Macellum
CAPITAL MANAGEMENT

The Apparel Retailer Renaissance

The market is entering a period of prosperity for traditional apparel retailers. The time has come when we will see apparel retailers consistently beat #s and be revalued higher. In summary, the Amazon / Ecom threat has been met, discretionary spending is set to accelerate with a meaningful tailwind, spending is shifting away from the home, the significant capital expenditure and SGA spending cycle is over and having stores has suddenly become an offensive weapon. The result will drive earnings and cash flow significantly higher than 2019 and we believe the group will be accorded higher multiples as long-term visibility improves.

- **Part 1: Retail Armageddon?**
    - Let's rewind the tape a bit for perspective - retailers experienced significant growth and margin expansion coming out of the Great Recession. Inventory levels were very low. Retailers struggled to buy fast enough to keep up with demand. As a result, markdowns were low and full price selling was high. That equated to meaningful sales growth and significant margin expansion. However, by 2015/16 the water found its level. Mark downs reverted to historical levels and retailers realized they underinvested in their Ecom/omni channel. The sector spent the next 4 years playing catch up. This led to significant spending, margin compression and free cash flow deterioration.

    - The resulting market narrative was the dominance of Amazon. Market sentiment was reduced to buy Amazon, sell all retailers and go home. For years this worked and was punctuated by the destruction the pandemic wrought which resulted in numerous retailer bankruptcies. This, in turn, exacerbated the investor narrative as it looked very much like Amazon was leaving a wake of destruction with retailers piled up in ruins on the shore.

- **Part 2: Up from the Ashes...**
    - Fast forward, and today most retailers have a competitive omni channel offering and stores have quickly become a tool to gain market share. The seminal moment, that was lost on many, was Amazon buying Whole Foods p.s. they should have bought Kroger. Nonetheless, Amazon realized they needed a physical presence. Since then, many digitally native businesses are rushing to open stores i.e. Casper, Untuckit, Lovesac, Away, Adore Me, Warby Parker, Bonobos and even Amazon. It is critical to growing their profitability. The Ecom only model has largely been disproven. Advertising was, in fact, not a fixed cost. Most Ecom only players can't reach escape velocity over their fixed cost because the advertising expense is variable. With so many retail vacancies, the cheapest way to acquire new customers today is actually a store front. There's nothing more ironic than seeing an Amazon bookstore where a Barnes and Nobel once stood.

- More recently, during the pandemic, the value of having a store fleet has become apparent. If a retailer wants to participate in same day/next day fulfill or returns, they need stores to do it. Target says 95% of their Ecom orders touch the store. Most retailers are now capable of accepting returns from on-line purchases, having customers pick up on-line orders in store, at curbside or brought to a car in the parking lot. Lastly, they can ship from a store which is very beneficial to profits. Each store now is its own distribution center.

- Coming out of COVID we now have traditional retailers with 20-40% of their sales from on-line orders. They are truly "omni-channel" retailers, agnostic to where and how their customers shop. To wit, most are growing faster than the Ecom only players. An index of omni-channel retailers experienced 36% Ecom growth in Q1. That compares to an index of publicly traded, on-line pure plays that grew only 31% and Amazon North America that grew 39% during Q1. Over the last 2 years the difference is even starker with the omni-channel retailers growing 85% and Amazon growing 68% and the on-line only players growing at 65%. <u>Traditional retailers are finally punching above their weight in the on-line world.</u>

- **Not So Fast – isn't this a post-COVID blip?**
  - Or to put it another way, won't this all come to a screeching halt once stimulus money runs out? In short – no. There are a number of positive tailwinds that should support increased spending. 1) the Gross saving rate in the country is 6% higher than 2019. 2) Savings as a percent of income is more than double historical levels. 3) Consensus estimates for Personal Consumption Expenditures for 2021 and 2022 are above 7% and 4%, respectively. 4) GDP, though less directly tied to spending, is also forecast to be up 6.5% and 4.5% in 2021 and 2022, respectively. 5) As the economy continues to open, unemployment will get back to pre-pandemic levels. Providing another tailwind to spending. 6) Bank deposits, another proxy for savings levels, are up 42% or $1.5 trillion from 2019.

- **What's Next?**
  - A number of factors are going to lead to higher profits and better valuations.
    - 1) The pandemic forced retailers to evolve quickly. Two important developments came out of the pandemic - a) inventories dropped dramatically. On average retailers' inventories were 22% below the change in sales in Q1. b) Retailers learned to do more with less cost. Most retailers experienced meaningful margin expansion in Q1 from 2019 levels.
    - 2) The step function capital expenditure and spending cycle needed to build out an omni-channel offering is behind the retailers.
    - 3) the low inventory levels are reminiscent of 2010 where short supply coming out of the Great Recession led to years of high full price selling and low market downs.
    - 4) The survivor benefit. Weak players have been weeded out. Bankruptcy has removed capacity. During COVID a dozen chains closed like Stage Stores, SteinMart, JC Penney, Pier One, Sears, Ascena (Ann Taylor, Loft, Lane Bryant, Justice) Christopher and Banks. We estimate that 10% of stores closed last year. If you survived the pandemic you're going to be around for the foreseeable future. When the economy reopens, those sales $ will get spread around a smaller group of stores.
    - 5) Burn your pajama parties. During the pandemic we were all stuck at home and spending was focused on nesting. As the pandemic subsides people are rejoicing. They're going out in droves to celebrate and they need new clothes.

        - 6) Nearer term the child tax credit will kick in just as the back to school spending cycle begins in August. Parents haven't had to buy their children new school clothes for 2 years. The kids clearly don't fit into anything they bought in the fall 2019.

- **The Retail Survivors Taking Flight**
    - Ok, so the survivors are here to stay. Sales and eps should be substantially higher than 2019 driven by better gross margins, lower SGA and greater free cash being applied to shrink share counts. Also, as the significant capital expenditures cycle for Ecom is largely over, free cash flow growth should be higher than eps growth. Another major contributor to value creation will be the multiple expansion. With the improved visibility and the realization these companies aren't going away, the market will ultimately determine they have a higher degree of confidence in future cash flows and accord the group better valuations.

    - Lastly, why not value Ecom higher? Omni-channel retailers' Ecom businesses are growing at least as fast as their on-line pure play competitors. Recently, in a little notice transaction, Hudson's Bay (Canadian parent) sold a 25% of Saks.com for 2.5x revenue. Why shouldn't omni-channel retailers receive similar value for their fast growing Ecom businesses? The sum of the parts math is compelling. For some retailers it would imply 300% upside with zero value allocated to the traditional business.

    - While the stocks have certainly bounced off their COVID lows of last summer, many are still below pre-pandemic levels and most are materially under-performing the market. Now it's time for the sector to combine a good macro backdrop with solid company specific fundamentals and out-perform the market. <u>The traditional/apparel retail sector has spent enough time wandering aimlessly in the desert - and now they're poise to emerge…</u>