

- 5.7% FCF margin is the single best 5-year rolling cumulative FCF margin TUES has achieved in its history (from 2001-2005).
- Their cumulative FCF conversion as a percent of revenue is 2.9% (since FY 1997)
- In 17 years the company has only generated a cumulative $360 million in FCF versus a current EV $930 million.
- TUES' single best 3-year rolling average FCF period from FY 2001- 2003 at $61.5 million.
  - Another way to think of current valuation is to take the current EV and divide by this peak FCF
  - EV/peak rolling 3-year average FCF is 15.1x
  - This is purely a theoretical exercise as they are unlikely to generate cumulative FCF at all over the next several years as many needed major store and Distribution Center investments are still needed.
  - It appears at first glance as if they generated $17.6 million of FCF in FY 2014, but there was a total of $28.8 million in favorable working capital account shifts, the majority of which are neither repeatable nor sustainable and in fact many will reverse and become a drag in future periods.

If they comp negatively or start a cycle of weak comps with a growth expectations reset the stock could immediately and easily see 50%+ downside.

One thing that would make the short more attractive would be a sloppier balance sheet, but TUES actually has a debt-free balance sheet (ignoring mandatory operating leases).

What does sell-side price in? The stock is already at 13.5x 2019 EPS estimates from Stephens. This assumes positive high single digit comps each year along with 2% operating margin improvements each year, equally split between gross margin expansion and SG&A expense leverage. Secondly, they assume no recession in between now and 2019? During the recessionary period of 2009 the company comp'd negatively at -12.5%. Even if backing up three years, shares are trading at 18x their 2016 EBITDA estimates. They use a 9.0x exit multiple at the end of 2019 for their 5-year DCF, to top off 36% 5-year EBITDA CAGR.

- Screening for any and all completed Retail buyouts in North America within the last two years we can find that the median EV/EBITDA takeout multiple has been 10.87x (30 deal sample size).
  - Skewed higher by some higher multiple franchisor deals being included for conservatism sake, e.g. BKW merging with Tim Hortons.
  - Skewed higher by Sports Chalet acquisition which had marginally positive EBITDA making the multiple higher, yet buyout was a
  - Median multiple paid for just Private Equity backed deals is 8.52x EBITDA

        - Max EBITDA multiple in proposed takeover by a PE firm was just 9.64x in KKR for coveted brand Steinway (pianos)—deal terminated
        - These deals include: Apax buying rue21 at 9.2x (1.01x revenue), Sycamore Partners buying Hot Topic at 8.34x (0.72x revenue), and Apollo Global Management buying CEC Entertainment at 7.83x EBITDA (1.58x revenue—highest EBITDA multiples of any restaurant stock)
        - Assuming TUES exceeds revenue estimates this year and hits $930 million, hits 5% EBITDA margins and is bought at the peak proposed private equity buyout multiple of 9.6x (9.6 * 46.5mm), the shares would be worth $10.21, or 51.7% downside.
- 32% of total announced retail deals had a premium of < 10%
- Some other recent deals:
    - Proposed takeover of FDO by Dollar General just a few months ago
        - 12.2x trailing EBITDA
        - 0.94x sales
        - FDO with 6.5% trailing EBITDA margins
    - Men's Warehouse merger with JOSB
        - 11.6x trailing EBITDA
        - 1.4x EV/Sales
        - JOSB did 12.7% EBITDA margin the previous fiscal year, but EBITDA margins were collapsing
    - Canada Pension Plan Investment Board acquired 99 Cents Only Store in January 2012
        - 8.9x EBITDA
        - 0.29x EV/Revenue
        - Trailing EBITDA margins were 7.0%
    - I think a more relevant transaction is that of the struggling Hasting Entertainment chain in July of this year
        - 10.86x EV/EBITDA, 0.18x EV/Sales
        - Trailing EBITDA margins were 1.6%, more in-line with TUES

The scariest upside valuation scenario I can fathom is one using Cost Plus World Market as a takeout comp. Cost Plus was bought out at 11.7x EBITDA by BBBY in July 2012. It was doing only 5% TTM EBITDA margins at the time and was in the midst of a turnaround and comping up in the high single digits. It was bought at 0.64x sales, only had 259 stores so it was bought out at $2.43mm/store, but was doing $3.8mm/sales per store (stores easily 2x more productive than TUES). Compare this profile to TUES at ~$1.05mm/store and current valuation of 1.05x EV/Sales and 1.2% TTM EBITDA margins. That is the scariest buyout scenario I can think of...this was a strategic buyer and the transaction was tiny for BBBY. So again, even if TUES gets to say 7.5% EBITDA margins in next two years and comps up 10% each year, and is bought out at 12x EBITDA that would mean just 9% upside for the stock (from $21.15)...that is worst case scenario for a short and that is years down the road at best.

Here are some other older yet relevant Transaction Comps similar to CPWM that show a median takeout at 9.6x and average at 12.1x:

Target Company	Date	Total Value	TV/EBITDA	TV/EBIT	TV/Rev	TV/Total Assets
Toys R US Inc/Old	3/17/2005	$ 7,544	11.4x	24.5x	0.7x	0.8x
Dollar General Corp/Old	3/12/2007	$ 7,321	16.3x	29.5x	0.8x	2.4x
Neiman Marcus Group LLC	5/2/2005	$ 5,044	9.6x	12.0x	1.3x	1.8x
Isetan Mitsukoshi Ltd	8/23/2007	$ 4,133	19.1x	37.9x	0.6x	0.8x
Burger King Holdings Inc	9/2/2010	$ 3,934	8.9x	11.8x	1.6x	1.4x
Edgars Consolidated Store	2/8/2007	$ 3,673	9.6x	10.4x	1.6x	3.3x
Statoil Fuel & Retail AS	4/18/2012	$ 3,527	5.9x	8.8x	0.3x	0.9x
AC Moore Arts & Crafts In	10/4/2011	$ 44	--	--	0.1x	0.2x
Brick Ltd/The	11/11/2012	$ 741	6.6x	8.8x	0.6x	1.1x
Restoration Hardware Inc	11/8/2007	$ 278	32.3x	--	0.4x	0.8x
Bals Corp	9/2/2011	$ 169	5.9x	8.0x	0.5x	0.9x
Lesnina doo	8/19/2008	$ 159	7.1x	8.5x	0.9x	1.3x
Sodice Expansion SA	1/9/2006	$ 114	--	11.0x	0.7x	1.3x
Cost Plus Inc	**5/9/2012**	**$ 630**	**11.7x**	**17.9x**	**0.6x**	**1.8x**
Median		**$ 4,009**	**9.6x**	**11.4x**	**0.7x**	**1.2x**
Average		**$ 2,665**	**12.1x**	**15.6x**	**0.8x**	**1.3x**
Max		**$ 7,544**	**32.3x**	**37.9x**	**1.6x**	**3.3x**

ROIC

ROIC for a retailer is mostly a function of its store base (invested capital), gross margins, and working capital turnover. If a company can increase its sales per store or sales per square foot they can leverage their existing fixed-cost/asset base which has a very positive impact on incremental ROIC.

Using consensus expectations the stock would be doing 25% ROIC by 2017, 2.11% higher than BBBY's peak ROIC in FY2005 (BBBY being one of the single best retailers by this metric we can find). Once again, this highlights how optimistic the expectations are, how they are disconnected from economic reality, and how they are more than priced in.

Michael Rouleau took Michael's stores from negative returns to eventually a 15.8% ROIC at its 2005 peak (took 9 years of positive comps). I'm not sure what is structurally different that will allow TUES to become a top-tier ROIC retailer, much less a top performing ROIC company in the entire market. Inventory turns are generally already on par with peers.

Scrutinizing Capital Expenditures

"[We] have now entered what we call a rebuilding phase. This phase is filled with longer term investments…" – CFO on Q1 2015 conference call.

Key Voss Variant View: Even with their extreme "no frills" store format, TUES is under spending on cap-ex relative to their own 20 year history. Their long term average spend on Cap-Ex is 2.0% of sales. During their hey-day period from 1999-2006 they spent 2.4% (peak for a given year was 4.71% in 2002). The lowest rolling three year period was from 2012 - 2014 at 1.5%.

Date	Revenue	Cap-Ex	% of Sales
Q12015	202,208,000	(1,876,000)	-0.9%
Q12014	183,678,000	(3,198,000)	-1.7%
Q12013	172,795,008	(3,614,000)	-2.1%
Q12012	170,652,992	(2,482,000)	-1.5%
Q12011	172,756,000	(5,388,000)	-3.1%
Q12010	165,867,008	(3,757,000)	-2.3%
Q12009	173,400,992	(3,637,000)	-2.1%
Q12008	201,656,000	(3,267,000)	-1.6%
Q12007	189,156,000	(3,404,000)	-1.8%
Q12006	187,759,008	(2,385,000)	-1.3%
Q12005	185,594,000	(4,047,000)	-2.2%
Q12004	168,596,992	(6,279,000)	-3.7%
Q12003	150,354,992	(3,482,000)	-2.3%
Q12002	132,923,992	(15,357,000)	-11.6%
Q12001	109,518,000	(2,471,000)	-2.3%
Q12000	90,491,000	(2,667,000)	-2.9%
Q11999	71,761,000	(2,039,000)	-2.8%
Q11998	58,811,000	(2,064,000)	-3.5%
Q11997	47,514,000	(1,473,000)	-3.1%
Average			**-2.8%**
High	**Q1 2002**		**-11.6%**
Low	**Q1 2015**		**-0.9%**

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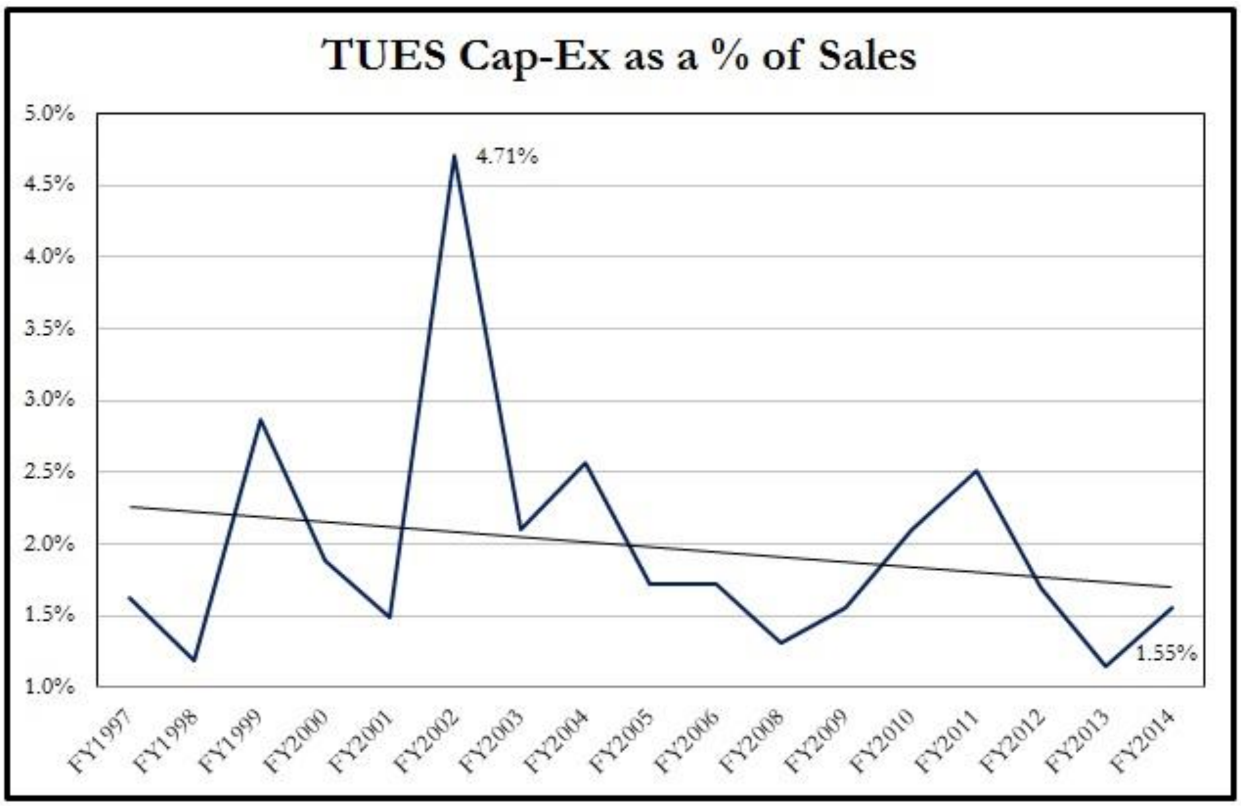
In fiscal FY 2014 they spent 1.6%. <u>In Q1 2015 they spent only 0.9% of quarterly sales on Cap-Ex, the second lowest amount on record for the company.</u> Adjusting for seasonality (e.g. only look at all Q1's—previous low was during a fiscal second quarter when sales are much higher), this latest quarter was a record low. This is strange because on the Q1 2015 earnings conference call the CFO states that they've entered an investment phase.

The average age of assets has been stretched to 9.4 years while the previous peak was in 2001 at 8.12 years. It was after this previous 2001 peak in average age of assets that cap-ex had to ramp up meaningfully to 4.7% in 2002, 2.1% in in 2003 and 2.6% in 2004 (compare to 1.5% in FY2001). We look for a similar ramp in Cap-Ex over at least the next two years as they spend an additional $5-6mm building out three new distribution centers. TUES will likely have negative FCF over the next 2-3 years and if operating margins don't pick up they'll be walking a tight rope and may need to start taking on debt via their revolver.

Sell-side FCF Estimates

	2014A	2015E	2016E	2017E	2018E	2019E
Revenue	864,844	917,870	961,435	1,018,148	1,083,496	1,166,692
CFO	26,878	38,503	47,560	52,264	69,754	90,263
Cap-Ex	(13,434)	(13,837)	(14,252)	(14,680)	(15,120)	(15,574)
% of Sales	***-1.6%***	***-1.5%***	***-1.5%***	***-1.4%***	***-1.4%***	***-1.3%***
FCF	$ 13,444	$ 24,666	$ 33,308	$ 37,584	$ 54,634	$ 74,689
FCF Margin	*1.6%*	*2.7%*	*3.5%*	*3.7%*	*5.0%*	*6.4%*

As the company moves into an investment phase, the sell-side's Cap-Ex estimates have the company spending 30% less on cap-ex than their long term average and ~17.5% lower than their previous lowest rolling 5-year period Cap-Ex spend (1.4% of sales versus lowest in history of 1.7%).



TUES			
Date	Capital Expenditures	Revenue	CapEx as % of Sales
Current	$ (12,112,000)		
FY2014	$ (13,434,000)	$ 864,844,032	1.6%
FY2013	$ (9,608,000)	$ 838,313,984	1.1%
FY2012	$ (13,765,000)	$ 812,782,016	1.7%
FY2011	$ (20,600,000)	$ 821,150,016	2.5%
FY2010	$ (17,432,000)	$ 828,265,024	2.1%
FY2009	$ (12,475,000)	$ 801,721,984	1.6%
FY2008	$ (11,562,000)	$ 885,281,024	1.3%
FY2006	$ (15,701,000)	$ 911,107,008	1.7%
FY2005	$ (16,059,999)	$ 931,827,008	1.7%
FY2004	$ (23,027,000)	$ 897,841,024	2.6%
FY2003	$ (17,273,000)	$ 822,646,016	2.1%
FY2002	$ (34,294,000)	$ 728,846,016	4.7%
FY2001	$ (9,550,000)	$ 642,398,016	1.5%
FY2000	$ (11,046,000)	$ 586,867,008	1.9%
FY1999	$ (14,036,000)	$ 488,865,984	2.9%
FY1998	$ (4,705,000)	$ 396,095,008	1.2%
FY1997	$ (5,310,000)	$ 327,307,008	1.6%
Average			**2.0%**
Average from 1999-2006			**2.4%**
Average 2012-2014			**1.5%**
Lowest Rolling 5-year Cap-Ex Spend			**1.7%**

Arguably the stores will become more productive so sales can ramp up while cap-ex spend comes down as a percentage of sales. The best sales era for them, the period of 1999-2006, we can see that cap-ex was actually elevated relative to their entire history. As the company tries to shift their perception in the market place, it will likely require more capital expenditures than they've historically needed. Not to mention they've alluded to needing new point-of-sale systems and are building out four new distribution centers in the next few quarters (equipping these will cost $5-6mm). To maintain the more upscale perception with shoppers will likely require more maintenance cap-ex as they can't let things get out of control the way they have been historically.

By way of comparison and to give context, the next lowest Cap-Ex spender of any peer is Big Lots, which is also arguably the next worst retail experience (at least speaking from personal opinion). The next lowest spender after BIG is WMT, but their stores are much more productive on a sales per square foot basis. Even the lowest of the low, the dollar stores, spend well over 2x that of TUES on cap-ex as a percent of sales.

	Long Term Average Cap-Ex as % of Sales	TTM Cap-Ex as a % of Sales	Delta b/w TTM and LT Average	Minimum Rolling 5-year Cap-Ex as % of Sales	Delta b/w TTM and Min. Rolling 5-year Avg
TUES	2.0%	1.6%	-21.7%	1.7%	-7.7%
BIG	2.5%	1.7%	-30.9%	1.4%	21.2%
FDO	4.1%	4.2%	1.3%	2.4%	71.4%
KIRK	4.6%	5.5%	20.2%	2.8%	93.0%
TJX	3.3%	3.2%	-3.4%	2.8%	12.6%
ROST	3.5%	5.0%	44.1%	2.8%	77.9%
SMRT	2.2%	3.1%	40.0%	1.5%	112.7%

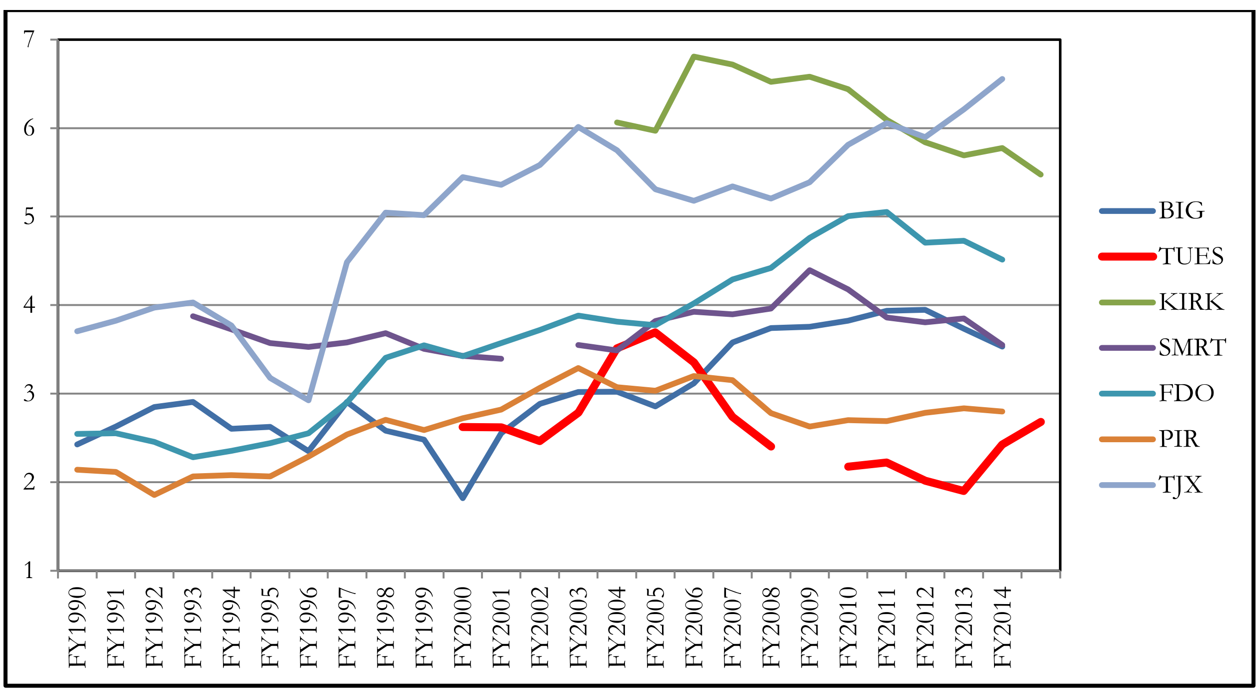
Observations and Key Takeaways from the table above:

- TUES' lowest rolling 5-year period is 1.7% and has been very consistent. No matter which way you slice it, TUES is under spending, especially in the midst of a turnaround moving up-market.
- Because of this, the sell-side is overly optimistic in their future cash flow estimates.
    - Also EV/EBITDA will not be the optimal metric to use to value TUES since Cap-Ex has been depressed. EBITDA-CapEx has been negative in each of the last two fiscal years.
- TUES may be underspending on cap-ex by 33% (1.5% versus long term average of 2.0%).
    - It is tough to enact a turnaround and simultaneous shift up-market while spending a record low amount on cap-ex.
        - Sell-side has cap-ex as percent of sales declining even further, every year from now through 2019.
    - In the latest quarter they gutted cap-ex at 0.94% of sales as cash was likely getting tight and they wanted to avoid taking on debt.
        - This was the second lowest spend in company history (the absolute lowest if excluding higher sale calendar fourth quarter periods).
            - I am not sure how they are doing this—simultaneously gutting cap-ex and enacting a turnaround. In studying other turnarounds, the trend is usually the opposite.
- The lowest rolling 5-year cap-ex spend for BIG was the time period 2006-2010 at 1.4% of sales. BIG's long term average is 2.5%, though, so 2006-2010 was a real outlier.
- Family Dollar's (FDO) minimum rolling 5-year cap-ex spend was 2.4% and the minimum rolling three year period was 2.1%--this is still 0.6% higher than TUES has currently spent on a trailing three year basis and is 0.7% higher than sell-side is modeling in for TUES over the next few years.

Steinmart (SMRT) had the second lowest rolling 5-year period of cap-ex spend just behind BIG at 1.5%, from FY 2000-2005. It should be noted that during this time period they comped -0.70% in 2002, -0.80% in 2003, -4.7% in 2004 and had flat to negative store net store growth.

A lot can go right for TUES, but the way the CEO and sell-side talk continues to be out of touch with the reality of the actual numbers coming out.

Inventory Turnover Comparison

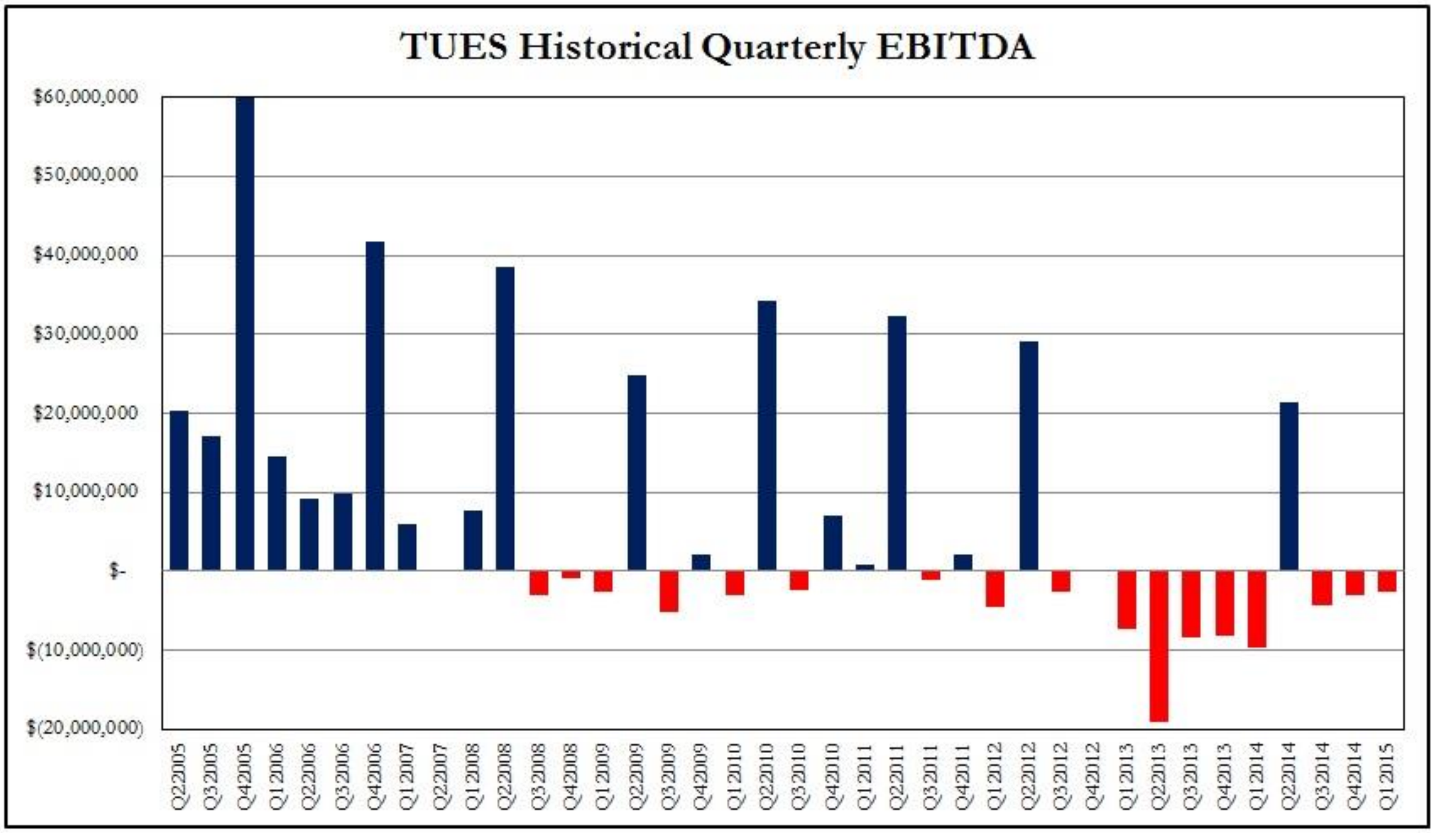


TUES emphasizes inventory turnover improvement, but as we calculate it, any improvement so far looks to be a rounding error. On a per store basis at end of FY2014, inventory was 0.1% higher than a year earlier.

	COGS div by Avg Inventory Inventory Turnover TTM
Q12015	2.60
Q42014	2.56
Q32014	2.53
Q22014	2.43
Q12014	2.58

TUES inventory turnover improvement under the turnaround so far is nearly a rounding error. Management aims to keep the percentage of clearance merchandise at a permanently lower plateau within stores, but this again could be a strategic mistake as we believe it is the "treasure hunt" in the large assortment of items on clearance that drives frequent store visits among its core customer, the bargain shoppers.

Holiday Season is key: As with many retailers, but TUES to an even greater degree, the calendar fourth quarter is key for full year profitability. Since the start of fiscal year 2009 excluding each fourth calendar quarter (so 19 quarters total), TUES has only been EBITDA profitable three times (once was for only $2,000 and another only $755,000). So there is extreme seasonality and the holiday shopping season will be key for TUES and for management's credibility. Our store checks leading up to Halloween showed TUES' seasonal Halloween related merchandise pretty lacking relative to competitors, but it's hard to scientifically quantify that. We will monitor stores leading up to Thanksgiving and Christmas in the Houston and Dallas areas (their largest exposures). Early store checks reveal HomeGoods' selection of and floor space dedicated to Christmas related merchandise is about 10x that of TUES.



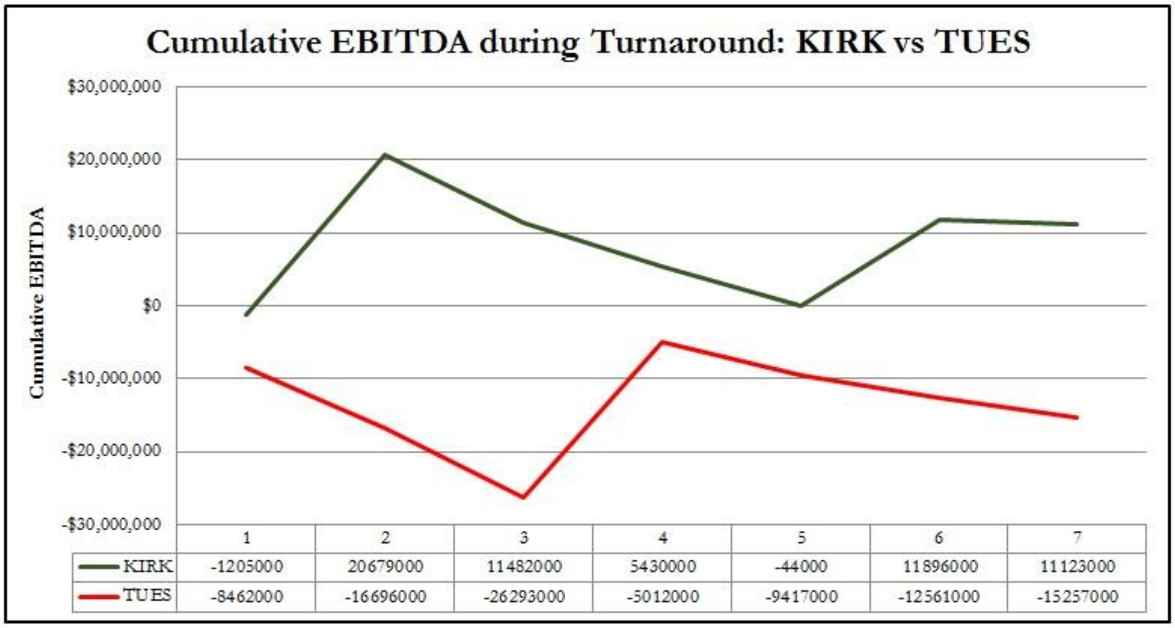
Margins are not improving as quickly as Wall Street has expected yet they maintain their maniacal focus on SSS comps and Rouleau's unbounded excitement over how all the stores look so great. This holiday season will be very important for TUES.

Operating loss in the latest quarter was $5.8 million, compared to an operating loss of $12.5 million the year before. The prior year included $2.4 million in net pre-tax expenses for related turnaround SG&A items, so the adjusted operating loss was $10.1 million.

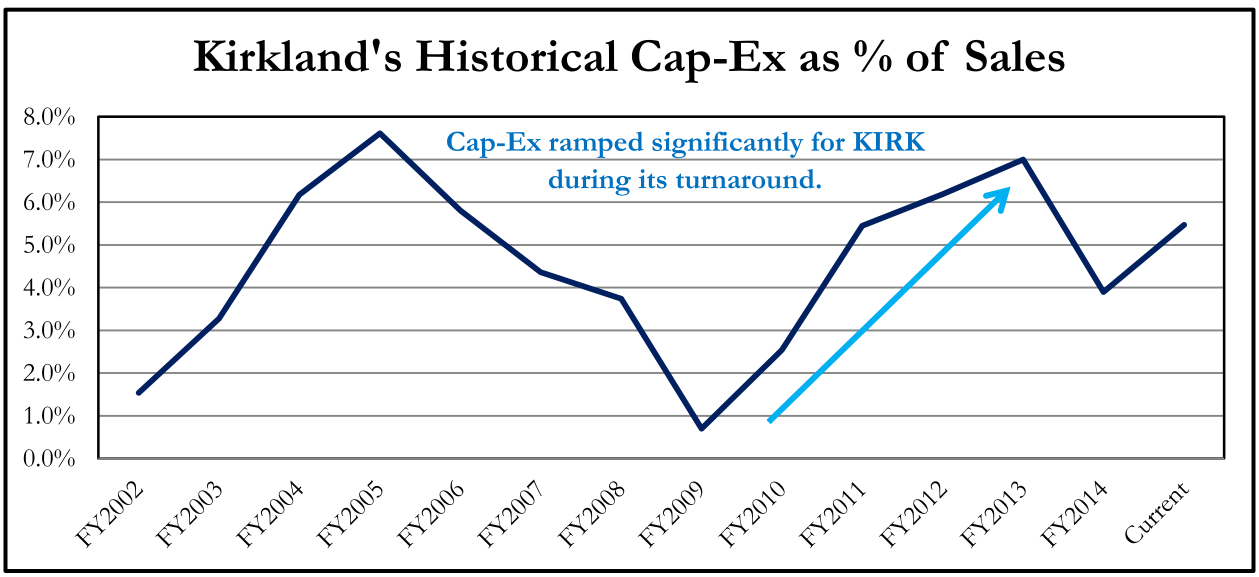
Historical Comparisons and Case Studies

I think there are several apt recent historical case studies to put the lack of TUES turnaround into perspective, but we will focus on just a few of them that I am more familiar with.

Firstly, Kirkland's. During the Great Recession KIRK was quickly shifting its store base from inside malls to off-mall. They shifted **58% of the store base in 5-years** into lower rent per-square-foot locations, all the while comping up (several quarters of double digit positive comps in the midst of the turnaround), ramping up cap-ex, and continuing to generate FCF. TUES is shifting the store base into higher rent locations, though not as rapidly. TUES has also gutted its already record low cap-ex (often the stores have bare cement floors and the shelving is 20 years old) and still is not EBITDA positive. This chart shows the cumulative EBITDA for KIRK versus TUES at a similar point in their turnaround. It is hard to pick a precise starting point that matches them up exactly, but the below starts the quarter AFTER both companies took large inventory write-downs, which I think represents a good "re-set" type of equivalent starting point in a turnaround effort. KIRK was generating positive EBITDA, while TUES' cumulative EBITDA is still solidly negative seven quarters after the big inventory bath.

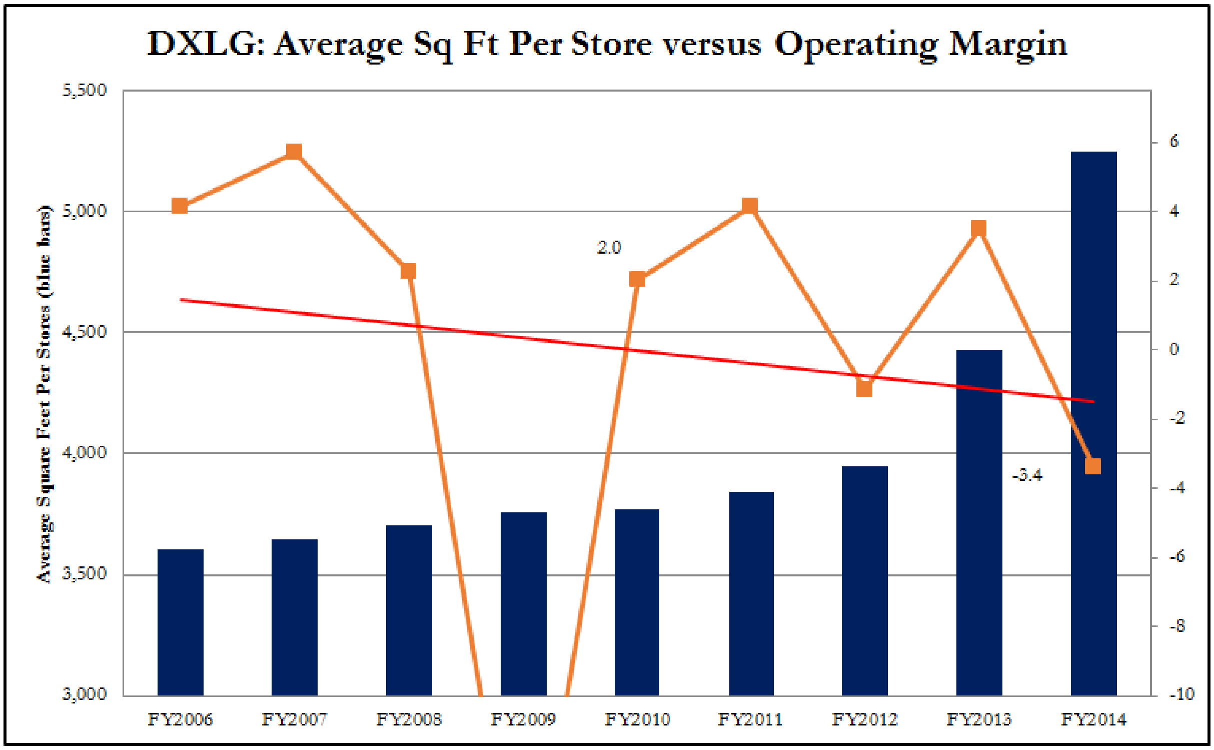


An additional point to note is that 7-quarters into its turnaround effort, KIRK had spent an average of 3.8% of sales on Cap-Ex, with a front-end loaded effort of 4.6% (ranging from 2.5%-6.9%) during the first year.



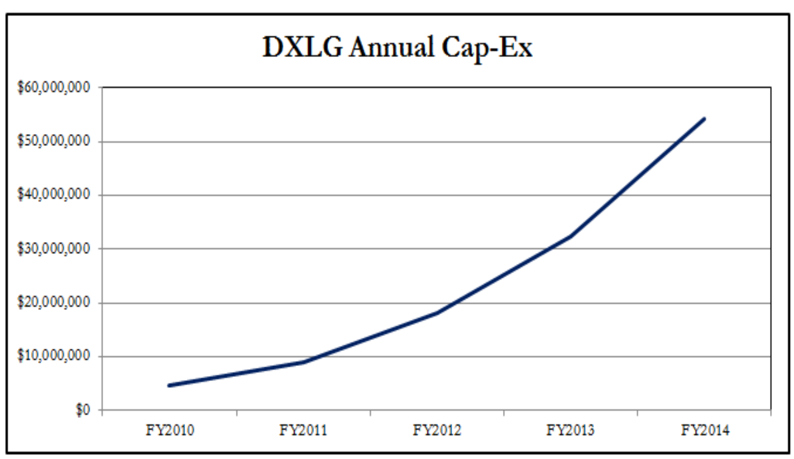
In reviewing their old conference call transcripts it is clear that KIRK began a heavy emphasis on its online and eCommerce presence in the middle of its turnaround. They had already amassed a 2.5 million person e-mail distribution list and "re-launched" their eCommerce platform, specifically allowing women to order/pay online and pick-up merchandise in stores. Also KIRK strives for more proprietary merchandise relative to TUES, which is of course focused more on buying closeout retail goods. It is obvious that walking into a Kirkland's there is more unique merchandise versus walking into a Ross store or Tuesday Morning where much of the merchandise overlaps (e.g. they both have all the exact same luggage).

Another good case study is the old Casual Male Retail Group, now called Destination XL Group (ticker DXLG). DXLG is a retailer of men's "big and tall" clothing. In a turnaround effort for DXLG management's main strategy was to shift to aggressively shift to a nicer larger store base and close smaller stores, going from 3,200 square stores up to a range of 8,000-12,000 square feet.



The chart above shows DXLG's average square feet per store with their operating margins overlaid. Shifting to a larger store format was certainly no panacea as in the most recent fiscal year DXLG's operating margins have gone solidly negative (red-line in the chart is a trend line of operating margins), just when their store sizes have really ramped up as their strategy accelerated. We cannot necessarily imply causation from correlation, but the obvious parallels to TUES strategy are there. *There are many other interesting insights to be gleaned from the DXLG case study*:

- DXLG has had positive SSS comps in each of FY2011, FY2012, FY2012, FY2013, FY2014 and first two quarters of Fiscal 2015
  - Only two negative quarter comps (Q1 2011 and Q1 2014).
    - This is not unlike TUES with its positive comps and like TUES, DXLG is struggling to maintain gross margins and is *not* operating income positive.
- With hindsight it is clear beyond all doubt that the sell-side had drastically overestimated DXLG's FCF in future periods as they extrapolated unsustainably low cap-ex from FY2010 and FY2011.
  - Actual cap-ex ramped up ~10x over the next five years.
  - Using estimates from the end of 2011, the consensus FCF estimates were overestimated by a cumulative $63.7 million over the next three years (that is for FY 2012, FY2013, FY2014).
  - While shifting the store base to larger stores and comping positively, DXLG's stock has gone no where in two years despite starting at a valuation about ½ that of TUES (based on EV/Forward Sales)
  - DXLG has seen multiple expansion and yet the stock has still been flat
  - TUES could play out very similarly.



Off-Price Retail is Getting Quite Saturated

TUES biggest exposures are to Texas, California, and Florida. These are also HomeGoods' top three states in terms of number of locations, and are three of the top four states for HomeGoods in terms of unit growth from 2009-2014. TUES does not have an online sales platform, so although it technically competes with the likes of Amazon, Zulily and other close-out eCommerce companies, we will focus on just a few of the brick-and-mortar competitors.

In general, off-price retailers such as TJX Companies and Ross Stores have no doubt been taking market share from the likes of JCP, SHLD KSS, and mall-based department stores.

JP Morgan is predicting 5% square footage growth over next 10 years for the off-price space in aggregate, which is actually lower than a bottom-up forecast I derive using guidance from some of the major players.

TJ Maxx/Marshalls: current = 2,021 | Target = 3,000 (opening ~75/year)

HomeGoods- TJX's home fashion store: current store count = 450 | target = 825

- Started in 1992.
- 450 stores.
- Home basics, giftware, accent furniture, lamps, rugs, wall décor, decorative accessories, seasonal merchandise.
- Average square footage per store is 25,000.
- Progression of store growth: 415 in 2013, 450 in 2014 (8.4% YoY growth), est. 485 in 2015 (7.7% store growth YoY).
- Sometimes stores are co-located with a TJ Maxx or Marshall's in a superstore format.
- Net sales in 2014 were $2.99 billion.
    - Up from $2.24 billion in 2012.
    - 12.9% segment operating income (before corporate overhead allocation).
    - SSS +7.0% in FY2014.
        - Compare this to TUES SSS in 2014 of +6.1% (even with the benefit of playing games by shifting to 2x larger stores).
        - Assuming the stores opened in FY2014 were perfectly evenly spread throughout the year, there was an average of 432.5 stores.
            - HomeGoods does $6.913 million in sales per average store.
            - Using average 25k square feet/store this means HomeGoods does $276.53 sales/psf.
- TJX consolidated geographic revenue concentration: 24% NE, 12% Midwest, 25% South, 15% West (76% total due to just counting US sales).
- TJX consolidated gets 28% of sales from Home Fashions category.
- Is HomeGoods having an effect on Tuesday Morning?
    - Let's examine this…

Homegoods Top Ten Growth States			TUES Net Closure in Homegood Growth States		
1	California	18	1	California	-13
2	New York	15	2	New York	-2
3	Texas	14	3	Texas	-1
4	Florida	8	4	Florida	-2
5	Illinois	7	5	Illinois	-2
6	Virginia	7	6	Virginia	-4
7	New Jersey	7	7	New Jersey	-1
8	Pennsylvania	7	8	Pennsylvania	-2
9	Maryland	4	9	Maryland	-2
10	Massachusetts	3	10	Massachusetts	-1
		90			-30

What this table shows is the net change in store count by state from 2009-2014 for both HomeGoods and Tuesday Morning. 2009 was the first year that TUES provided a state-by-state breakdown. The states were chosen because they are the ones where HomeGoods has grown their net store count the most since 2009. The key takeaway is that in the states that HomeGoods is growing store count the fastest in account for a disproportionate amount of the TUES net store closures since the end of 2009.

- Key insight: In 2009 TUES had only 48% of its store base in the top ten states that HomeGoods has grown store count, versus 64% of its total net store closures coming from those ten states.

Now we cannot necessarily imply correlation with causation, but this certainly isn't an incremental positive for TUES any way you slice it. Naturally the store concentration profiles are similar for both companies are they include many of the most populous states and can bear the most retail square footage. To put it simply though, it appears that TUES is shutting stores most aggressively where HomeGoods is most aggressively growing. HomeGoods is presumably experiencing positive SSS comps in these geographies or they would not keep growing. This demonstrates that several competitors are "out-competing" TUES and running them off.

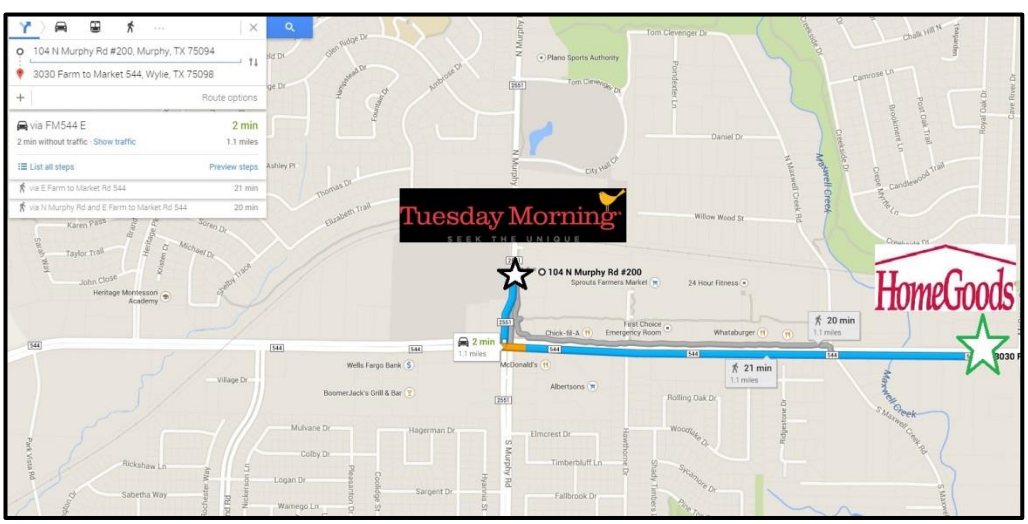
Additional observations using HomeGoods expansion as a proxy for competition:

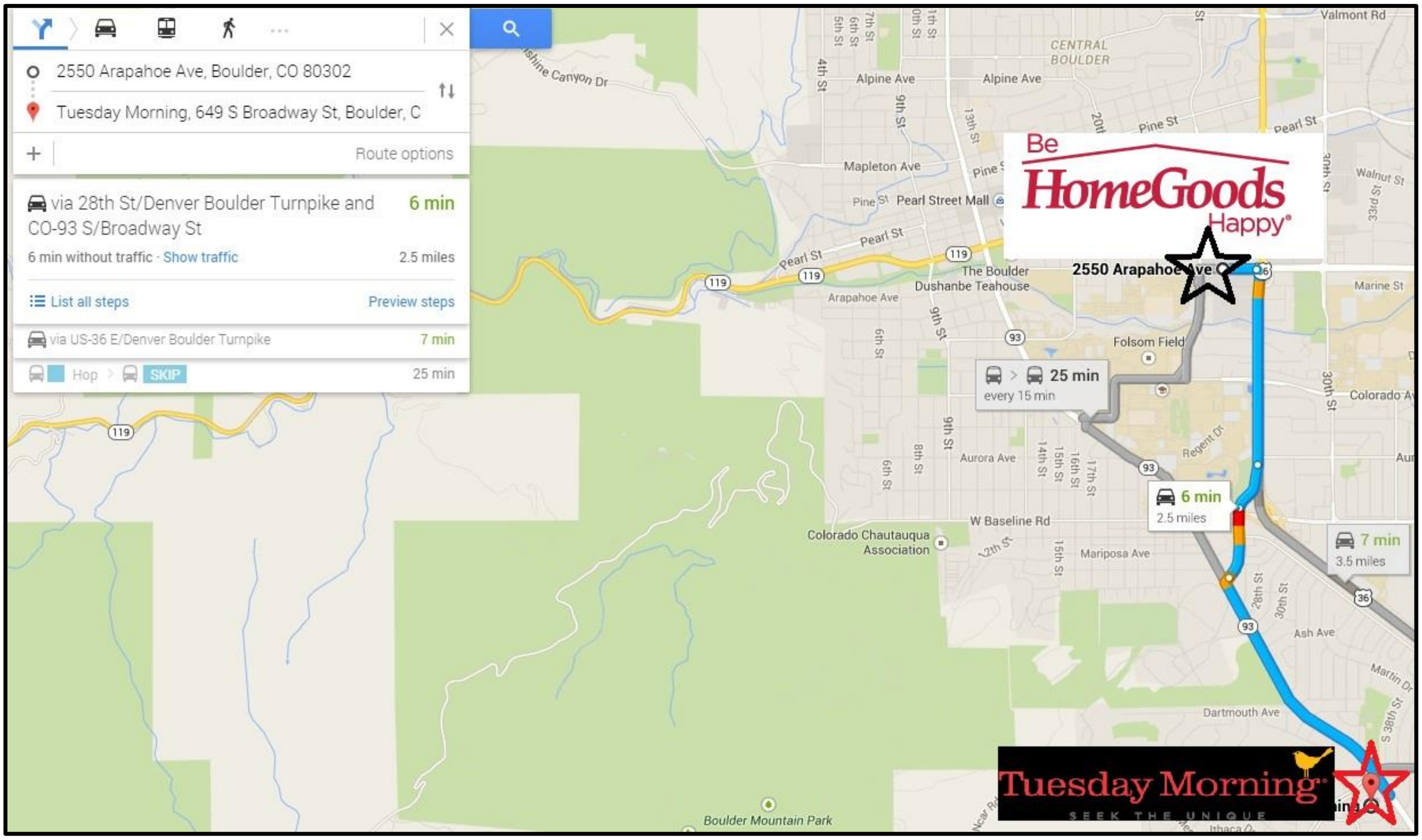
- TUES actually has had minor net store growth in 9 total states since 2009.
  - Cumulatively 11 net store count growth in these 9 states, ranging from +1 to +2 stores
    - HomeGoods did not open any stores in 2 of the 9 states (KS & OR)
    - HomeGoods only has 1 store 3 of the remaining 7 states
    - 3 of the remaining 4 states were in HomeGoods' bottom 10 in terms of store growth (typically growth of only +1 store)
  - Again it is tough to tell exactly without mapping out each store that is opened/closed, but when HomeGoods zigs, it looks like TUES zags the heck out of there.
    - A positive for TUES is that they clearly were moving some stores into states where HomeGoods is absent or not focused on growing, e.g. Kansas.

While not exactly mapping out every store, we can take this geographical analysis one step further and we can discover that HomeGoods is very recently literally moving into Tuesday Morning's backyard all over the country. Checking a very small, random sampling of the most recently opened HomeGoods locations that are listed on HomeGoods website as brand new ("Now Open!"), I find that almost everyone I check is <4 miles from an existing Tuesday Morning store. Many have just opened within the last 1-3 weeks (Kissimee, FL location—November 13th, 2014).

This is one of the random new HomeGoods locations I checked. Pretty simple process-- after punching in the address to GoogleMaps, I'd search Tuesdaymorning.com's store locator for the same zip code and then enter the address that was closest. The majority of the new HomeGoods stores are at least within five miles of existing TUES locations. Shown in the above screenshot is a new HomeGoods that **just had its grand opening event on October 26th 2014**. This new HomeGoods is only 0.3 miles from an existing TUES location in Fairview Heights, IL. **Is it so crowded that HomeGoods is opening up a brand new store literally across the street from a Tuesday Morning in Fairview Heights, Illinois—population a whopping ~17,000.**

Below is a new HomeGoods that opened sometime in August 2014 that is just 1.1 miles down the road from an existing TUES in Wylie, Texas.





One more example for good measure. Here is brand new 25,000 square foot HomeGoods mapped relative to a TUES in Boulder—**this HomeGoods also just opened [October 26th, 2014], less than three weeks ago.**

Here are stats on a few more (without the maps):

- HomeGoods opened in Little Rock, AR on October 26th, 2014 3.5 miles from nearest TUES.
- HomeGoods opened in Tequesta, FL **next door in the same shopping center** as TUES on October 16th, 2014.
- HomeGoods opened in Pleasant Hills, CA in Q1 2014 1.7 miles from nearest TUES.
- HomeGoods opened in Cedar Rapids, IA 1.6 miles from nearest TUES in early fall 2014.
- HomeGoods opened in Baton Rouge, LA on October 5th, 2014 3.3 miles from nearest TUES.
- HomeGoods opened in Gaithersburg, MD on May 18th 2.0 miles from nearest TUES.
- At least five others have opened between 4-5 miles away within the last quarter.7) Talk

Most of the new HomeGoods locations I checked were in cities I have never heard of, such as Wylie, Texas (population 41k, median household income of $58k). I think this demonstrates solid evidence and proof of the extremely competitive nature of the saturated off-price brick-and-mortar retail segment. The biggest players are moving into cities with populations as low as 17k. Also as previously demonstrated, TUES is exiting states/areas where HomeGoods is growing most aggressively. Not even thinking about online competition or any other off-price retailer opening stores we know that HomeGoods is slated to open 35 new stores this year, likely continuing the trend of opening within 1-3 miles of Tuesday Mornings. We now know that they are willing to scrape the bottom of the barrel move into third-tier cities with populations as small at 17k people. While three miles away in some sprawling cities is quite far and it is quite common for competitors to be next door to each and both survive (e.g. Burger King across the street from MCDonald's or Lowe's and Home Depot across the street from each other), in this particular instance HomeGoods moving in one miles is not positive any way you slice it. TUES is fighting for every dollar of revenue at this point and any incremental negative will hurt the turnaround effort. Positive SSS comps will be tougher and tougher for TUES to achieve. So far they have only been at the cost of gross margin compression (negative EBITDA and operating margin 6 quarters into "turnaround") and shifting to 100% larger stores while keeping those stores in the comp group.

I'll quickly comment on a few other similar retailers:

- Ross Stores: current = 1,287 | target = 2,500 (there are already 30+ in Houston MSA)
  - More soft-line merchandise focus, but significant overlap with similar prices in categories such as kitchen ware and luggage.
- Burlington Coat Factory: current = 522 | target =1,000 (there are 10 in Houston MSA already)
  - In addition to coats, suits and clothing, they sell luggage, wall art, kitchen utensils/dishes/pots-n-pans
    - More overlap with TUES than many think
- Cost Plus World Market, owned by BBBY
  - Sales mix ~65% home furnishings
  - 237 stores at end of 2004, 265 at end of 2013
  - More proprietary products and private label relative to Tuesday
    - Makes TUES hopes for equal profitability less likely
    - Only achieved 4.3% average EBITDA margins from 2002-2012, peak EBITDA margin was 9.7% in FY2004 (same year of TUES peak)
    - Gross margins peaked at 35% in FY2003 & FY2004
      - Average gross margin from 2002-2012 was 31.4%
- At Home – (formerly Garden Ridge, but converting all stores): "The Home décor superstore"
  - ~85 locations, significant geographical and product overlap with TUES.
    - Six in D/FW area, TUES highest concentration.
    - Highest concentration in Texas
  - Merchandise strategy is deep and cheap, "fast and affordable" with eCommerce level of breadth under one roof.
    - 50,000 SKUs
    - Claim to have 10x the assortment/choices of competitors in products such as mirrors, area rugs, outdoor furniture
  - Company plans to open 200 new stores by 2020, ultimate goal is to have 500 stores.
    - Opened/opening 16 in 2014
    - Target closed nine stores in 2013 and At Home moved into seven of them.
    - Also moving into former department store spaces in malls.
  - Had $388 million in annual sales at time of sale in 2011
  - New CEO, Lee Bird, in December 2012
    - Conversations with private equity associates reveal he is truly a detailed oriented retail turnaround expert
      - Moved corporate headquarters into unused space within the company's Plano distribution center (awesome).

The competition to acquire close-out merchandise from other retailers and manufacturers has stiffened significantly with the explosive growth of BigLots, TJX Companies and many pure eCommerce players like Overstock.com (OSTK).

Discount Mass Retailers such as WMT and TGT can also be considered competition. They may not provide as many brand name goods but our close examination of TUES' merchandise reveals significant overlap in the majority of categories where brand is not as important as price (e.g. dog toys). These mass discount retailers turn inventory over very quickly and can rapidly respond to shifting product demand trends. For example during the great scrapbooking bubble I discussed, WMT made many public comments about designating more shelf space to arts & crafts and quickly ramped up the relevant SKUs available in their stores. If any certain category TUES is in catches on the Wal-Marts and Targets can quickly stock up on similar merchandise.

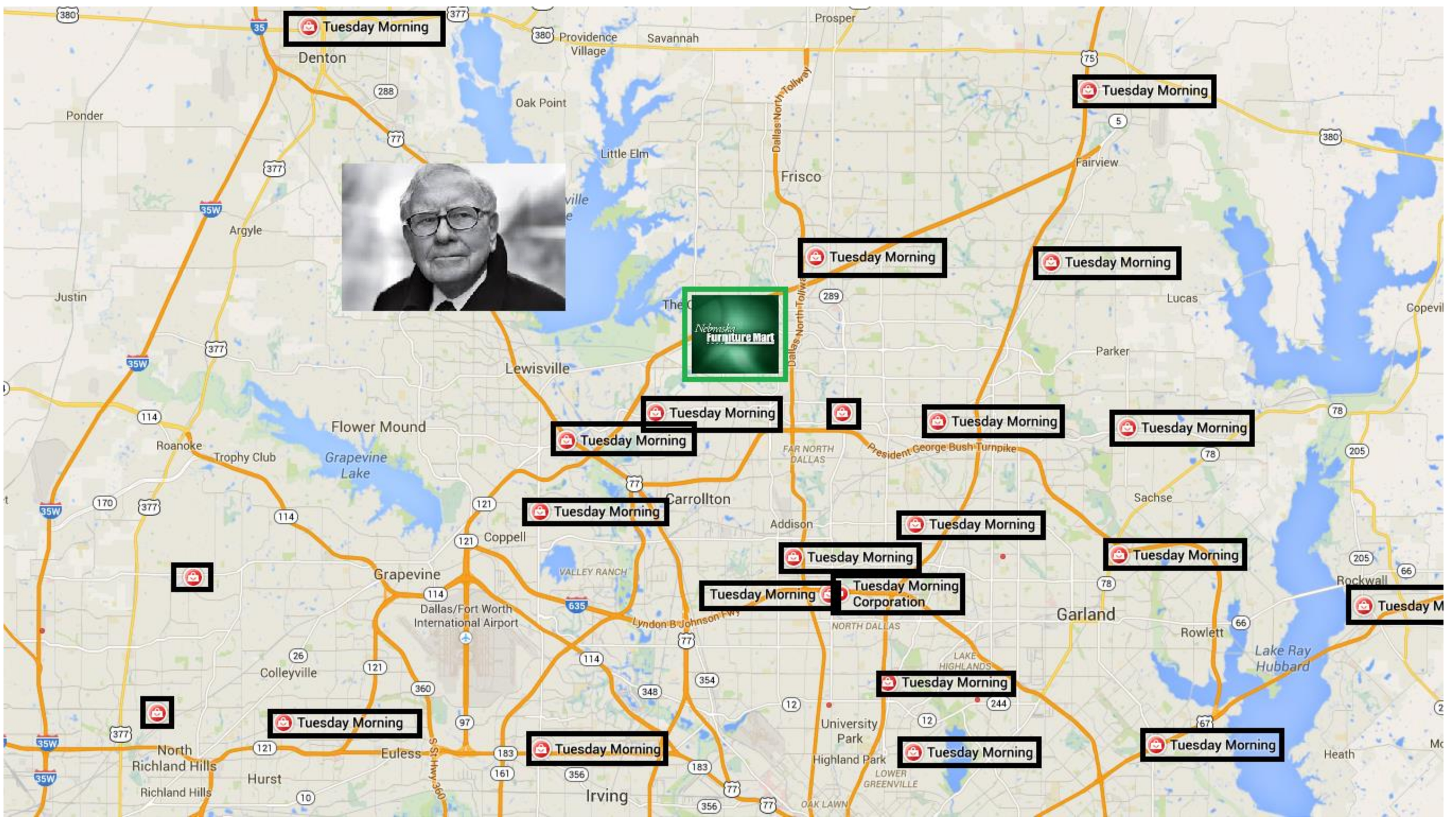
I'm sure there are many others I am excluding here for the sake of brevity (…I say as we are on page 34). Growing current 4,270 off-price retailer store count 5% for 10 years would mean there would be 6,955 by end of 2024. Store targets added up is equal to 7,555. Can the US (and TUES) bear 62% more discount stores in ten years' time? The store economics will likely have to get worse from here for all players.

I will touch on one more noteworthy competitor…

The Mother of all furniture/home décor stores is about to land in Tuesday Morning's back yard…

Nebraska Furniture Mart of Texas is slated to open in spring 2015 the middle of The Colony (North Dallas), which is where TUES' greatest store concentration is (map below). Nebraska Furniture Mart of Texas is expected to be the single largest retailer in the country (expected to have $600mm in sales—*not my estimates*). The merchandise overlap may be minimal and the target audience slightly different, but with hundreds of millions in sales expected and its near proximity to 15+ Tuesday Morning locations, at the very least Nebraska Furniture Mart of Texas will be a slight incremental negative.

http://www.nfm.com/list.aspx?dsNav=Ntk:primary%7Ctexas+store%7C3%7C



Additional New Online Competitors to consider: ZU, Overstock, Groupon.

Insider Selling:

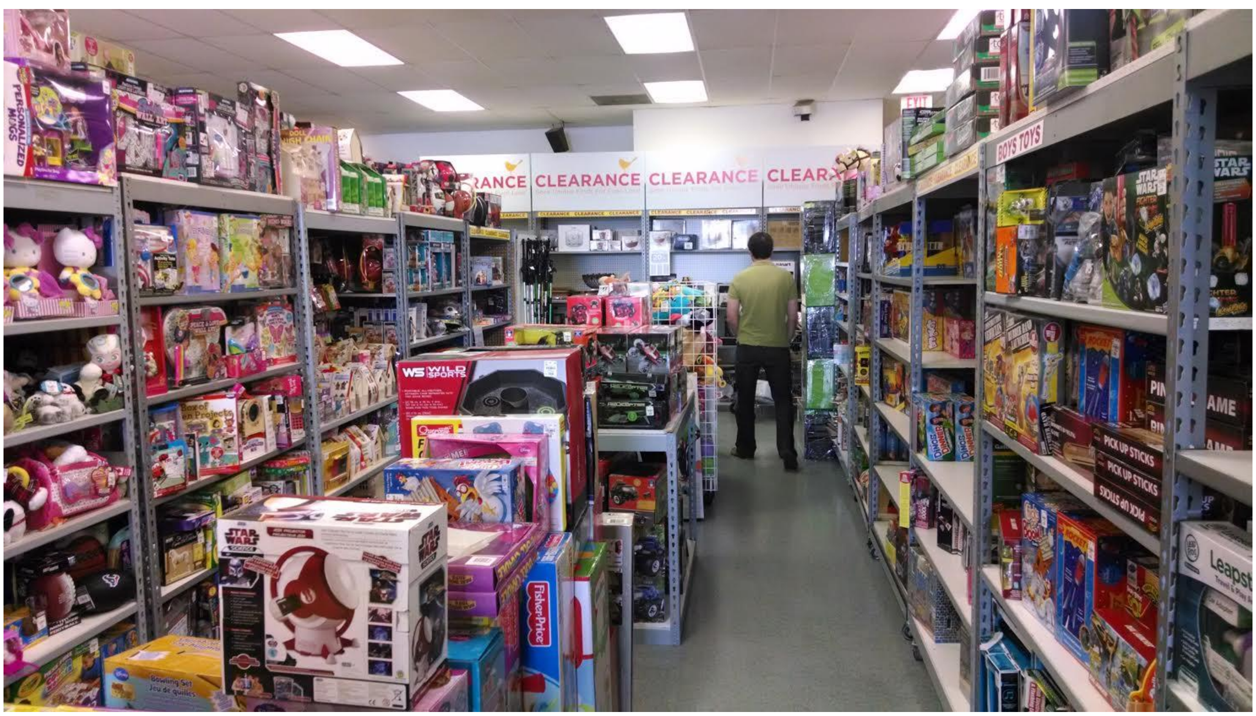
Steven Becker, noted hedge fund manager and retail activist out of Dallas (Becker Drapkin Management) got on TUES' Board in July 2012 and took over as Chairman of the Board in November 2012. Becker has been selling his position down aggressively, starting at prices as low as $12 versus the current price of $21.80. His stake is down to <0.5% (seemingly on its way to zero) from 8.7% a few quarters back. This gives me confidence that a takeout is much less likely, because if Becker were confident in either the turnaround prospects/earnings power or valuation and ultimately company sale, I don't think he would have been eliminating his position at prices up to 43% lower than the current share price.

- Also Board member at Fuel Systems Solutions and SDIX Inc.
- Originally filed a 13-D on June 6th, 2012
- Note that he is known for being on the board of Hot Topic and helping enact that turnaround.
  - HOTT buyout was at < 8.5x EBITDA and HOTT had 8.5% EBITDA margins
    - If TUES achieved these metrics on forward sales it would give the stock 29% downside

Transaction Type: Open Market Sale | 9) Chart | 10) Table
Shareholders: All | Range 11/10/11 - 11/10/14

	Trade Date	No. Part	Participants	Net Sell (Shares)	Net Buy (Shares)	Close Price	Volume
11)	06/06/2014	1	BECKER DRAPKIN	-25,000		18.5100	556,498
12)	06/05/2014	1	BECKER DRAPKIN	-75,000		18.6300	1.522MLN
13)	06/04/2014	1	BECKER DRAPKIN	-150,000		18.0600	2.096MLN
14)	02/25/2014	1	BECKER DRAPKIN	-147,815		15.6000	865,397
15)	02/24/2014	1	BECKER DRAPKIN	-25,000		14.6200	344,917
16)	02/14/2014	1	BECKER DRAPKIN	-186,596		14.0000	396,226
17)	02/13/2014	1	BECKER DRAPKIN	-210,000		14.0700	457,399
18)	02/12/2014	1	BECKER DRAPKIN	-500,000		14.2800	1.202MLN
19)	01/03/2014	1	BECKER DRAPKIN	-20,800		14.9300	339,723
20)	01/02/2014	1	BECKER DRAPKIN	-31,520		15.2000	399,845
21)	11/29/2013	1	BECKER DRAPKIN	-43,115		13.8500	143,425
22)	11/27/2013	1	BECKER DRAPKIN	-153,301		14.0500	430,603
23)	11/26/2013	1	BECKER DRAPKIN	-198,898		14.0500	748,379
24)	11/07/2013	1	BECKER DRAPKIN	-70,433		12.5200	426,213
25)	11/06/2013	1	BECKER DRAPKIN	-255,600		12.6500	699,092
26)	11/05/2013	1	BECKER DRAPKIN	-496,055		12.9800	906,962
27)	08/30/2013	1	JOHNSON STARLETTE	-32,136		12.3100	256,823
28)	08/23/2013	1	BECKER DRAPKIN	-955,000		13.9000	1.687MLN
29)	02/17/2012	1	PAGE MELINDA	-26,617		3.5900	150,014

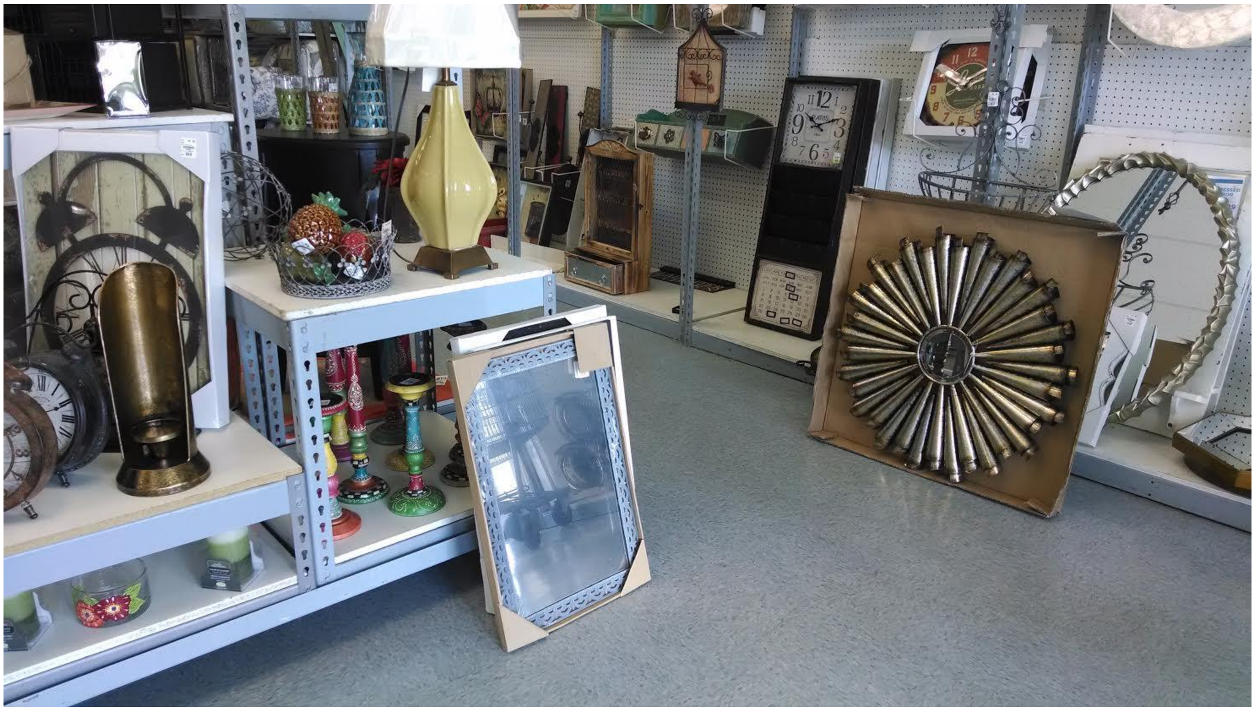

PRESCHOOL TOYS
CORVETTE C6-R
PORSCHE
BUGS BUNNY
RESCUE VEHICLES

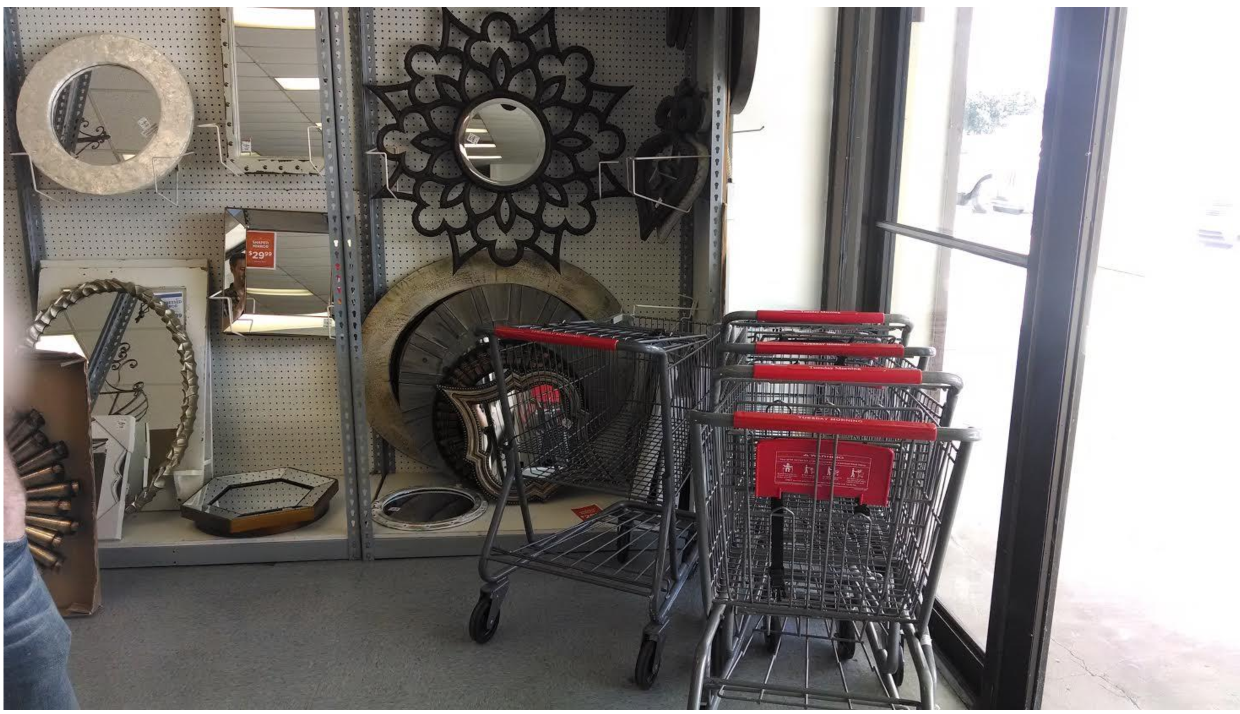

CLEARANCE
CLEARANCE
BOYS TOYS
STAR WARS
PICK UP STICKS
Fisher-Price

"*Our stores are looking pretty darn good, all looking similar…*" CEO on latest conference call.

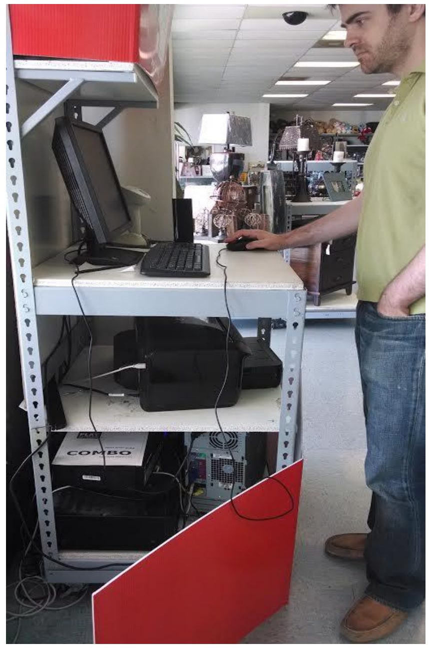
Above is the view at the back of one of the Houston locations we visited. Unopened boxes of inventory stacked to the ceiling, spilling out into main shopping aisle. In front of that, merchandise is literally falling off the clearance shelves. Notice the industrial looking shelving that you may have in your garage. These no doubt have solid asset-lives, but one drawback is they are generally fixed to the ground. If you walk into a Pier-1 or Kirkland's you will see their nice shelves are usually on wheels for quick movement to change the store layout periodically. We actually think there is some benefit in the eyes of many TUES shoppers of having a disorganized "garage sale-esque" feel to the stores. By way of comparison, think of some of the cheap dumpling shops that are in nice neighborhoods in NYC (such as C&C Prosperity Dumpling on the Lower East Side). You walk in and the place is tiny and cramped, like with many TUES locations the dirty linoleum floors have clearly not been replaced in at least 20 years, there is a dirty area rug scrunched against the wall in a random place on the floor, and the chairs along ratty wall counter are old and none of them match. If you are a bargain hunter like me, you derive some perverse satisfaction in this as you fork over only $1.25 for four scrumptious, large pork dumplings. You feel like you're getting a great deal and the sense of getting a bargain goes hand-in-hand with decrepit décor. If they remodeled the place it would seem "off."

They utilize a color coded "sticker strategy" to denote clearance items that are sprinkled throughout the store. As shown above there is also always a designated clearance rack at the back of a store, which is also what HomeGoods does. The sticker strategy is similar to the way Cash America Pawn Shops operates or my Aunt in her periodic garage sales.





The floor doubles as shelf space.



Here Jon is trying to sign up for Tuesday Morning's e-mail list and loyalty program on what is frankly an ugly computer set-up near the entrance. The program/computer did not work and we were unable to sign-up. No employee approached us or was visible to ask if we needed assistance. This is one cost-advantage TUES has—a "self-serve" environment with usually only one employee in the store at a time during our mid-afternoon visits.

Risk to my short thesis:

- Faster than expected improvement in operating profits.
- Overpriced acquisition by a strategic that can pay more and eliminate more G&A than I expect.
- If they have poor comps, I am confident that management will do a good job explaining away any weakness in the near term, e.g. blame the winter weather or some other unverifiable exogenous factors, so longs might not give up hope.
- The stock is already heavily shorted and I doubt most shorts are as patient as we are so they are likely to capitulate and cause substantial mark-to-market losses in the short-to-intermediate term.
- Gasoline prices are collapsing nationwide. This could provide a powerful tailwind for discretionary consumer spending at places like TUES during the peak Holiday shopping season of 2014 and keep the enthusiasm for the stock elevated.
- As they accelerate the shift in store base to larger stores each year they relocated stores will have an even larger impact on SSS contribution, keeping the charade going. Also one thing they could do is shift into even bigger stores each year to continue to try and juice comps (e.g. go from 13k new square foot store average , to 15k, to 20k, to 22k each subsequent year).
    - Given this myopic focus on SSS comps, a major is a risk that even if they continue to be unprofitable and miss operating profit targets that sentiment will not turn negative as long as they are growing sales maintaining a rosy outlook.

Conclusion

In a recent meeting someone accused me of "loving to bet against the world." This is not true. What I actually love to do is challenge conventional wisdom. I like to evaluate data objectively and if it leads me to having a differentiated view then I am willing bet heavily against consensus no matter which "elephant" investors or executives may be on the other side. I also admittedly am drawn towards betting against cult-stocks whose CEOs are hype-artist and are seemingly undeserving of the massive personal wealth they are reaping without generating any sustainable economic benefit or value creation for shareholders and stakeholders. I am not attacking CEO Michael Rouleau's character or detracting from his professional accomplishments, which are long and noteworthy. I do, however, think there is some attribution mistakes being made by the many Rouleau worshippers on Wall St. and so the valuation TUES is given on the basis of his turnaround is misguided. In sum, Michael's Stores' comps and sales growth was in-line with its most direct peers as its niche benefitted from a secular growth period. Its operating metrics were in-line with peers and thus there was seemingly nothing special about Michael's. Similarly, there has been no improvement in financial performance of Tuesday Morning in the last 20 months and a multi-year turnaround is already much more than priced in. The competitive dynamics have intensified and TUES' glory days are long gone. The Chairman--hedge fund manager Steven Becker--has sold down his stake aggressively from 8.7% to 0.5% at prices well below the recent high of $21.80. TUES is set for a long, steady grind down from the current level. I am wary of the high short interest so would emphasize and express a bearish fundamental view with options, sizing up my position around earnings release dates, as each quarter that passes the risk of collapse due to disappointing comps grows, while the upside valuation is capped.

Links and Sources:

1: http://globenewswire.com/news-release/2012/11/29/508460/10014047/en/Tuesday-Morning-Corporation-Appoints-Retail-Veteran-Michael-Rouleau-to-Board-of-Directors.html

2: http://www.everything-about-scrapbooking.com/history-of-scrapbooking.html

- Additional on scrapbooking craze: "I think the scrapbooking craze peaked a few years ago."
    - http://www.clnonline.com/memorypaperstamps.html

3: http://community.seattletimes.nwsource.com/archive/?date=20051231&slug=scrapbook31

http://articles.dailypress.com/2002-09-28/business/0209280091_1_michaels-stores-arts-and-crafts-michael-rouleau

http://www.nytimes.com/2002/01/13/business/investing-arts-and-crafts-stores-defy-retailing-s-slump.html

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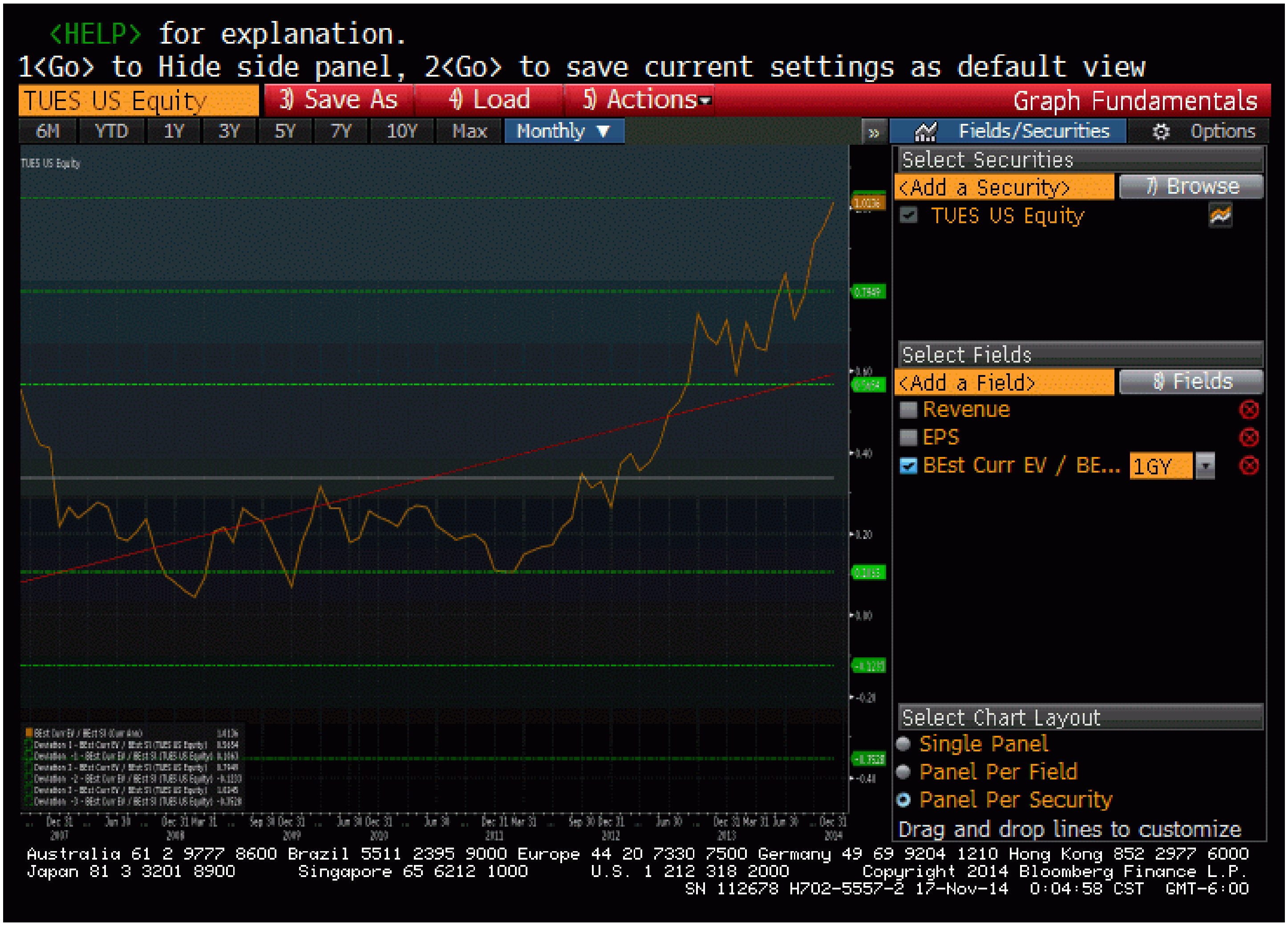
Law of Hype: if the news is not good, or you don't know just say you don't want to talk about it.

Aram H. Rubinson (TUES Q2 2014 call): Can you just add a little color on the merchandising side, maybe if Melissa is there, on what kind of brands and relationships you guys are striking out that you hadn't had before to give us just a little flavor of what to expect?

Michael Rouleau answer: Melissa isn't here, but I am here. I am involved in that. We just don't want to comment on that now. You'll have to go see in the stores. I think we're making some good headway in certain areas, but I think we just don't want to talk about it.

- Very little detail is offered on the merchandise plans and how/which categories will drive the turnaround



TUES is three standard deviations away from its 7-year average forward sales multiple (EV/Forward Sales Estimate). It is also three standard deviations away on a trailing sales basis.

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