Retailing - Hardlines

Red Sea impact: Higher shipping costs will pressure margins across Hardlines

Price Objective Change

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Equity
United States
Retailing-Hardlines

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Companies with Europe exposure most directly impacted

In this note, we analyze the impact of Red Sea disruptions on our coverage. According to BofA US Transportation Analyst Ken Hoexter, increasing attacks on vessels by Yemeni Houthis have severely constrained transit across the Red Sea and Suez Canal. Roughly 28% of the world container trade was using the Suez/Red Sea. Major container liners have diverted traffic around the Cape of Good Hope, extending voyages 10-15 days on average. The shipping routes most impacted are Asia to Europe, Asia to US East Coast, and Middle East/India to Europe and US. Within our coverage, we expect those with European exposure to be most directly impacted, but we see risk broadly to our coverage from a widespread increase in ocean freight rates.

Red Sea issues spike container rates 100-200% YoY

Per the World Container Index (WCI) and Freightos Index, spot rates for China to US West Coast shipping increased roughly 100-200% YoY in January (up from a 5-15% YoY increase in December). This is smaller than the increase in 2021 which saw a YoY peak of 250-500%. Since most companies in our coverage have annual ocean freight contracts that reset on or around May 1st, we are concerned that many will see margin pressure when these contracts get stepped up to higher rates. That said, we don't expect contracted rates will be reset as high as spot rates given the view that the Red Sea issue could prove transitory and expectations for increasing vessel capacity. On the positive side, US trucking costs continue to track down low double digits YoY in January.

SONO, MAT, HAS, GPC, TPX, WHR most directly impacted

Within our coverage, we see Sonos (SONO), Mattel (MAT), Hasbro (HAS), Genuine Parts (GPC), Tempur Sealy (TPX), and Whirlpool (WHR) most at risk of direct impact from the Red Sea disruption given their exposure to Europe. Per their most recent 10-Ks, SONO earned 31% of total revenue from EMEA, MAT earned 24% of total revenue from EMEA, HAS earned 25% of its Consumer Products segment revenue from Europe (at least 18% of total revenue), GPC earned 14% of total revenue from Europe, and TPX earned 11% of total revenue internationally. WHR earned 20% of total revenue from EMEA, but the company expects to sell the majority of its European business by April.

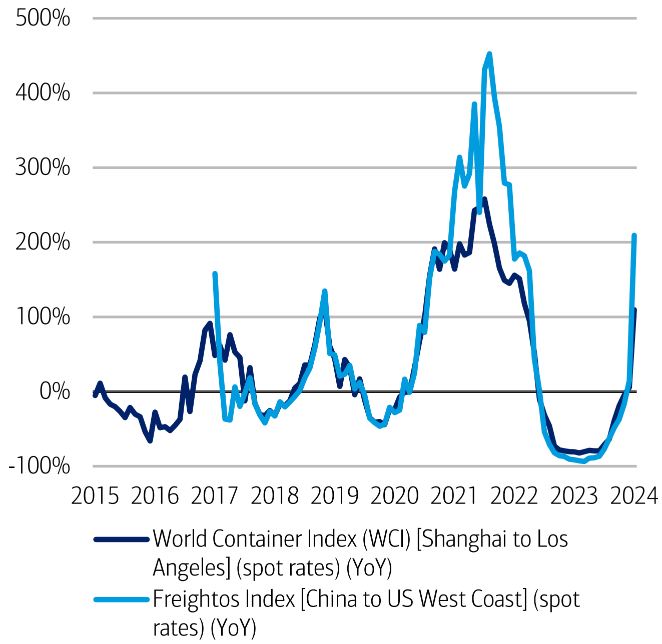
Service-oriented businesses will see minimal disruption

In addition to the aforementioned companies, we expect the majority of our hardlines coverage will be indirectly impacted by the Red Sea disruption due to higher ocean freight rates which will most likely pressure margins. We expect companies that import a large percentage of bulky, big-ticket products will be most negatively impacted by elevated freight rates. In contrast, we expect the following companies will see no to very minimal impact given their service-orientation: Mister Car Wash (MCW), Driven Brands (DRVN), PROG (PRG), Upbound (UPBD), and Rollins (ROL). Given higher peer multiples, we're raising the following POs: raising ARHS PO from $11.40 to $13.5 now based on 18x '24 P/E (15x prior), raising WSM PO from $186 to $222 based on 16x '24 P/E (13x prior), raising AZO PO from $2,730 to $3,110 based on 20x '24 P/E (17x prior), and raising ORLY PO from $1,066 to $1,250 based on 30x '24 P/E (26x prior).

Refer to important disclosures on page 4 to 8. Analyst Certification on page 3. Price Objective Basis/Risk on page 2.

Exhibits

Exhibit 1: Ocean freight costs from China to the US
Both indices experienced a sharp increase and grew 100-200% YoY in Jan 2024.



Source: Bloomberg

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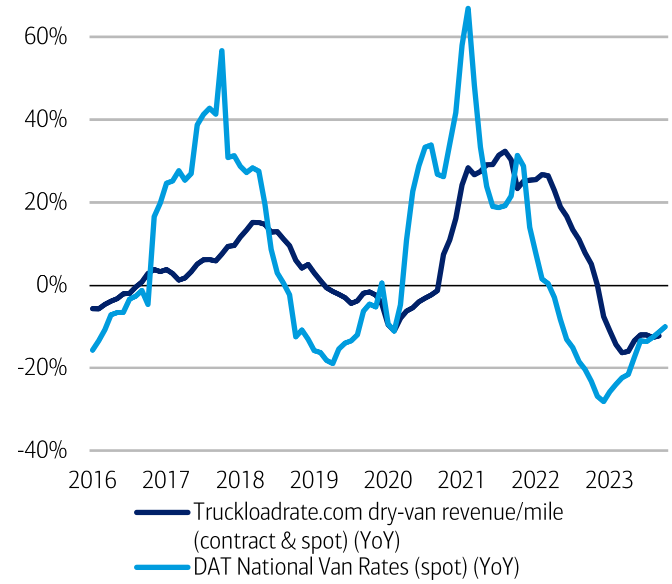
Exhibit 2: Trucking spot rates
Trucking spot rates have not experienced significant change recently. The YoY % change remains around -10%.



Source: Truckloadrate.com, Bloomberg

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Stocks mentioned

Prices and ratings for stocks mentioned in this report

BofA Ticker	Bloomberg ticker	Company name	Price	Rating
ARHS	ARHS US	Arhaus	US$ 11.43	C-1-9
AZO	AZO US	AutoZone	US$ 2803.98	B-2-9
ORLY	ORLY US	O'Reilly Auto	US$ 1055.62	B-1-9
WSM	WSM US	Williams-Sonoma	US$ 199.69	C-2-7

Price objective basis & risk

Arhaus, Inc (ARHS)

Our $13.5 PO is based on 18x 2024E P/E, which is below other high-growth retail concepts. We believe this is warranted given higher sales growth but lower scale, slightly lower margins and at present and lower store growth.

Downside risks to our PO are: Tough comparisons for the home furnishings industry after significant growth in 2020/21 and the release of backlog in 2022, the discretionary nature of Arhaus' products, continued supply chain uncertainty, and key man risk in Arhaus' CEO.

Upside risks to our PO are: Greater than expected home furnishings industry growth, higher than expected online sales growth, a reduction in supply chain costs and disruptions and better than expected productivity in new and existing markets as the brands grows.

AutoZone Inc. (AZO)

We value AutoZone at a PO of $3110 based on 20x the average of our FY24 & FY25 EPS estimates. This is above AZO's 10-year pre-COVID average of 15x, which we think is warranted given the AZO's consistent market share gains in both the do-it-yourself (DIY) and Commercial/do-it-for-me (DIFM) channels.

Upside risks are 1) stronger-than-expected auto parts demand, 2) stronger operating leverage or gross margin expansion as costs contract, 3) larger market share gains than expected, 4) stronger FCF generation enabling share repurchases above our estimates.

Downside risks: 1) AZO's competitors could consolidate the industry faster through acquisitions, knocking AZO out of the market leading position, 2) pricing pressure from online and discount retailers could be more acute than expected, particularly given AZO's overexposure to the DIY channel, 3) cost inflation (most notably wages) could accelerate faster than AZO is able to mitigate margin pressure through pricing or cost cutting.

O'Reilly Automotive, Inc. (ORLY)
Our PO of $1250 is based on about 30x our 2024 EPS estimate, above the company's 10-year pre-COVID average (20x). Given O'Reilly's attractive characteristics of 1) balanced DIY vs DIFM mix, 2) expected pace of store growth and organic market share gains, and 3) above-average operating margin, we believe that a P/E multiple above the peer group historical average (10x-20x) is warranted. In the current consumer backdrop, we also expect investors to ascribe a premium to best-in-class retailers in non-discretionary product categories, such as ORLY.

Upside risks are accelerated share gains, faster than expected penetration of the Northeast and a continuation of accretive and market share gaining acquisitions.

Downside risks are: 1) announcements by online retailers of increased focus on auto parts would drive further negative investor sentiment and potential market share loss, 2) miles driven trends decelerate, 3) new vehicle sales strengthen and/or scrappage rates increase, reducing the average age of the vehicle fleet, 4) increased competition on price in the DIFM channel, further pressuring margins.

Williams-Sonoma (WSM)
Our PO of $222 is based on 16x our '24E EPS estimate. Our target multiple is roughly in-line with other mature-growth hardline retailers.

Upside risks to our PO are: 1) A stronger-than-expected housing market drives outsized home furnishings spend, 2) WSM's B2B and international growth initiatives provide a greater-than-expected tailwind and 3) The industry holds pricing better-than-expected.

Downside risks are: 1) Industry demand cools, 2) WSM needs to reinvest more in price and promotions, 3) SG&A costs stick even as comps decelerate, and 4) Recapture rates from WSM's store closure plans are worse-than-expected.

Analyst Certification

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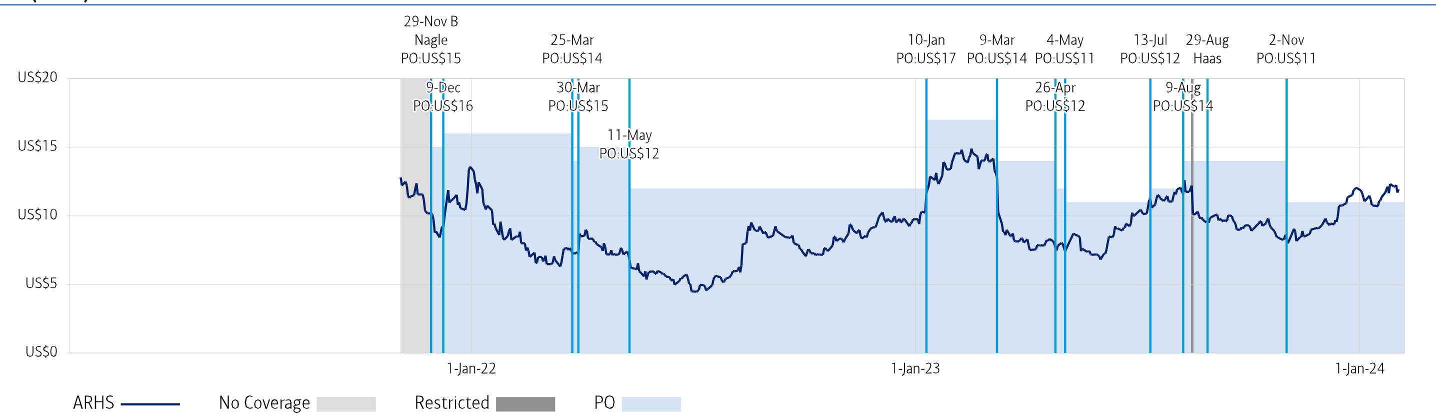
US - Retail Hardline Coverage Cluster

Investment rating	Company	BofA Ticker	Bloomberg symbol	Analyst
BUY				
	Arhaus, Inc	ARHS	ARHS US	Jason Haas, CFA
	Boot Barn	BOOT	BOOT US	Jason Haas, CFA
	Driven Brands	DRVN	DRVN US	Jason Haas, CFA
	Five Below Inc.	FIVE	FIVE US	Jason Haas, CFA
	Floor and Decor Holdings, Inc.	FND	FND US	Robert F. Ohmes, CFA
	Genuine Parts	GPC	GPC US	Jason Haas, CFA
	Lowe's Companies, Inc.	LOW	LOW US	Elizabeth L Suzuki
	Mattel	MAT	MAT US	Jason Haas, CFA
	Mister Car Wash	MCW	MCW US	Jason Haas, CFA
	Ollie's	OLLI	OLLI US	Jason Haas, CFA
	O'Reilly Automotive, Inc.	ORLY	ORLY US	Jason Haas, CFA
	Petco	WOOF	WOOF US	Jason Haas, CFA
	PROG Holdings Inc	PRG	PRG US	Jason Haas, CFA
	Rollins Inc.	ROL	ROL US	Jason Haas, CFA
	Tempur Sealy International Inc.	TPX	TPX US	Jason Haas, CFA
	The Home Depot, Inc.	HD	HD US	Elizabeth L Suzuki
	Upbound Group Inc.	UPBD	UPBD US	Jason Haas, CFA
NEUTRAL				
	AutoZone Inc.	AZO	AZO US	Jason Haas, CFA
	Hasbro	HAS	HAS US	Jason Haas, CFA
	Sonos, Inc.	SONO	SONO US	Jason Haas, CFA
	Williams-Sonoma	WSM	WSM US	Jason Haas, CFA
UNDERPERFORM				
	Advance Auto Parts, Inc.	AAP	AAP US	Jason Haas, CFA
	Best Buy Co., Inc.	BBY	BBY US	Robert F. Ohmes, CFA
	Snap-on	SNA	SNA US	Elizabeth L Suzuki
	Tractor Supply Company	TSCO	TSCO US	Jason Haas, CFA
	Whirlpool	WHR	WHR US	Jason Haas, CFA

Disclosures

Important Disclosures

Arhaus (ARHS) Price Chart



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

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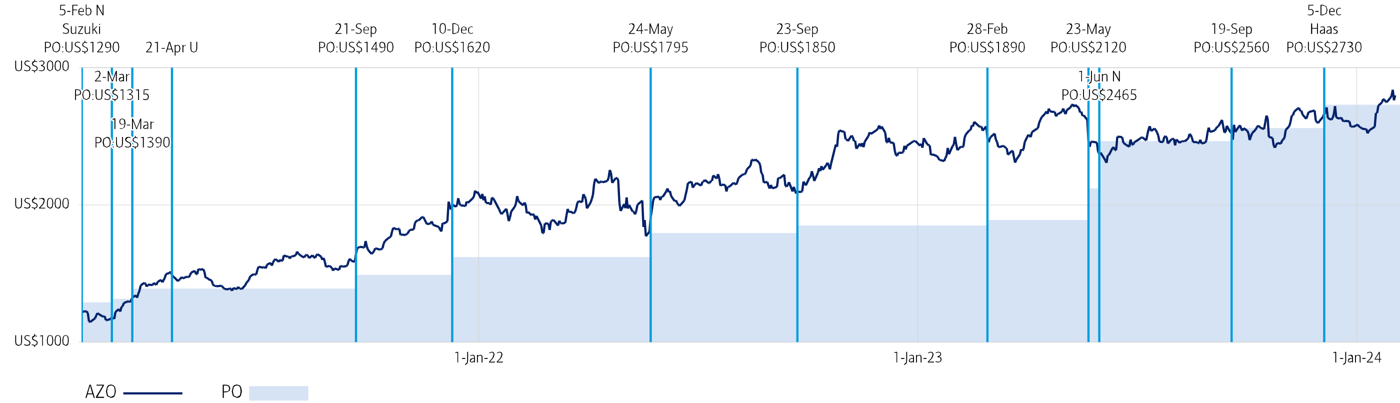
AutoZone (AZO) Price Chart



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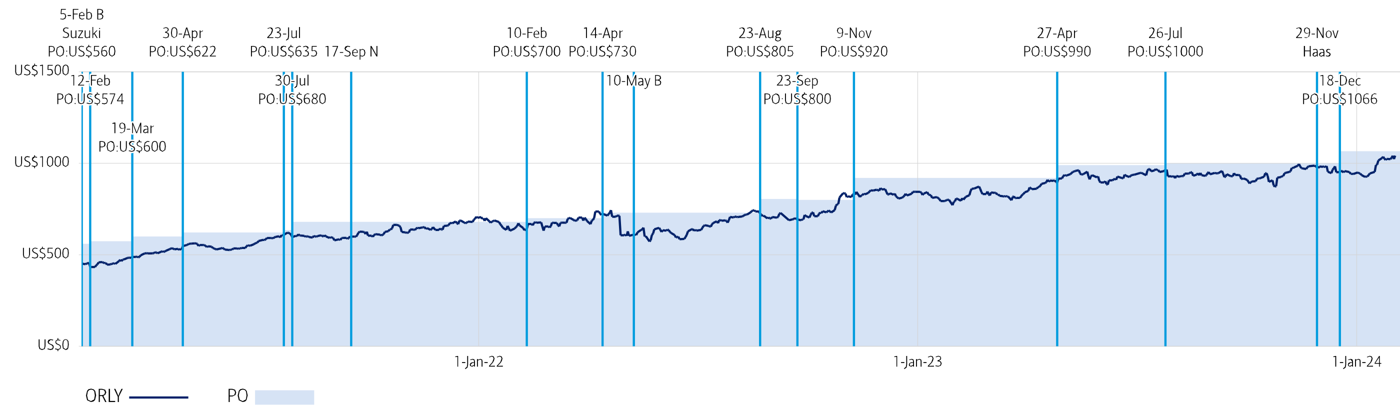
O'Reilly Auto (ORLY) Price Chart



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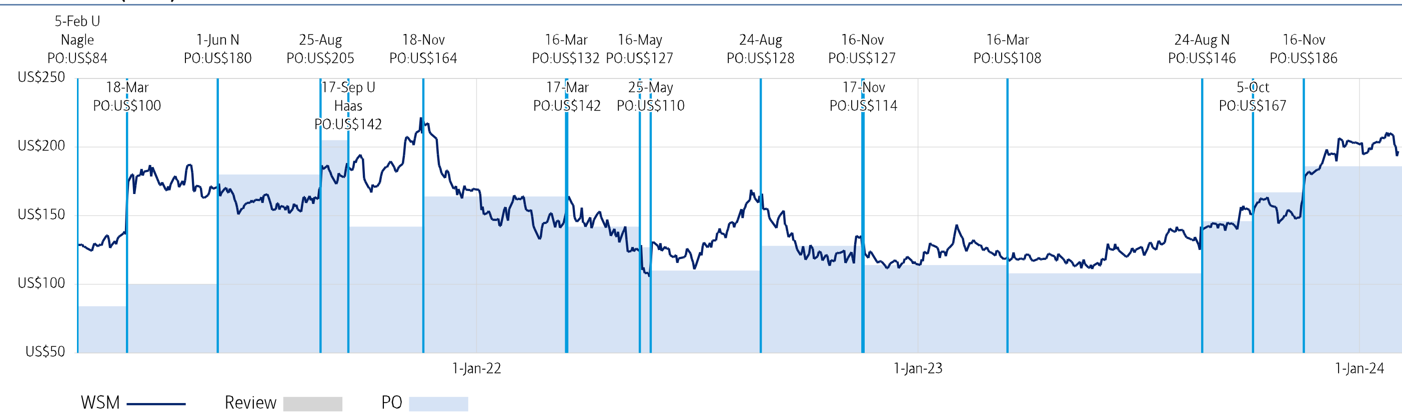
Williams-Sonoma (WSM) Price Chart



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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: Technology Group (as of 31 Dec 2023)

Coverage Universe	Count	Percent	Inv. Banking Relationships R1	Count	Percent
Buy	215	53.09%	Buy	111	51.63%
Hold	97	23.95%	Hold	45	46.39%
Sell	93	22.96%	Sell	24	25.81%

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%

[R1] Issuers that were investment banking clients of BofA Securities or one of its affiliates within the past 12 months. For purposes of this Investment Rating Distribution, the coverage universe includes only stocks. A stock rated Neutral is included as a Hold, and a stock rated Underperform is included as a Sell.

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Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

[R2]Ratings dispersions may vary from time to time where BofA Global Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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