Specialty Retail and Department Stores

Gross margin deep dive: freight recapture is over, now what?

Industry Overview

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Equity
United States
Retailing

Lorraine Hutchinson, CFA
Research Analyst
BofAS
+1 646 855 0951
lorraine.hutchinson@bofa.com

Christopher Nardone
Research Analyst
BofAS
+1 646 743 2016
christopher.nardone@bofa.com

Alice Xiao
Research Analyst
BofAS
+1 646 743 0227
alice.xiao@bofa.com

Melanie Nuñez
Research Analyst
BofAS
+1 646 855 2279
melanie.nunez@bofa.com

Consumer spending holds up after strong holiday

2023 was a year characterized by strong gross margin expansion across the group as 2022's transportation inflation unwound and companies lapped historically high inventory levels and associated promos of 2H22. With both behind us, we dig into 2024's margin drivers and conclude that outside of some product cost deflation, the industry likely has less GM upside from here. We prefer stocks with company specific margin drivers rather than relying on sales-driven leverage. Our top picks for this theme are BBWI and URBN.

GM by component: some upside from raw mats remain

Many retailers' GMs are 200-300bp above 2019 levels. Retailers held onto price increases implemented during the supply-demand imbalance in the pandemic, while freight and raw material cost pressures have normalized. See Exhibit 1 for quarter by quarter GM puts/takes for each company. Lower price point retailers (AEO, Old Navy (GPS)) have some commodity benefit into 2024 as raw material costs normalize. Cotton spot prices have dropped 47% to 90c per pound after surging to 173c per pound in May 2022.

Red Sea disruption a small NT pressure on inbound cost

China to west coast shipping prices are up 60% since Dec 1, which is 78% below peak rates during the supply disruption in 2021. US specialty retailers saw 200-500bp of extra freight cost pressure from these higher rates plus the cost of switching to air. We expect this NT pressure on inbound freight to be much smaller in magnitude (<50bp) as a 1-2 week delay will cause less modal mix, leaving only the container rate pressure.

Apparel CPI remains 5% above 2019 levels

Broader US apparel and footwear CPI was deflationary in the decade leading up to 2009, recovered almost to 2010 levels the five years following the GFC, and became deflationary again in the five years leading up to the COVID-19 pandemic. US apparel CPI remains 5% above Jan 2019 levels as of November 2023. We see the rapid share gains of digital low cost names like Shein and Temu as a risk for pressure on prices.

BBWI still well below pre-covid GM

We view BBWI as one of the most compelling stocks in our coverage with multiple opportunities for margin expansion. GM still holds >300bp of raw material and transportation cost pressures versus 2019 levels. We expect 2H24 to reap most of the benefits of new category growth, customer acquisition, unit growth, and AUR support.

URBN has more margin recapture ahead

We see continued margin upside at URBN driven by 100bp of IMU improvement from sourcing initiatives (deeper fabric positioning, improved mode mix, 3D technology) and better inventory management at the struggling Urban Outfitters (UO) brand resulting in lower promotions. UO cleared through excess inventory and will exit the quarter cleaner, setting up for a better flow of newness and lower markdowns in F25 under a new leader.

GM: gross margin

BBWI: Bath & Body Works

URBN: Urban Outfitters

AEO: American Eagle

GPS: Gap Inc.

1H: first half

GFC: great financial crisis

ASP: average selling price

AUR: average unit retail

MM: merchandise margin

IMU: initial mark up

NT: near term

Timestamp: 11 January 2024 12:01AM EST

What will drive margins in 2024?

Most retailers benefitted from raising prices and reducing promotions during the tight inventory environment from supply chain constraints in 2021. Merchandise margins generally declined in 2H22 due to promotional pressures, but improved in 2023 as retailers rightsized inventory and held on to pandemic-era price raises.

Higher freight costs both from port congestion and the usage of air freight in 2H21 pressured margins, but by 4Q-1Q22 most retailers started to benefit from lapping these costs, and these benefits continued into 2023. LULU, BURL, and GPS were among those that started to see freight cost benefit in 3Q22; TJX and AEO started seeing freight cost benefit in 4Q22, and URBN saw freight cost benefit beginning in 1Q23 (Exhibit 1).

As of 3Q23, many retailers maintain GMs 200-300bp above 2019 levels (LULU, TJX, URBN, GPS, and AEO). Retailers held onto price increases implemented during the pandemic while freight and raw material cost pressures normalized. BBWI's GM is still below 2019 levels, as it continues to recoup benefits from lapping raw material cost inflation pressures experienced in 2022.

A deeper look into the drivers in 2024 of each of the components including freight cost, raw material (cotton and polyester) costs, labor costs in key manufacturing countries, and apparel inflation are included in the sections below (available in excel).

Exhibit 1: GM components for specialty retailers (1Q21-3Q23 actuals)
As of 3Q23, many retailers maintain GM's 200-300bp above 2019 levels (LULU, TJX, URBN, GPS, and AEO) as they held onto price increases implemented during the supply-demand imbalance in the pandemic while freight and raw material cost pressures in 2022 have normalized.

	1Q21	2Q21	3Q21	4Q21	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23	3Q23
Off-Price Retailers											
Burlington Stores											
GM	43%	42%	41%	40%	41%	39%	41%	41%	42%	42%	43%
GM bp change	4,131	(361)	(358)	(272)	(234)	(322)	(25)	84	129	272	204
GM bp chg vs 2019	233	76	(97)	(230)	(1)	(247)	(122)	(146)	128	25	83
	- MM +340bp - Freight (110bp) **^ all vs 2019**	- MM +200bp - Freight (120bp) **^ all vs 2019**	- MM +80bp - Freight (180bp) **^ all vs 2019**	- MM + 30bp - Freight (260bp) **^ all vs 2019**	- MM (80bp) - Freight (150bp) **^ back to y/y**	- MM (210bp -- half markdown, half true up from shortage reserve) - Freight (110bp)	- MM (90bp) - Freight +70bp (favorable)	- MM (40bp) - Freight +130bp	- MM (20bp) - Freight +150bp	- MM +150bp - Freight +130bp	- MM +150bp - Freight +50bp
Ross Stores											
GM	29%	29%	27%	25%	26%	26%	25%	25%	27%	28%	28%
GM bp change	3,175	649	(49)	(87)	(295)	(319)	(229)	(14)	51	185	263
GM bp chg vs 2019	34	47	(83)	(211)	(261)	(272)	(313)	(224)	(210)	(87)	(50)
	- MM +85bp - Occupancy +60bp - Freight (75bp) - Distribution (25bp) - Buying costs (10bp)	- MM +80bp - Occupancy +80bp - Buying costs +10bp - Distribution costs (40bp) - Freight (85bp)	- MM (40bp) - Occupancy +65bp - Buying costs (10bp) - Distributio n costs +25bp - Freight (125bp)	- MM (50bp) - Occupancy +30bp - Buying costs (20bp) - Distribution costs (70bp) - Freight (100bp)	- MM (170bp) - Occupancy (40bp) - Buying costs +20bp - Distribution costs (25bp) - Freight (80bp)	- MM (205bp) - Occupancy (55bp) - Buying costs +60bp - Distribution costs (85bp) - Freight (35bp)	- MM (165bp) - Occupancy (20bp) - Buying costs +75bp - Distribution costs (140bp) - Freight +20bp (favorable)	- MM +15bp - Occupancy (5bp) - Buying costs +85bp - Distribution costs (90bp) - Freight (20bp)	- MM +120bp - Occupancy (5bp) - Buying costs (60bp) - Distribution costs (65bp) - Freight +60bp	- MM +200bp - Occupancy +20bp - Buying costs (100bp) - Distribution costs +5bp - Freight +60bp	- MM +235bp - Occupancy +25bp - Buying costs (85bp) - Distribution costs +45bp - Freight +40bp
	^all vs 2019	**^all vs 2019**	**^all vs 2019**	**^all vs 2019**	**^back to y/y**						

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	1Q21	2Q21	3Q21	4Q21	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23	3Q23
TJX Companies											
GM	28%	29%	29%	27%	28%	28%	29%	26%	29%	30%	31%
GM bp change	2,819	699	(70)	(83)	(16)	(176)	(37)	(104)	102	254	198
GM bp chg vs 2019	(39)	121	68	(125)	(54)	(55)	31	(229)	48	199	229
	- MM lower than expected	- Freight (150bp) - store closures (60bp) - debt extinguishment (200bp) - MM +220bp prior to freight	- Freight (160bp) - Significant increase in MM driven by strong mark-on and lower markdowns	- Freight (280bp) - Shrink (80bp)	- Freight (220bp)	- Freight (240bp) - MM down	- Freight (120bp) - MM flat	- Shrink (60bp) - Freight was a benefit - MM down slightly	- Freight benefit significantly more than expected; better markon - Unfavorable hedges, shrink accrual, SC investments	higher MM due to lower freight	higher MM from lower freight; expense leverage
Specialty Retailers											
American Eagle											
GM	42%	42%	44%	32%	37%	31%	39%	34%	38%	38%	42%
GM bp change	3,703	1,205	410	(163)	(538)	(1,119)	(564)	151	145	684	312
GM bp chg vs 2019	550	532	614	139	12	(587)	50	290	156	97	363
	VS 2019: MM expanded significantly; Higher delivery, distribution and warehousing costs, as well as higher incentive compensation.	VS 2019: 2/3 MM; Rent and delivery leverage offset by higher distribution	- +30bp MM y/y '- Rest from leverage on buying and occupancy and warehousing, rent, and logistics efficiencies includes - VS 2019: +500bp MM; +100bp from leverage on buying and distribution and rent	- Freight (400bp); $80mn in elevated freight (60mn air freight specific to Vietnam factory closures)	- Freight (340bp) - Supply chain investments (120bp)	- Freight (200bp) - Markdowns (750bp -- 1/3 higher end of season selloffs) - Quiet Platform integration (60bp); delivery, rent also up	- Markdowns & increased product costs (400bp) - Quiet Platforms (70bp)	- Higher MM due to lower product and freight costs, partly offset by higher markdowns - Quiet Platforms (80bp)	- MM improvement: lower transportation costs, partly offset by higher markdown. - benefit from lower compensation and delivery costs; offset by higher rent from new store openings	- MM expansion: lower markdowns, lower transportation and product costs - also benefits from early profit improvement initiatives and lower delivery/distribution/warehousing costs	- strong demand, lower product and freight costs, continued benefits from profit improvement work (incl lower markdowns and leverage on rent, distribution and warehousing and delivery).
Bath & Body Works											
GM	50%	49%	50%	48%	46%	41%	42%	43%	43%	40%	44%
GM bp change	1,525	402	(78)	(365)	(436)	(786)	(767)	(483)	(342)	(87)	143
GM bp chg vs 2019	903	811	608	75	467	25	(158)	(848)	126	(62)	(15)
		MM increased significantly	driven principally by MM	MM decline due to inflationary	significant MM decline, remainder	Significant MM decline:	- Significant MM decline – cost	- MM decline - increased product cost,	- half driven by B&O deleverage on	MM improvements: - cost deflation	+200bp MM: $40m (260bp) of deflation

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	1Q21	2Q21	3Q21	4Q21	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23	3Q23
		vs 2019, decreased vs LY as returned to normalized semi-annual sale in June (2020 sale minimal). Additionally, higher SC costs this year.	decline. Higher SC and transportation costs 45m (270bp) impact, offset by pricing increases and adjusted promotional offers. Also had a lower buying and occupancy expense rate on higher than forecasted sales.	costs (at high end of forecast 90-110m, which is 300-365bp impact); partly offset by price increases & promo adjustments buying and occupancy expense deleveraged vs LY, lapping 20m 1x rent concessions in 2020 and continued investments in direct fulfillment capabilities	driven by buying/occupancy exp deleverage; MM decline vs LY was driven by inflationary costs of 50m, (which is 345bp), in line w/forecasted; MM higher than initial forecast as some international WS sales shifted out of 1Q into 2Q. AUR -4% in Qtr. but up significantly vs pre-pandemic.	MM decline was driven by AUR -MSD% vs LY (-320bp est) as well as inflationary pressure (-400bp est). AUR is still significantly up vs 2019 B&O expense deleverage (-65bp est).	inflation (-330bp est) and promos (-210bp est), investment in product (-30bp est) - B&O deleverage on sales decline (-60bp est) - AUR - MSD%	due to inflationary pressure in raw material, transport, labor of $60mn (210bp), and incremental promo to drive sales (-150bp est) - AUR - LSD%	lower sales, new DTC fulfillment ramp, and new store growth; - MM decline driven by cost inflation in raw materials and investment in formulation and packaging, totaling $13mn (90bp) with greatest proportion from raw materials.	benefit ($5m/30bp est) - increased AUR (+10bp est) - reduced transportation cost - partially offset by continued investment in product formulations and packaging innovation (-40bp est) -MM improvements offset by buying and occupancy expense deleverage (-85bp est), primarily due to lower sales and increased occupancy expense from new store growth.	benefits, lower product cost, reduced transportation cost. - Partly offset by continued investment in product formulations, packaging, and innovation (-30bp est), and some estimated B&O deleverage (-80bp est) on lower sales.
Gap Inc.											
GM	41%	43%	42%	34%	32%	36%	39%	34%	37%	38%	41%
GM bp change	2,812	821	134	(405)	(932)	(730)	(322)	(10)	566	158	263
GM bp chg vs 2019	458	444	288	(263)	(474)	(286)	(35)	(272)	91	(128)	229
	'VS 2019: - ROD +430bp primarily related to online growth, store closures and rent negotiations - Merchandise margins +20bp as strong product acceptance resulting in lower discounting mitigated about - (200bp) from higher shipping costs associated with increased online sales	VS 2019: - ROD +330bp - MM +110bp incl shipping (130bp)	VS 2019: - ROD +300bp due to strong online growth, strategic store closures and rent negotiations - MM (10bp) as strong product acceptance offset nearly 200bp online shipping costs and	VS 2019: - MM (500bp); (600bp) air freight - ROD +240bp	- MM (760bp) ---> freight (480bp), cost inflation - ROD (170bp)	- MM (370bp) --> cost inflation (200bp), freight (130bp; $50mn incremental), higher discounting - ROD (30bp)	- MM (370bp) --> Freight +200bp (favorable), cost inflation (200bp), higher discounting - ROD 50bp excluding Yeezy impairment charge	- MM +20bp --> Freight +540bp (favorable), cost inflation (200bp), markdowns (320bp) - ROD (30bp)	- MM +610bp --> lower freight (+560bp Est), improved promotional activity (+380bp est), partly offset by cost inflation (-330bp est) - ROD (40bp)	- MM +260bp --> lower air freight usage (+200bp est), improved promotional activity (+200bp est), partly offset by cost inflation (-140bp est) - ROD (100bp)	- MM +340bp --> lower commodity costs (+180bp est) and improved promotional activity (+160bp est) - ROD (80bp)

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As of 3Q23, many retailers maintain GM's 200-300bp above 2019 levels (LULU, TJX, URBN, GPS, and AEO) as they held onto price increases implemented during the supply-demand imbalance in the pandemic while freight and raw material cost pressures in 2022 have normalized.

	1Q21	2Q21	3Q21 freight (250bp)	4Q21	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23	3Q23
Victoria's Secret											
GM	43%	41%	39%	39%	37%	36%	35%	38%	36%	35%	34%
GM bp change	4,092	1,976	251	(367)	(664)	(544)	(451)	(137)	(17)	(148)	(43)
GM bp chg vs 2019		1,189	2,280	800	447	645	1,829	664	430	497	1,786
			-increase in MM dollars due to net sales increase. negatively impacted by $50m SC cost pressures (350bp) 90% air/10% sea 3-4Q of 2021	- negatively impacted by $110m of headwind from SC cost pressures (510bp), both rates and mix of ocean/air. 90% air/10% sea 3-4Q of 2021	- Supply chain (550bp) - Balance from lapping higher margin sales from stimulus benefit	Freight $60mn (395bp) Rest: incremental SC + raw material cost pressure; incremental semi-annual sale activity y/y; uptick in promotions given weak store traffic	targeted promotional activity; deleverage in buying and occupancy expenses on lower sales(80bp); an increase in shrink levels as expected as the operating environment in stores continues to normalize now that fitting rooms and store entrances are fully open.	- headwind primarily due to targeted promotions (peak holiday moments to remain competitive) - deleverage in B&O on lower sales - SC and raw material cost pressures < 4QLY by $65mn (+320bp)	- headwind from higher targeted promotions/customer response to promo, deleverage in B&O. - almost entirely offset by favorable SC related costs, lower rates and shift in modal mix to more ocean.	- Selling margin flat: lower inbound freight cost (ocean and air) offset by higher targeted promo activity given softer traffic/conversion challenges and higher shrink - B&O (150bp)	- favorable merch mix, lower freight cost, partly offset by targeted event-driven promo activity. - B&O (120bp)
Urban Outfitters Inc.											
GM	32%	38%	35%	28%	31%	32%	30%	27%	33%	36%	35%
GM bp change	3,041	796	123	92	(168)	(595)	(416)	(68)	260	416	509
GM bp chg vs 2019	129	477	202	(222)	(39)	(117)	(214)	(290)	221	299	295
	- Anthropologie +300bp improvement in markdowns - FP +400bp MM	- Both UO and Anthropologie brands posted Q2 record low markdown rates for their respective brand - Free People delivered +400bp of merch markdown rate improvement	- Delivery deleverage, inbound freight were the difference between 2Q/3Q	- Price adjustments offset almost a third of the total freight increases - (350bp) initial product margin deleverage	- Lower initial merchandise markups driven largely by higher inbound transportation expenses and raw materials costs.	- Higher markdown, lower IMU, small part from fuel surcharge	- Higher markdowns at all 3 brands - lower IMU driven by higher inbound freight	- (40bp) from store impairment charge - higher markdown in UO and FP retail - decline in wholesale profit rate given discounts to clear out excess - Nuuly gross margin improved	- IMU higher at all 3 retail segment brands from lower inbound transportation costs - Lower markdowns at Anthro and FP	- higher IMU at all 3 retail segment brands primarily driven by lower inbound freight	- IMU increase and lower markdown at all 3 retail segment brands - IMU improvement primarily driven by lower inbound transport cost
Athletic											

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	1Q21	2Q21	3Q21	4Q21	1Q22	2Q22	3Q22	4Q22	1Q23	2Q23	3Q23
Lululemon Athletica											
GM	57%	58%	57%	58%	54%	56%	56%	57%	58%	59%	58%
GM bp change	581	388	104	(49)	(315)	(160)	(124)	(68)	357	229	214
GM bp chg vs 2019	319	310	206	4	4	150	82	(64)	361	378	296
	- 220bp occupancy/ depreciation/ product team cost - 80bp increase in product margin with decline in markdowns - 20bp favorability in FX **^vs 2019**	- 290bp occupancy/ depreciation/ product team costs - 60bp favorability and fx - 40bp decrease in product margin driven by 120bp increase in air freight **^vs 2019**	230bp leverage on occupancy, depreciation, product team costs - 30bp favorability and fx - offset by 50bp decline in product margin, 230bp increase in air freight **^vs 2019**	-(130bp) product margin incl 530 airfreight, MD down 110bp vs. 2019 - 20bp fx - 120bp leverage occ/depn **^vs 2019**	- (370) product margin incl 340 airfreight, MD flat (down 40bp vs. 2019) - (10bp) fx - (20bp) DC & product costs - 80bp leverage occ/depn **^back to y/y**	- (150bp) product margin incl -130bp airfreight & markdowns (30bp) (flat vs 2019) - (40bp) fx - (40bp) DC & product costs - 70bp leverage occ/depn	- (40bp) product margin incl 80bp airfreight benefit & markdowns -60bp (flat vs 2019) - (60bp) fx - (70bp) DC & product costs - 40bp leverage occ/depn	- +30bp product margin - (50bp) fx - (60bp) DC & product costs - 10bp leverage occ/depn	- +430bp product margin - (50bp) fx - (30bp) DC & product costs - 10bp leverage occ/depn	- +330bp product margin - (30bp) fx - (50bp) DC & product costs - (20bp) occ/depn	- +250bp product margin - (10bp) fx - (20bp) occ/depn

Source: BofA Global Research, company reports

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'21 freight costs recouped, but recent disruptions raise inbound cost

Freight costs have normalized back to 2019 levels, and retailers have recouped all of the benefits from lapping expensive air freight usage in 2H21 for inbound freight expense. Some benefits could continue as domestic trucking costs come down. Spot rates have normalized back to 2019 levels since April 2023 (Exhibit 6), but contracts generally lag spot by 8-9 months as retailers re-negotiate rates once or twice per year.

Inbound ocean freight costs rising due to recent Red Sea conflict

Recent geopolitical disruptions in the Red Sea could lead to higher costs ahead for inbound freight costs. The Freightos China to West coast index is up 67% since the beginning of December (Exhibit 2). However, this is still substantially below peak rates during the supply disruption in 2021: the Freightos index is 87% below peak 2021 levels (Exhibit 5). In comparison, most US specialty retailers saw 200-500bp of incremental freight cost pressure per quarter from a combination of higher ocean rates and the cost of switching to higher usage of air in 2H21. During 2021, peak rates of over $20k per box were 930% higher than January 2019 prices. The current 67% price increase would imply a much smaller impact in comparison; in addition, we do not expect retailers to employ more than a normal amount of air freight in this case. Air is often over five times more expensive than ocean, according to Freightos. See the BofA transport team's report for more on the Red Sea impact to broader transport.

Exhibit 2: Weekly Asia to US West Coast indices are up 60% in Jan 2024 vs Dec 1 prior to the Red Sea conflict, but remain 78% lower than 2021 peak rates
Summary of weekly prices

Freight Index (international ocean freight)	WCI Shanghai to LA Container Freight Benchmark Rate per 40ft box	Drewry Hong Kong-Los Angeles Container Rate Benchmark Rate per 40ft box	Freightos Index - China to US West Coast
Jan 2024 price	$2,726	$2,769	$2,713
vs. Dec 1	40.6%	72%	67%
vs. Jan 2019	41.2%	25%	36%
vs. peak in 2021	-78%	-68%	-87%
Avg vs Dec 1		60%	
Avg vs Jan 2019		34%	
Avg vs 2021 peak		-78%	

Source: Bloomberg indices, Freightos, BofA Global Research

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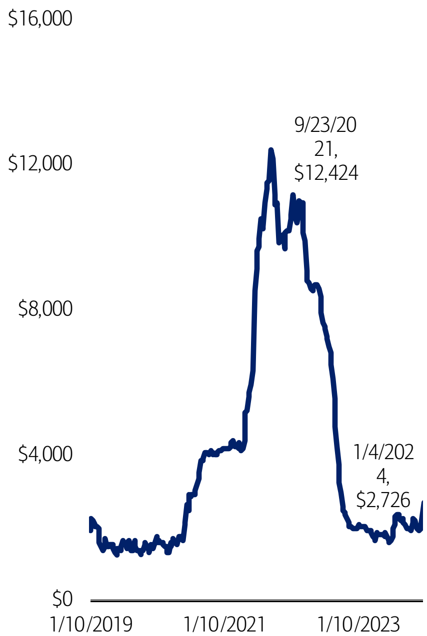
Exhibit 3: WCI Shanghai to LA Container Freight increased 41% since Dec 1
Price of $USD per 40ft box (weekly)



Source: Bloomberg, BofA Global Research

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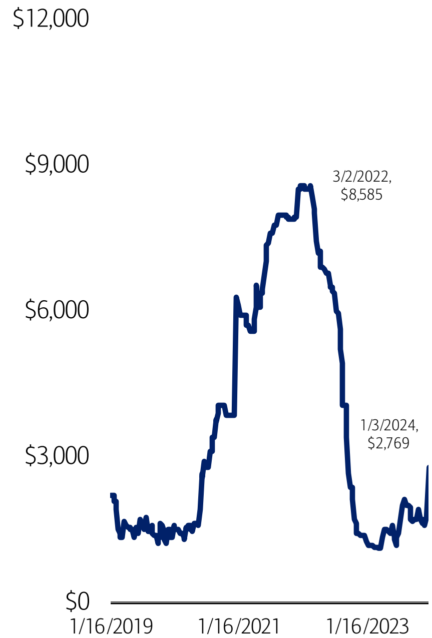
Exhibit 4: Drewry Hong Kong-Los Angeles Container Rate increased 72% since Dec 1
Price of $USD per 40ft box (weekly)



Source: Bloomberg, BofA Global Research

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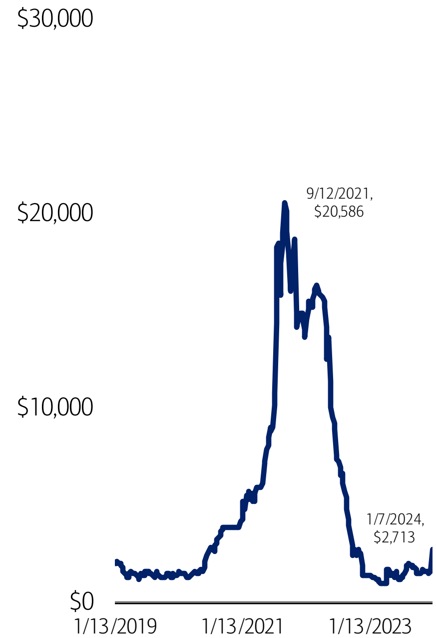
Exhibit 5: Freightos Index - China to US West Coast increased 67% since Dec 1
Price of $USD per 40ft box (weekly)



Source: Freightos, Bloomberg, BofA Global Research

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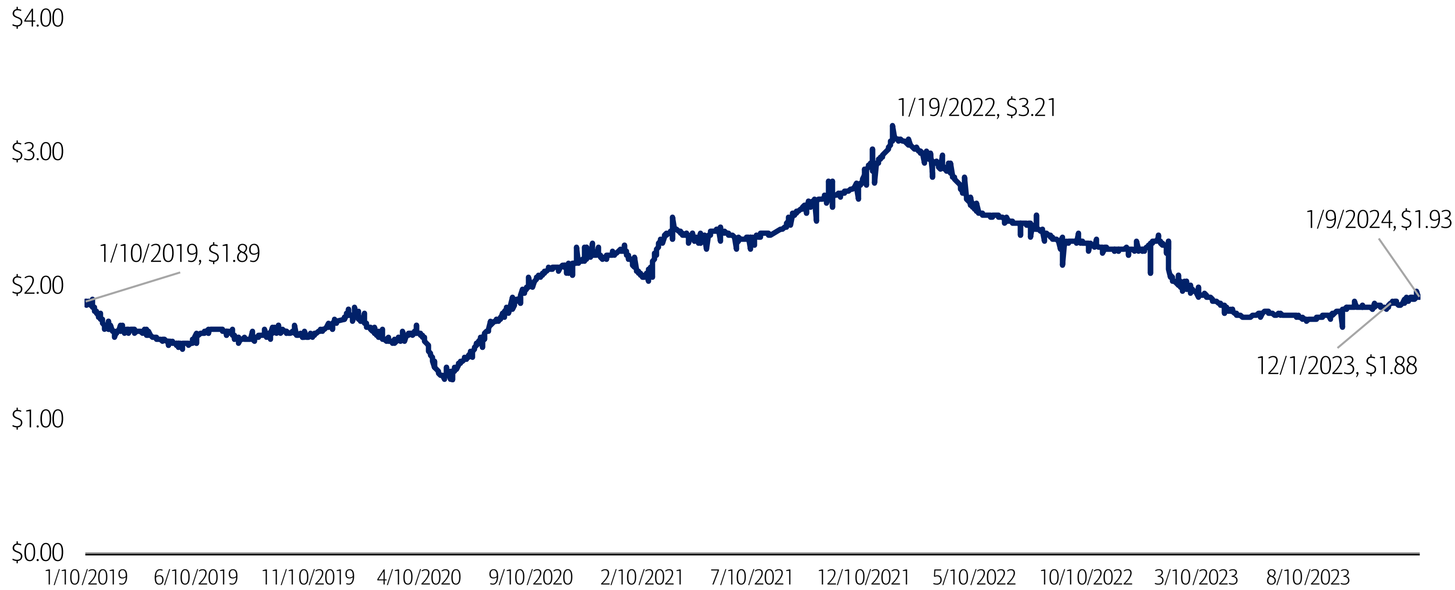
Domestic freight costs remain steady

Domestic freight rates have come down since 2022 levels, and are on par with January 2019 prices. Dry-van truckload spot rates have come down 40% since peaking in January 2022 to $1.93, and are currently only 2% above January 2019 prices (exhibit 6). Trucks move about 72% of all tonnage in the US and make up 81% of transportation spending. Over 50% of US truck shipping is related to retail. Contract rates typically lag spot truckload prices by 8-9 months, as retailers re-negotiate contracts once or twice a year. We expect retailers to continue to benefit from lower domestic transport rates, but fuel surcharges could hinder this progress depending on the price of oil. In 2022, more retailers have moved to re-negotiation frequencies greater than the historical once per year, given the large volatility of prices.

Exhibit 6: Daily spot dry truck shipping rates (including fuel) that would be incurred by retailers to ship domestically have come down 40% to $1.93 since 2022 highs of $3.21, and are just 2% above January 2019 price of $1.89 a mile. Contract prices typically lag spot by a few months as a retailers re-negotiate contracts once or twice a year

TRRTDVTR Index (includes fuel); US dry van truckload spot shipping rates



Source: truckstop.com, Bloomberg index, BofA Global Research

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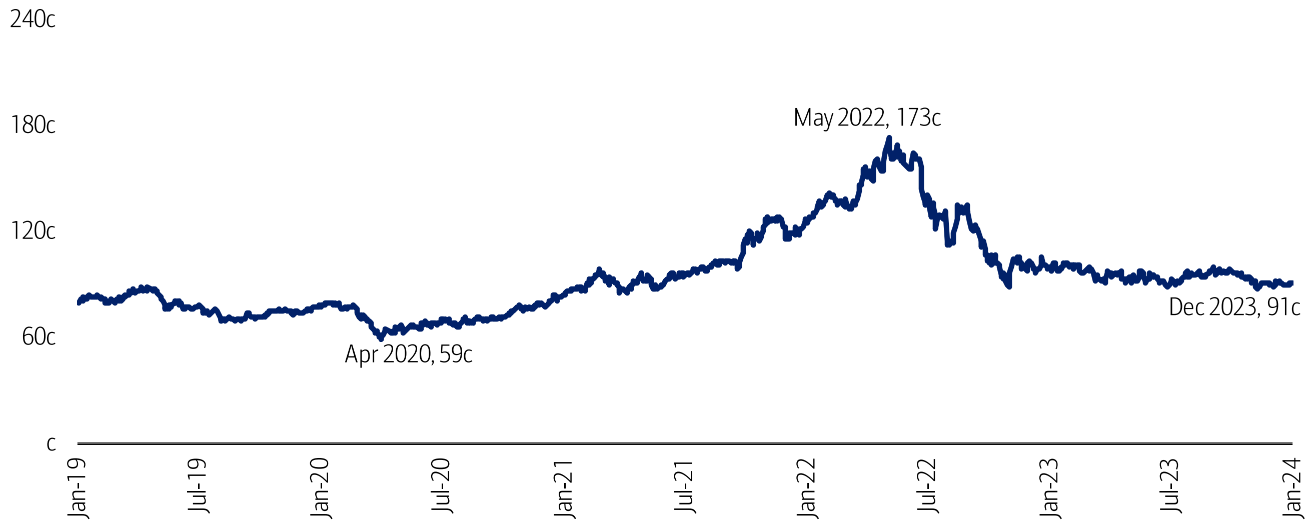
Raw material cost benefits to continue as input costs remain down

Some retailers (AEO, CRI, Old Navy (GPS)) have commodity benefits into 2024 as raw material costs continue to normalize. Typically, 50-60% of input costs are raw materials, and the remaining 40-50% are overhead and labor. Cotton and polyester filament prices are the two biggest raw material inputs for most apparel.

Cotton spot prices have come down 47% to around 90c per pound after surging to 173c per pound in May 2022 (Exhibit 7). The 91c/lb in January 2024 is still 10% above January 2019 levels and price continues to come down. Retail Average Unit Cost (AUC) lag cotton prices by 2-3 quarters because prices are typically negotiated 8-10 months ahead of product hitting the shelves. We expect retailers to continue to benefit from normalized cotton prices into 2Q24 as a result.

Polyester filament prices have stayed below 2019 levels, and remain 22% below both the June 2022 high and the January 2019 price per ton (Exhibit 9).

Exhibit 7: Cotton spot prices have tapered back to remain around 90c/lb after surging to 173 cents per pound in May 2022 (-47% from peak)
Raw cotton A index daily spot prices (USD cents per pound)



Source: Bloomberg, Cotton Outlook Index

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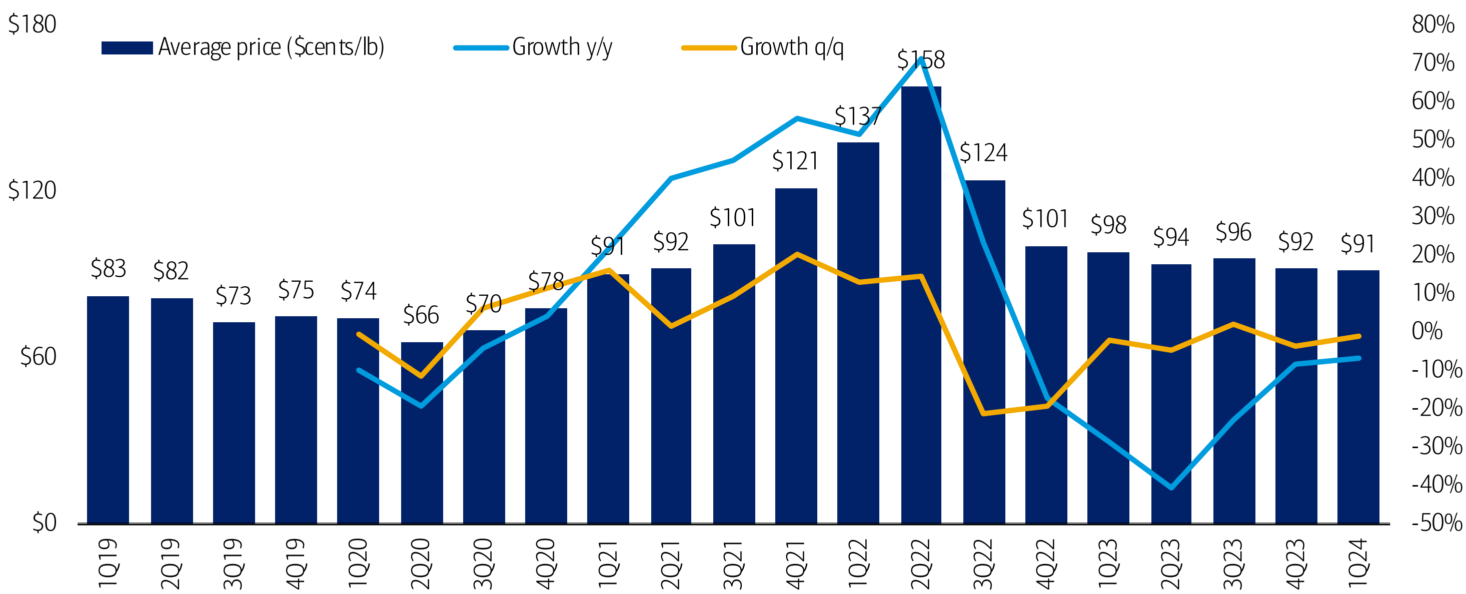
Exhibit 8: Cotton's 91c/lb in January 2024 is still 10% above January 2019 levels and price continues to come down
Quarterly average prices of raw cotton A index daily spot (USD cents per pound)



Source: Bloomberg, Cotton Outlook Index, BofA Global Research

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Exhibit 9: Polyester filament (imported fibers) weekly avg spot price has come down over 21% since June 2022 and the beginning of 2019
Polyester (imported fibers) weekly average spot price (CNY/metric ton)

Source: Bloomberg, National Bureau of Statistics China

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Higher manufacturing costs pressure lower priced retailers more

Manufacturing wages have increased dramatically in China, Vietnam, and Bangladesh, three of the biggest regions for apparel sourcing. China average manufacturing wage increased 38% since 2019 (Exhibit 10). Vietnam average manufacturing wage increased 22% since 2019 (Exhibit 11). Bangladesh raised its minimum monthly garment manufacturing wages 56% from $75 to $113 in November 2023, after having kept it steady since 2018.

Higher priced retailers such as LULU and Anthropologie (URBN) are less susceptible to these costs as wages are a lower percentage of selling prices. Lower priced brands such as CRI and Old Navy (GPS) would be more pressured by surges in the manufacturing wages in these countries.

Exhibit 10: China average manufacturing wage has increased 38% since mid-2019
China average monthly manufacturing wage (converted to $USD)

Time period	$USD monthly manufacturing wage	growth y/y
Jun 2023	$1,330	7%
Jun 2022	$1,246	10%
Jul 2021	$1,136	4%
May 2020	$1,089	13%
May 2019	$962	11%

Source: Ministry of Human Resources and Social Security, take-profit.org

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Exhibit 11: Vietnam average manufacturing wages have increased 22% since mid-2019
Vietnam average monthly manufacturing wage (converted to $USD)

Time period	$USD monthly manufacturing wage	growth y/y
Jun 2023	320.42	4%
Jun 2022	307.50	5%
Mar 2021	292.70	16%
Jun 2020	252.31	-4%
Jun 2019	262.65	-

Source: general statistics office of Vietnam, FXEmpire.com

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Apparel was a deflationary category; now CPI still above 2019 levels

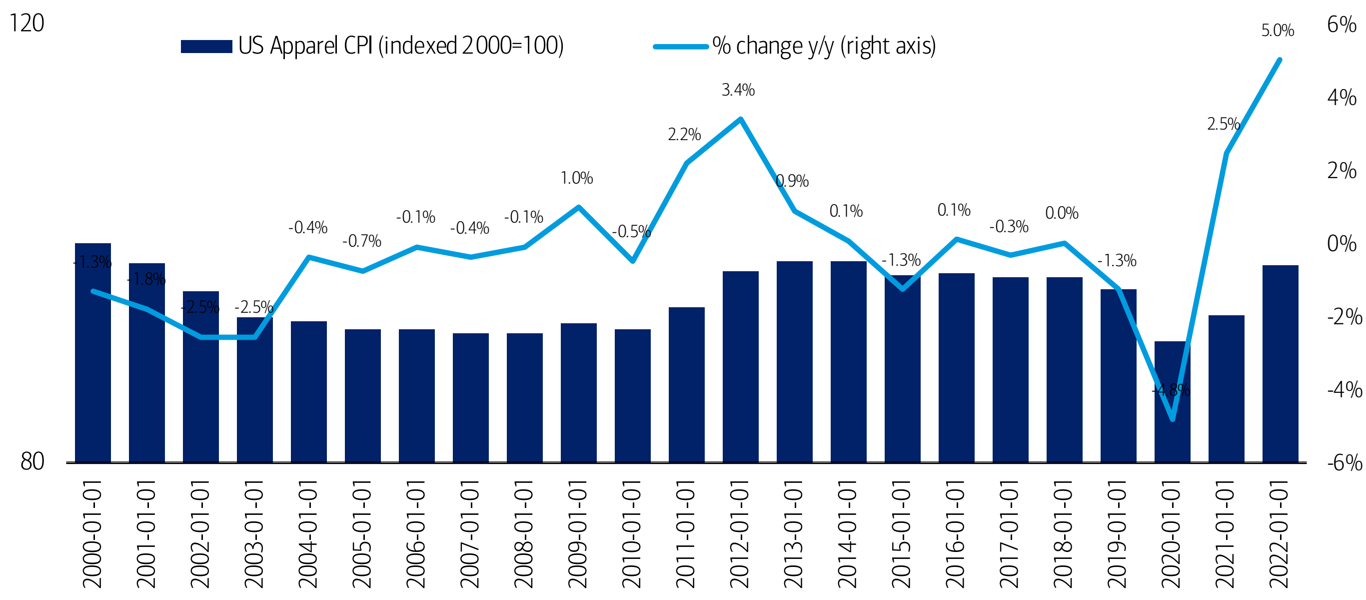
Broader US apparel and footwear CPI was deflationary in the decade leading up to 2009, recovered almost to 2010 levels in the five years following the GFC, and became deflationary again in the five years leading up to the COVID-19 pandemic (Exhibit 12). Many factors contributed to broader deflation, including increasing casualization of workwear, market share gains by off-price, and the rise of fast fashion.

Post-pandemic was a time of tight inventory combined with great consumer demand for reopening apparel in 2021; many retailers took the opportunity to raise prices 10-20% (ie, Urban Outfitters AUR increased 20%/5% in 2021/2022) as well as mark record levels of full-price sell through. Many retailers over-ordered inventories in anticipation of continued supply chain disruption, and subsequently inventory gluts led to a highly promotional environment in 2H22.

Now, prices continue to be above 2019 levels, but the promotional environment has for the most part returned. US apparel CPI remains 5% above Jan 2019 levels as of November 2023 (Exhibit 13). We do not expect greater price increases to the magnitude of that seen in 2021 as current consumer appetite for higher prices is low.

Going forward, we see the rapid share gains of digital low cost players like Shein and Temu as a pressure on prices. We think Old Navy (GPS) and private brands at Kohls (KSS) are at risk of being out-priced, while Revolve (RVLV), Urban Outfitters (URBN), American Eagle (AEO) are among those at risk from Shein given a fashion focus. See our more in-depth Temu/Shein note.

Exhibit 12: US Apparel had been largely deflationary in the few years leading up to 2019, dipped in 2020, and spiked in 2021-22 during recovery
US Apparel CPI, all urban consumers city averages, not seasonally adjusted. Year 2000=indexed to 100, through 2022 actuals



Source: Federal Reserve Economic Data, Federal Reserve Bank of St. Louis, BofA Global Research

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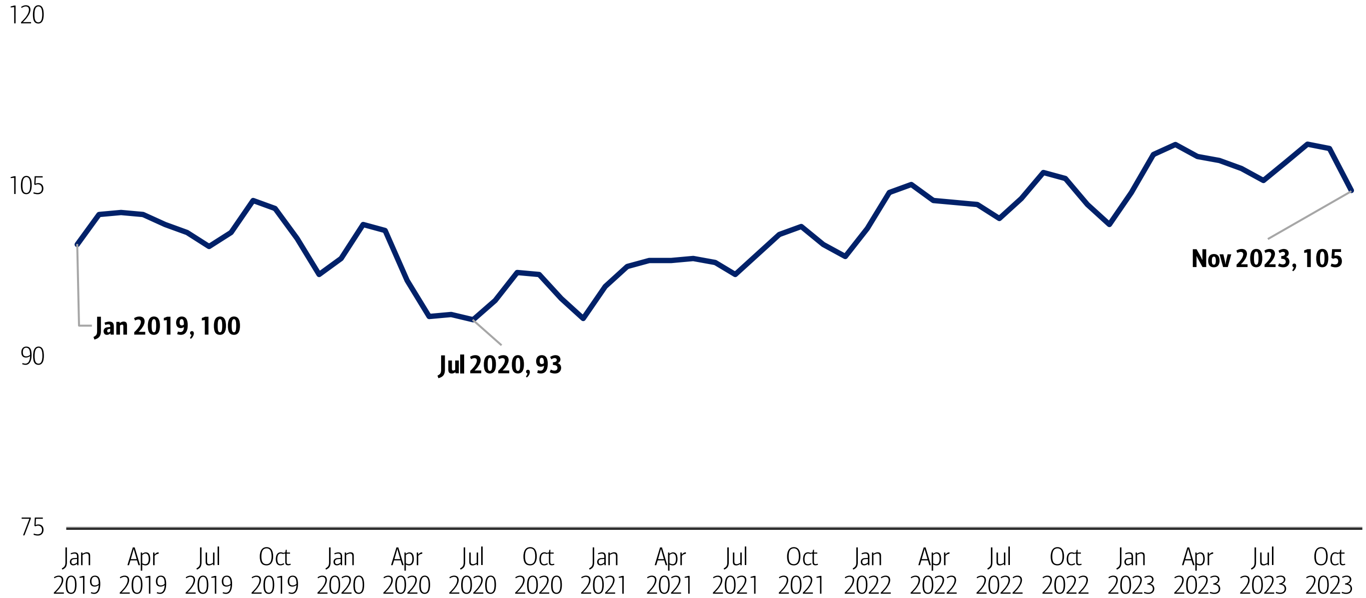
Exhibit 13: Apparel CPI has continued its increase since a low during mid-2020 in the pandemic; it is now 5% above 2019 levels as of Nov 2023
US Apparel CPI, all urban consumers city averages, not seasonally adjusted. Year 2019 indexed to 100, Jan 2019 through Nov 2023 actuals



Source: Federal Reserve Economic Data, Federal Reserve Bank of St. Louis, BofA Global Research

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Promotions were held in holiday, but warm weather a risk to margins

Retailers for the most part held promotions vs LY this holiday (see our Black Friday note) and we expect end-of-season clearance to be lower due to much better-positioned inventories. An unprecedentedly warm December has caused weaker outerwear sales. We see continued warm weather as a risk for retailers with a sizable outerwear franchise (VFC, ATZ) in January/February. Coats are generally higher ticket and higher margin product, and the need for coat clearance would be detrimental to gross margins.

Winners with gross margin upside to go

Bath & Body Works: BBWI

We view BBWI as one of the most compelling stocks in our coverage with multiple opportunities for margin expansion. GM is still below 2019 levels, as BBWI continues to recoup benefits from lapping raw material cost inflation pressures experienced in 2022.

We expect BBWI's new categories (men's, hair care, laundry, and lip) to aid average unit retail (AUR) improvement. The broader expansion of new categories is planned for Spring 2024 and completion by Fall 2024. We expect 2H24 to reap most of the benefits of customer acquisition, unit growth, and AUR support. See our BBWI category expansion deep dive.

BBWI has also begun to test multiple initiatives on personalized marketing through its growing loyalty program (41mn members, 75% of US sales since launch), and will expand on these in 1H24. Greater personalization could aid full price sell through, in our view.

Our PO of $48 reflects 9x our F24 EV/EBITDA, which is below consistent compounder peer multiples to reflect higher leverage and the continued normalization of sales from pandemic-era over-earning, but above mall-based specialty peers given a higher LT margin structure than most apparel peers.

Urban Outfitters: URBN

We see continued margin upside at URBN driven by IMU improvement from cross functional initiatives and better inventory management at the struggling Urban Outfitters (UO) brand resulting in lower promotions. Cross functional initiatives include deeper fabric positioning, improved mode mix, 3D technology to send samples back digitally. We see 100bp of additional IMU opportunities (1H25 weighted) and the potential for less markdown pressure at UO (2H25 weighted). UO cleared through excess inventory and will exit the quarter cleaner, setting up for a better flow of newness and lower markdowns in F25.

URBN recently announced the much awaited appointment of its new UO brand North America head, Shea Jensen, effective in February. We expect Jensen's expertise in merchandising and innovation to lead the improvement in product offering and strengthening of marketing that is needed to turn UO.

Our PO of $45 reflects 6x our F25 (C24) EV/EBITDA, in line with peer average and reflects its strategic positives of a lean store base, high ecommerce penetration, strong customer loyalty, and clean balance sheet.

Price objective basis & risk

Bath & Body Works Inc (BBWI; C-1-7; $44.13)

Our PO of $48 values BBWI at 9x our F24 estimated EV/EBITDA. We expect BBWI to withstand the consumer slowdown better than peers due to its affordably luxury stance and replenishment model. This multiple reflects its history of, and our outlook for, consistent growth. It is below consistent compounder valuations and peer multiples to reflect higher leverage and risks that pandemic-era sales will not hold.

Upside risk to our price objective is if the company is able to continue to drive strong sales growth. Downside risk to our PO is if BBWI comps decelerate further than our estimates call for.

Urban Outfitters (URBN; B-1-9; $38.40)

Our $45 price objective is based on 6x our F25 (C24) EV/EBITDA estimate. This is in line with the peer average and reflects its strategic positives (small store base, high ecommerce penetration, strong customer loyalty, clean balance sheet).

Downside risks to achieving our price objective are if comps decelerate, preventing gains in productivity and operating margins. The stock could surpass our price objective if comps rebound more quickly than expected in coming quarters.

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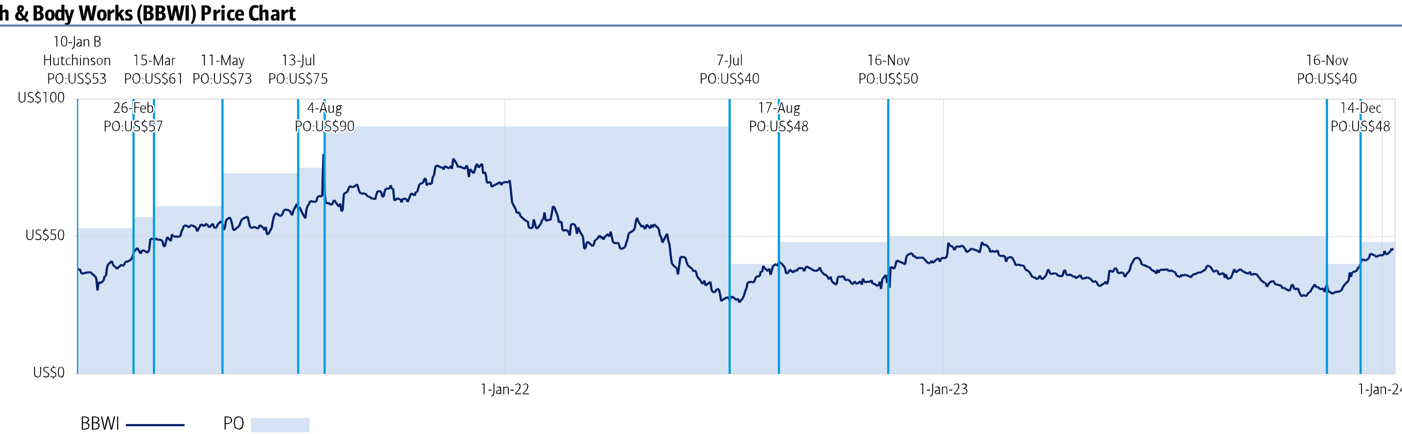
US - Softline Retailing and Dept Stores Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
BUY				
	Bath & Body Works Inc	BBWI	BBWI US	Lorraine Hutchinson, CFA
	Burlington Stores	BURL	BURL US	Lorraine Hutchinson, CFA
	Crocs, Inc.	CROX	CROX US	Christopher Nardone
	Deckers Outdoor Corp	DECK	DECK US	Christopher Nardone
	European Wax Center	EWCZ	EWCZ US	Lorraine Hutchinson, CFA
	lululemon athletica Inc	LULU	LULU US	Lorraine Hutchinson, CFA
	Oddity Tech	ODD	ODD US	Lorraine Hutchinson, CFA
	PVH Corp	PVH	PVH US	Christopher Nardone
	Ralph Lauren	RL	RL US	Christopher Nardone
	Ross Stores Inc	ROST	ROST US	Lorraine Hutchinson, CFA
	Tapestry Inc.	TPR	TPR US	Lorraine Hutchinson, CFA
	TJX Companies	TJX	TJX US	Lorraine Hutchinson, CFA
	Urban Outfitters	URBN	URBN US	Lorraine Hutchinson, CFA
	Victoria's Secret & Co	VSCO	VSCO US	Alice Xiao
NEUTRAL				
	American Eagle	AEO	AEO US	Christopher Nardone
	Birkenstock	BIRK	BIRK US	Lorraine Hutchinson, CFA
	FIGS, Inc.	FIGS	FIGS US	Alice Xiao
	Foot Locker	FL	FL US	Lorraine Hutchinson, CFA
	Levi Strauss & Co.	LEVI	LEVI US	Christopher Nardone
	Nike	NKE	NKE US	Lorraine Hutchinson, CFA
	Signet Jewelers	SIG	SIG US	Lorraine Hutchinson, CFA
	Ulta Beauty	ULTA	ULTA US	Lorraine Hutchinson, CFA
	Under Armour Inc	UAA	UAA US	Lorraine Hutchinson, CFA
UNDERPERFORM				
	Aritzia	YATZ	ATZ CN	Alice Xiao
	Aritzia	ATZAF	ATZAF US	Alice Xiao
	Carter's Inc	CRI	CRI US	Christopher Nardone
	Gap Inc.	GPS	GPS US	Lorraine Hutchinson, CFA
	Kohl's	KSS	KSS US	Lorraine Hutchinson, CFA
	Nordstrom	JWN	JWN US	Lorraine Hutchinson, CFA
	Revolve	RVLV	RVLV US	Alice Xiao
	V F Corp	VFC	VFC US	Lorraine Hutchinson, CFA

Disclosures

Important Disclosures

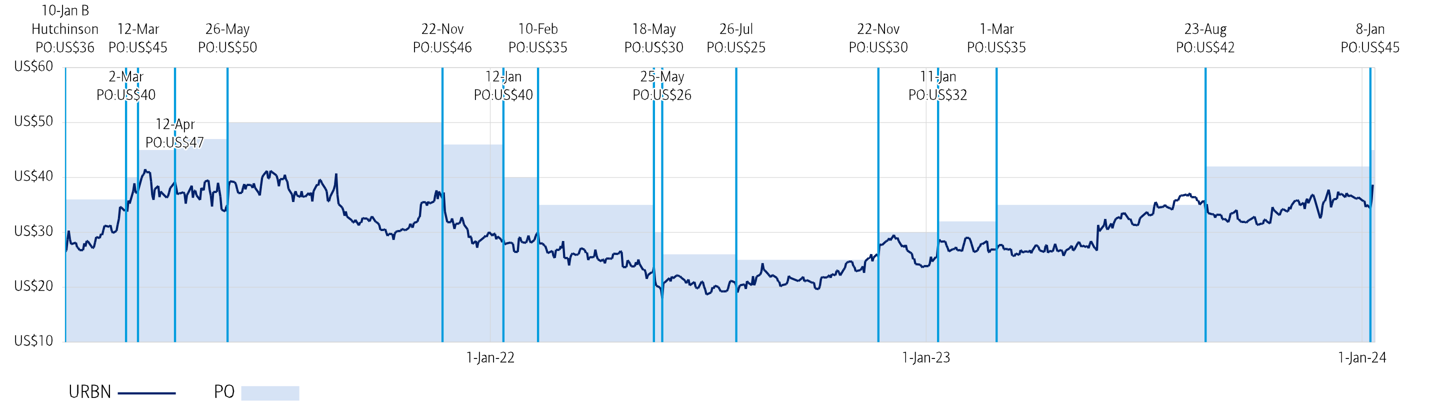
Bath & Body Works (BBWI) Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

The Investment Opinion System is contained at the end of the report under the heading "Fundamental Equity Opinion Key". Dark grey shading indicates the security is restricted with the opinion suspended. Medium grey shading indicates the security is under review with the opinion withdrawn. Light grey shading indicates the security is not covered. Chart is current as of a date no more than one trading day prior to the date of the report.

Urban Outfitters (URBN) Price Chart



B: Buy, N: Neutral, U: Underperform, PO: Price Objective, NA: No longer valid, NR: No Rating

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Equity Investment Rating Distribution: Retailing Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships R1	Count	Percent
Buy	96	57.83%	Buy	39	40.63%
Hold	32	19.28%	Hold	12	37.50%
Sell	38	22.89%	Sell	18	47.37%

Equity Investment Rating Distribution: Global Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships R1	Count	Percent
Buy	1895	53.62%	Buy	1083	57.15%
Hold	832	23.54%	Hold	454	54.57%
Sell	807	22.84%	Sell	383	47.46%

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster R2
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

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