J.P.Morgan

North America Equity Research
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Dept Stores / Specialty Softlines

Digging Deeper: Top 5 Investor Themes; Fieldwork/Data & Boss' Barbell Ranking

Retailing – Department Stores & Specialty Softlines

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With Boss' Wave 1 Retail Recovery moving to Wave 2 in the back half of the year – we thought value-add to dig deeper into the **Top 5 Investor Themes** (per recent incoming investor call volume) across our Dept Stores & Specialty Softlines coverage comprised of (1) Inflation/Pricing Power, (2) Inventory Control, (3) E-commerce Penetration, (4) Real Estate Consolidation, and (5) SG&A Permanent Efficiency.

Larger picture, Consumer Spending per our Chase proprietary credit card data has hit a new peak of +14% in 1H June relative to pre-pandemic 2019 levels accelerating sequentially from +13% in May and +9% in March/April led by building strength in discretionary (i.e. non-food) categories, Gen-Z/Millennial consumers, and digital channel stability despite brick/mortar reopening by our recent fieldwork and data scraping.

Ranking Our Barbell Approach:

#1: Off-Price = Near-term Opportunity to Own (OW-rated TJX/BURL/ROST) - (i) outsized market share capture in 1Q with strength sustained 2Q-to-date by our recent fieldwork, (ii) potential multi-year margin inflection on tap (inflation beneficiary, freight/covid headwinds at peak), and (iii) 45% YTD subsector underperformance relative to the retail sector.

#2: Specialty "L-A-G" (OW-rated LB/AEO/GPS) + ANF = "G-A-L-A" Through Year-End – (i) Back to School catalyst path with only 5 states in the US with partial closures in effect to date for in person learning, (ii) child tax care credit of $3.6K per child under 6 years old (or $3K per child 6-17 years old) with 50% paid monthly July-Dec, (iii) "potential" denim-led fashion cycle, (iv) 2012 lateral = 300bps EBIT margin upside on average, and (v) ROD savings post crisis w/ +245bps of occupancy-driven GPM expansion in 1Q21 vs. 1Q19 on average 6% sq. ft. decline.

#3: Global Brands: Compounders w/ Intl Exposure For Boss' Wave 2/3 Into 2022: TPR, NKE, LEVI, VFC, LULU – Bottom-line profiles accretive relative to pre-pandemic driven by (i) higher margin digital channel w/ ~10% penetration increase in FY20, (ii) distribution re-map to DTC from undifferentiated retail, and (iii) $200M average sub-sector permanent SG&A reduction.

See page 9 for analyst certification and important disclosures.

Top 5 Themes Through Year-End (by incoming call volume):

(1) Breaking Down Inflation Sub-Sector Implications: Accelerating topical call volume - CPI apparel was up 5.6% YOY in May, which exceeded the prior decade peak of 5.3% in 2012 and reversed apparel's more than 10 year course of deflation. **From an input cost perspective, higher costs are multi-faceted including cotton (CTZ1 +27% vs. 2019), oil prices (CLH1 +20% vs. 2019), freight (SHSPSCFI Index +364% vs. 2019), wages (w/ U.S. job openings +28% vs. 2019). That said, accelerated demand in larger-TAM categories (Active/Home) and Covid "recovery" (i.e. apparel/footwear) supports pricing power and AUR expansion with ~2% apparel inflation the "ideal" scenario per recent industry access**. Larger picture, our JPM Head of US Equity Strategy & Global Quantitative Research Dubravko Lakos-Bujas sees inflation as a more cyclical issue tied to reopening (vs. a runaway/structural issue) with economic reopening driving oil prices up and potential shifts in inflation from goods to services. *Near-term, Dubravko noted an increasingly "hot" inflation environment outcome is priced-in already based on investor conversations in recent weeks.*

- **(i) Global Brands**: **In our view, key points of pricing power differentiation include (i) product innovation, (ii) category growth/expanding TAM, and (iii) higher average unit retail (AUR).** Specifically, we see global brands with strong product innovation pipelines (NKE, LULU, LEVI) providing pricing power to at least partially offset rising input costs, noting precedent in 2011/12 with LULU peak sales/sq. ft. ~$2K (relative to ~$1.5K sales/sq. ft. average) and NKE consistently driving low-to-mid-single digit ASP growth in apparel/footwear. Furthermore, we see the current consumer backdrop (mid-teens personal savings rate, debt service ratio at 40-yr lows, and US household wealth creation of +$12T in 2020) supporting spending across the affordable to high-end luxury spectrum, noting a historical 0.9 correlation between the stock market and luxury retailer Saks' performance as a lateral example. To that point, AUR gains have been a key element of global brand strategic initiatives pre- and post-COVID, including RL (AUR +30% in F4Q21) and TPR (handbag AUR +25% globally in F3Q w/ continued opportunity to improve outlet AUR in particular for Coach and Kate).

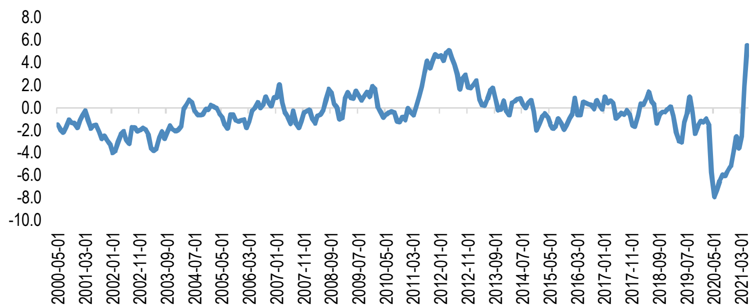
- **(ii) Off-Price**: Based on our work, apparel deflation over the past decade has been the largest driver of margin deleverage for Off-Pricers, with a potential inflection to apparel inflation (in part driven by lean inventory) raising AURs and driving a potential return to more normalized same-store-sales leverage hurdles in our view (historically low-single-digit SSS). To that point, while Off-Pricers have cited margin headwinds across the supply chain (i.e. product sourcing cost headwinds, elevated wages within DCs, and transportation costs), we see moderate inflation as a tailwind to Off-Pricers driving higher AURs (+ incremental units on pent up demand & fashion cycle/newness), equating to better leverage on supply chain/distribution expenses.

- **(iii) Dept Stores & Specialty Softlines**: As noted previously, we see 2012's prior inflation peak as the upside lateral for Specialty with +5.5% comps (relative to +0.7% in 2019) and peak GPM/EBIT margins driven by strong full-price sell-through in the last fashion cycle led by the skinny jean silhouette shift (see our 5/10 Apparel Sector Primer & Table 1 below). Recall, a key take from our **ANF** mid-April meetings was a 62-63% GPM target "in sight" (vs. FY20's 60.5%) with CFO Lipesky citing material progress on AURs the last 3 qtrs driven by lean inventory mgmt and strong product, which could offset potential 2H pressures on

AUC (cotton/energy pressures). Additionally, **AEO** mgmt. confirmed an initial mark-up benefit throughout the year (despite broader industry pressures on input costs), equating to merchandise margin for FY21 of +420bps vs. 2019 by our model and FY21 GPM of 39.1% (> Street 37.7%), noting 2012's GPM reference point of 40% as an upside scenario.

- **(iv) Dollar Stores & Discounters**: Mgmt. teams in 1Q cited ongoing industry-wide freight/supply chain headwinds given port delays (in particular the West Coast), trucker shortages and elevated ocean rates (both exceeding the magnitude of 2018's headwind), and competitive DC labor. We note **DG**, **FIVE**, **OLLI** are relatively more insulated from freight headwinds noting DG's private fleet now at >20%, FIVE's ability to lock in ocean carrier rates earlier in the year both from a rate and capacity perspective, and OLLI's FY21 GPM guidance maintained at 39.7%-39.8% despite transportation headwinds w/ the company's off-price back-end buying model mitigating margin pressure. For DLTR, we model ~$255M in freight headwinds for FY21, with ~$225M slated for 2Q-4Q ($0.70-$0.80 EPS impact, per guidance), predominantly impacting the DT banner, given the fixed $1 price point out the door.

Figure 1: CPI Apparel in Surpasses 2012 Peak



Source: U.S. Bureau of Labor Statistics.

Table 1: 2012 GPM Peak = 2021 Upside Potential

GPM	2012	2019	2021E
ANF	62%	59%	62%
LB	42%	36%	44%
BURL	39%	42%	42%
GPS	39%	38%	41%
AEO	40%	35%	39%
M	40%	38%	37%
KSS	36%	36%	36%
DDS	36%	32%	34%
JWN	37%	34%	33%
URBN	37%	31%	33%
TJX	27%	28%	29%
ROST	28%	28%	27%

Source: J.P. Morgan estimates, Company data.

(2) The Inventory Picture Today. On average retailers in our coverage exited 1Q21 with inventories -8% YoY ranging from DDS -29% to URBN +17% (attributed to in-transit inventories), translating to material merchandise margin gains vs. 2019 (+290bps on average) with JWN the notable laggard (-143bps vs. 2019). **Broadly, retailers by recent access remain optimistic on running more effective chase models, driving pricing power through data-driven pricing/promo strategies, and streamlining assortments with well-controlled inventories lasting through 2021 in our view, given retailers' conservative inventory planning & allocation 6-9 months ago (i.e. pre-vaccine rollout), 2H stimulus rollout coinciding with the first in-person BTS in 2 years, and pent-up demand on increased consumer mobility**. That being said, we note a natural reversion back to a "rebased" level of promotional behavior in 2022, noting a historical precedent from 2012 suggests a 2-year timeframe for Clothing & Clothing Accessory Store retail inventories to build back up from trough levels (see Figure 4).

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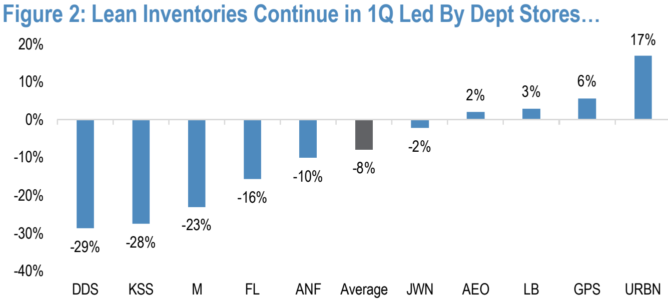
- (i) Off-Price: Based on recent investor call volume, the number one inbound for Off-Pricers is the question of "inventory availability" in light of broad-based lean retail inventories, in particular within the Dept Store channel. While we believe the share losses at mid-tier Dept Stores disproportionately benefit Off-Pricers (JPM Retail Apparel Landscape), we highlight Off-Pricers source the majority of goods from vendors directly through a combination of made-to-order product, opportunistic closeout buys in-season, and post-season packaway inventories, with Dept Stores only representing a low-single-digit% of Off-Price inventory today. **Looking back to the prior Clothing & Clothing Accessory Stores retail inventory trough in 2009/10 and periods where the inventory-sales delta at mid-tier Dept Stores has normalized (2009-2011) - Off-Pricers maintained strong comp performance w/ Marmaxx & ROST comps on average >5% (See Figure 4&5).** Importantly, Off-Pricers "solve vendor problems" by taking less than full assortments, cancelled orders, over-runs, and do not ask for retail concessions such as advertising, markdown allowances, or minimum gross margin guarantees, all of which department stores typically require. To that point, Off-Pricers have continued to grow global vendor bases & buying headcount over time: TJX: 16K vendors in 2009 to 21K in 2020 & 750 buying associates in 2009 to 1.1K in 2020, ROST 410 merchants in 2009 to >900 in 2020, suggesting continued ability to source inventory in our view.

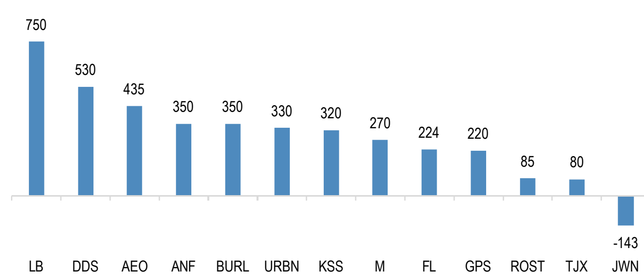
Figure 2: Lean Inventories Continue in 1Q Led By Dept Stores…



Source: Company reports.

Figure 3: …Driving Material Merch Margin Expansion vs. 2019

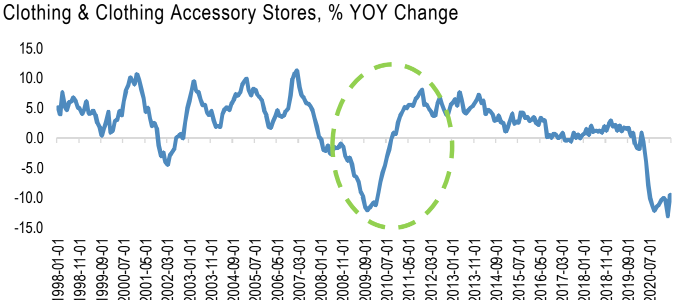
Basis points



Source: J.P. Morgan estimates, Company data.

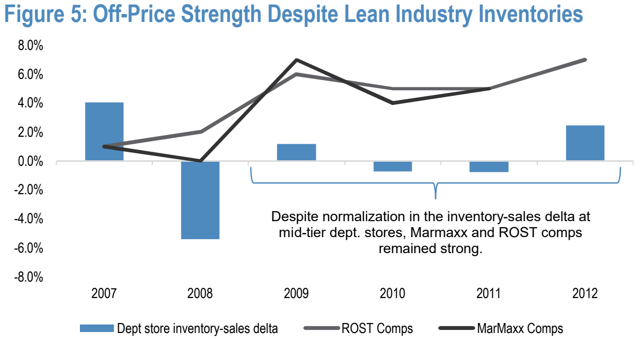
Figure 4: Historical 2-Yr Timeframe for Retail Inventories to Build Back

Clothing & Clothing Accessory Stores, % YOY Change



Source: U.S. Census Bureau.

Figure 5: Off-Price Strength Despite Lean Industry Inventories



Source: J.P. Morgan estimates, Company data.

(3) Accelerated Digital Channel Shift w/ All Eyes on Profitability: On the digital front – Dept Stores & Specialty Softlines digital sales remained strong growing > +50% vs. 2019 on average (more/less matching ~50% in 4Q) and reaching average 38% penetration (relative to 25% average 1Q19 penetration) with the consumer's shift to digital accelerated by the pandemic as doors shuttered in mid-March last year and social distancing/stay-at-home orders fell into place. The outsized digital performance contributed to a ~165bps average headwind relative to 2019 to 1Q21 GPM across our coverage driven by digital delivery expense deleverage on outsized volumes and elevated transportation costs. **In our view, the digital shift, while accelerated, is sustainable with multiple companies across our coverage establishing and/or raising long-term digital penetration targets including: M (>40% by 2023), KSS (40% by 2023), GPS (50% by 2023), LEVI (>50% DTC & franchise-partner penetration), VFC (20% ecomm by FY24), and NKE (50% DTC long-term w/ FY21 doubling to 30%). Putting this into perspective - our JPM Internet team expects long-term (i.e. 2030+) apparel & accessories ecomm penetration to reach 58%, which we see as achievable, with our math pointing to ~60% long-run ecomm penetration, noting the category reached >30% ecomm penetration in 2020 and has grown at a historical 10-year +17% CAGR per Euromonitor data.** Near-term, we anticipate FY21 ecommerce penetration to "normalize" between FY19/FY20's rates, as retailers cycle up against covid-mandated door closures and post-vaccine store traffic balances out strong digital performance in 2H20 (see Figure 6 below).

- (i) Global Brands: We see the accelerated shift to DTC structurally benefitting Global Brands exiting the pandemic with **NKE** and **VFC** as the largest beneficiaries from the sector's ongoing shift to DTC w/ LULU notably already benefitting from its fully DTC business model. **Specifically, our calculations point to the potential for the shift to add annually at least 100-150bps to revenue growth, ~40-60bps to GPM expansion and ~300-400bps to EBIT dollar growth each year to both NKE and VFC on our math (as noted in our Global Sporting Goods Primer).** Additionally, we see 2 notable "catch-up" opportunities in our view: (1) ecommerce penetration in handbags/accessories accelerated to ~30% in 2020 vs. ~mid-teens pre-pandemic w/ **TPR** mgmt citing the shift to digital as financially bottom-line accretive w/ digital operating margins >10%+ higher than B&M, and (2) ecommerce penetration reached ~40% for online luxury by our work (vs. 12% in FY19) pointing to potential upside for **MYTE** (targeting 30% by FY25).

- (ii) Dept Stores & Specialty Softlines: While Dept Stores have outlined long-term digital targets, such as M (>40% by 2023) and KSS (40% by 2023), **we note every 1% increase in digital penetration carries a 10-20bps headwind to M/KSS/DDS on average with M's $10B 2023 digital revenue target coinciding with a mid-30s GPM rate (i.e. 300bps below 2019's 38% base).** Said differently, we anticipate ongoing gross margin deleverage for Dept Stores (M/KSS/DDS) tied to a continued digital shift, leaving merchandise margin as the potential GPM offset. As an outlier, we note JWN's store/ecomm GPM and contribution margin profile is at parity, leveraging scale and efficiencies from the 50%+ ecommerce mix today. Worth noting, M's contribution margins from the digital channel are mid-single-digit higher than stores given lower payroll, benefits, and real estate costs with CFO Mitchell viewing the digital channel shift as accretive to EBITDA margin (LT target of "approaching high-single-digits"). **Within Specialty, ANF/AEO/LB's BBW have cited digital channel margins at parity with stores (= channel agnostic), while GPS faces a ~15bps headwind for every 1% increase in ecommerce penetration with the company targeting 50% digital mix by 2023 and URBN faces occupancy & delivery expense deleverage on an outsized shift of sales volumes to the digital channel (though the channel itself is accretive in a normalized environment).**

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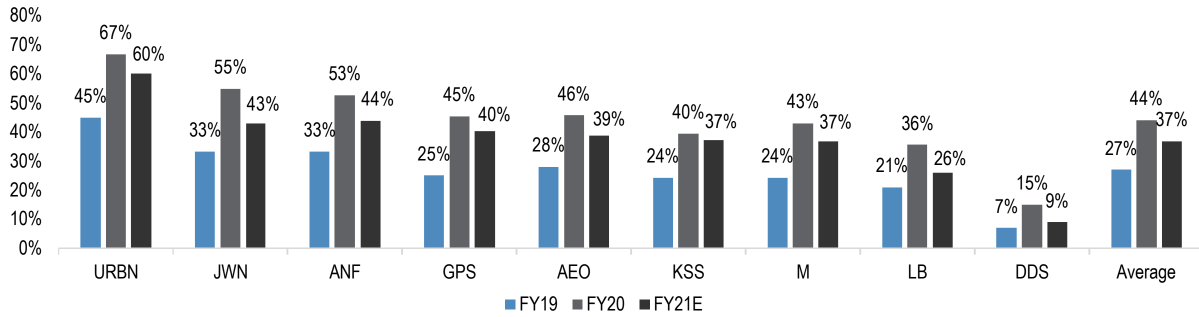
Figure 6: Boss' Dept Stores & Specialty Softlines Ecommerce Penetration Estimates



Source: J.P. Morgan estimates, Company data.

(4) Real Estate Evaluation: Store Fleet Donors vs. Growers. As illustrated in Figure 8 below, the US has highest shopping center retail globally at 22.9 retail square feet per capita more than doubling retail sq. ft./capita of 11 in Canada, and ~5 in UK/Australia. Further, there were 11,894 U.S. GAFO store closures in 2020, or > 20K closures over 2019/20, significantly higher than ~5,000 10 year historic average (see Figure 7). On timeline, at 2019/20's pace of ~10,000 closures it would take ~25 years for the US landscape to reach global equilibrium. Digging deeper, trailing 12 month Mall (regional and super regional malls) vacancy rates are running at a record 11.4%, representing a 100bps increase from our 2020 Bricks vs. Clicks report, and within the Retail sector broadly, 1Q21 effective rent per sq. ft. is down 1.5% yoy with the bottom five metro markets average ~3.5% yoy declines. **Fitting within our Barbell – we see Specialty (LB, AEO, GPS, ANF) as store fleet rationalization beneficiaries with occupancy leverage driving GPM expansion, and within growth/compounding names, we see Off-Pricers (BURL/TJX/ROST) and Dollar Stores (DG/DLTR) capitalizing on favorable lease terms to accelerate store growth and capture market share amidst a broader retail consolidation.**

- (i) Dept Stores & Specialty Softlines: Within Dept Stores, Nordstrom closed 16 full-price stores (~15% of US stores) in 2020, M has ~60 doors remaining to close within the 125 door closure guide by 2023, and DDS closed 4 stores. **Looking ahead, we see the store fleet remaining integral to Dept Stores portfolio, noting M projecting the "best locations," or A&B mall door fleet to represent 85% of the portfolio and 93% of sales and JWN's local market strategy affirmed at the 2/4 Analyst Day with the top 20 markets to represent 75% of sales.** Within Specialty, LB closed ~250 VS US/Canada stores in FY20 (= 27% of VS's North Americas store base), GPS ~245 net store closures including 190 net Gap/BR N. America door closures w/ ~160 more on tap through 2023, AEO shuttered 61 doors with ~190 more targeted through FY23, and ANF 166 store closures (including 8 flagships). **Importantly for Specialty, store fleet rationalization has translated to material rent/occupancy savings with ANF booking ~$120M of occupancy expense savings in 2020 (w/ >$20M on tap in 2021 by our model), LB driving >200bps of buying/occupancy leverage the last 3 qtrs, and GPS realizing >350bps of GPM expansion the last 3 qtrs driven by ROD leverage w/ mgmt expecting FY21 to finish with ~330bps of ROD leverage vs. 2019.** The notable outlier within Specialty is **BOOT** with mgmt confident in 10%+ store unit growth exiting the pandemic with new market doors outperforming internal payback metrics and initial cannibalization expectations in existing markets proving conservative.

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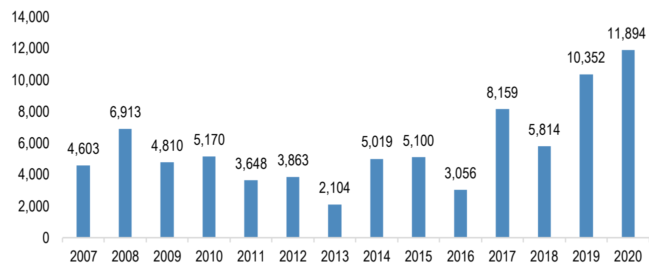
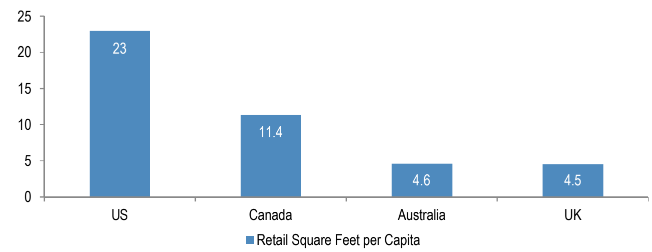
- (iii) Off-Price & Dollar Stores/Discounters: Conversely, Off-Pricers & Dollar Stores/Discounters continue to see store growth opportunities, capitalizing on a retail brick/mortar fleet rationalization and favorable lease terms exiting the pandemic with nearly every name affirming and/or raising long-term store targets. Specifically, **DG** raised LT store target to 17K doors (vs ~12K prior), including ~13K additional small box stores opportunities (>12K prior estimate), an additional ~3K pOpshelf store opportunities, as well as 1K more smaller footprint DGX format stores. Within Off-Price, **BURL** raised the long-term store saturation target to 2,000 doors (vs 1,000 prior) on 3/4, tied to an expanded whitespace oppty driven by the smaller ~25K sq. ft. Burlington 2.0 box format, and **TJX** raised the HomeGoods/HomeSense LT store target to 1,500 (vs 1,400 prior) in February.

Figure 7: US General Merchandise, Apparel, Furniture & Other (GAFO) Store Closures



Source: ICSC.

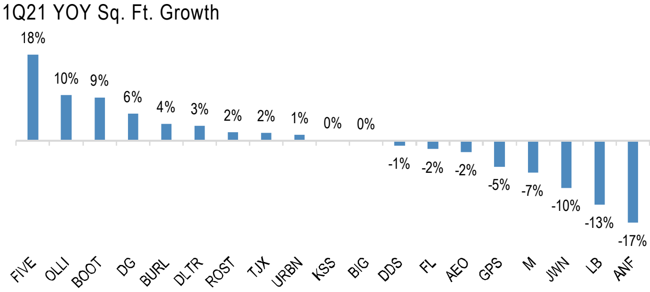
Figure 8: US Shopping Center Sq. Ft. per Capita Exceeds Int'l Avg.



Source: ICSC.

Figure 9: Off-Price & Discounters Store Fleet Insulation

1Q21 YOY Sq. Ft. Growth



Source: J.P. Morgan estimates, Company data.

(5) SG&A Actions Drive Permanent Efficiencies. Among 1Q21 performance, retailers broadly maintained SG&A expense discipline, partially offsetting inflation pressures, noting average Specialty EBIT flow-through of 89% 1Q21 vs. 1Q19 relative to 34% in 1Q19. **Notably, LB, AEO, and GPS (L-A-G), in addition to ANF, demonstrated compelling flow-through driven by ROD savings/rent negotiations and disciplined SG&A expense mgmt.** Broadly for the year, mgmt teams anticipate (i) ongoing covid expenses in 1H21 with a pullback of expenses in 2H21 with the U.S. full vaccination rate at 44%, (ii) continued supply chain/wage pressure, and (iii) savings reinvestments in digital/technology and marketing with all eyes on market share capture exiting the pandemic as the x-factor to drive expense leverage ratios back to FY19 (or below). Recall, a common thread in FY20 throughout our coverage was a "line by line" approach to evaluating the expense base, in addition to store fleet consolidations, and corporate overhead/headcount reductions (see Table 5 below). To that end, FY20 SG&A dollars were down YoY an average of 6.1% (including the headwind from COVID-costs) across our Department Stores/Specialty Softlines coverage with the most notable pullback at DDS (-28.4%), M (-24.8%), and JWN (-18.6%).

Table 2: Annualized Expense Savings Announced in FY20

Ticker	Expense Savings Announced in FY20 ($mn)
AEO	$225
ANF	$200
CPRI	$150
DDS *(JPMe)*	$150-200
GPS	$240
JWN	$370-420
KSS	$100
LB	$400
LEVI	$200
M	$900
RL	$200-240
TPR	$300
UAA	$120-160
VFC	$125
Average	**$284**

Source: J.P. Morgan estimates, Company data.

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Companies Discussed in This Report (all prices in this report as of market close on 16 June 2021)
Abercrombie & Fitch(ANF/$43.24/N), American Eagle Outfitters(AEO/$34.74/OW), Burlington Stores(BURL/$310.31/OW), L Brands, Inc(LB/$66.17/OW), Ross Stores(ROST/$118.98/OW), TJX Companies(TJX/$65.20/OW), The Gap, Inc.(GPS/$32.88/OW)

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Coverage Universe: Boss, Matthew R: Abercrombie & Fitch (ANF), Acushnet Holdings Corp. (GOLF), American Eagle Outfitters (AEO), Big Lots, Inc. (BIG), Boot Barn (BOOT), Brunswick Corp (BC), Burlington Stores (BURL), Callaway Golf (ELY), Capri Holdings Ltd (CPRI), Dillard's, Inc. (DDS), Dollar General Corp. (DG), Dollar Tree, Inc. (DLTR), Five Below (FIVE), Foot Locker (FL), Kohl's Corp. (KSS), L Brands, Inc (LB), Levi Strauss & Co. (LEVI), Macy's, Inc. (M), Mytheresa (MYTE), NIKE, Inc. (NKE), Nordstrom, Inc. (JWN), Ollie's Bargain Outlet Holdings (OLLI), PVH Corp. (PVH), Ralph Lauren Corporation (RL), Ross Stores (ROST), TJX Companies (TJX), Tapestry Inc (TPR), The Gap, Inc. (GPS), Under Armour, Inc. (UAA), Urban Outfitters (URBN), V.F. Corporation (VFC), lululemon athletica inc. (LULU)

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IB clients**	54%	48%	38%
JPMS Equity Research Coverage*	46%	39%	14%
IB clients**	78%	70%	55%

*Please note that the percentages might not add to 100% because of rounding.
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