# Long: Ross Stores (ROST)

**Company Overview:** Ross Stores is an "off-price" retailer that targets lower and middle income consumers. Approximately 70% of transactions are cash, with an average item retailing for $5 and an average basket of $10. Ross Stores has no e-commerce presence, nor do they want one: Ross' website simply directs you to the nearest brick & mortar location.

**Why We Like It:** Qualitatively, we are huge fans of Ross Stores. It is a fantastic business and will likely remain a core portfolio long. Quantitatively, like most of our long ideas today, the valuation is problematic. Ross is trading at stretched multiples and we plan to size the position accordingly with plenty of room to add lower.

Ross fits almost every aspect of our Long checklist:

**Honest, conservative management team who run their business with a "Depression era" mentality.** Ross' balance sheet is pristine and the firm is consistently in a net cash position. We have met with them countless times in our career and believe they may be the best operators in all of Consumer/Retail.

**Proven performance during recessions.** Our favorite screen for these types of businesses is simple. We pull up multiple decades of financials for a company, blank out the years and try to guess when recessions took place (2008-2009, 2001-2002, etc). If the answer isn't immediately obvious, we're interested – and Ross is one of the best we have seen.

**Ross Stores (ROST) - Summary Income Statement**

| In Millions of USD | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 | 10 |
|---|---|---|---|---|---|---|---|---|---|---|
| **Revenue** | **3,531.3** | **3,920.6** | **4,240.0** | **4,944.2** | **5,570.2** | **5,975.2** | **6,486.1** | **7,184.2** | **7,866.1** | **8,608.3** |
| *Growth % y/y* | *18.2%* | *11.0%* | *8.1%* | *16.6%* | *12.7%* | *7.3%* | *8.6%* | *10.8%* | *9.5%* | *9.4%* |
| **EBITDA** | **396.8** | **451.0** | **390.3** | **436.3** | **497.8** | **541.8** | **637.0** | **885.3** | **1,067.4** | **1,223.4** |
| *Growth % y/y* | *12.1%* | *13.7%* | *-13.5%* | *11.8%* | *14.1%* | *8.8%* | *17.6%* | *39.0%* | *20.6%* | *14.6%* |
| **EBITDA Margin %** | *11.2%* | *11.5%* | *9.2%* | *8.8%* | *8.9%* | *9.1%* | *9.8%* | *12.3%* | *13.6%* | *14.2%* |
| **Earnings Per Share** | **$0.32** | **$0.37** | **$0.30** | **$0.34** | **$0.43** | **$0.48** | **$0.58** | **$0.89** | **$1.16** | **$1.43** |
| *Growth % y/y* | *32.6%* | *16.7%* | *-17.7%* | *12.4%* | *25.0%* | *11.8%* | *22.6%* | *52.0%* | *30.5%* | *23.8%* |

Years 7-10 represent the years bracketing the Great Recession. Comparable store sales (aka same-store sales or "comps") increase for Ross during downturns as consumers trade down. Ross comped 5-6% (~10% revenue growth) throughout the 2008-2009 period while generating 20-30% earnings growth and expanding margins 300+ bps.

# <u>Long: Ross Stores (ROST)</u>

**Outsized Shareholder Return.** The firm generates 30-40% returns on equity while also buying back stock and paying dividends. Ross has massively outperformed the indices on any timeframe, with annualized returns of ~25% over 30 years vs. 6-8% for the S&P.

**Amazon-Proof:** What sets Ross apart is that they have a business model built to withstand the Amazon era. The unit economics of fulfilling and shipping a $5.00 item via e-commerce simply don't work. Ross relies on a "treasure hunt" model and the entire store's inventory turns over in a matter of weeks, promoting scarcity value and driving consistent traffic.

**Revenue Growth Driven By Traffic, Not Price:** Retailers grow sales through volume (traffic) or higher AUR (Average Unit Retail/price). We always prefer the former as price hikes eventually dent traffic – and a retailer without traffic is a dead one. Ross believes that "value never goes out of style" and their revenue tends to be entirely traffic-driven.

**Decades Of Growth Runway:** Ross has approximately 1,500 stores nationwide and sees runway to 2,500 or so – a figure that management continues to increase. Ross is still expanding in the Midwest and has near-zero Northeast and international presence. We view their long-term earnings algorithm as sustainable: 4-6% unit growth, 2-3% comps, 3% reduction in share count and a 1-2% dividend for 10-15% shareholder return.

**Favorable Competitive Landscape:** There are three other scale players in the off-price industry: T.J. Maxx (TJX), Burlington Stores (BURL) and Ollie's Bargain Basement (OLLI). TJX targets a higher-income consumer and does not directly compete with Ross – both management teams have stated that when a Ross and a T.J. Maxx are next to one another, <u>traffic increases.</u> The "treasure hunt" model is utilized by both and consumers are more likely to visit one of the two knowing they can hit multiple stores while they're shopping.

**Favorable Industry Structure:** These four firms have continued to vacuum up share at the direct expense of department stores. Department stores – most of which are both obvious and consensus shorts – suffer from inefficient expense structures, a weak and undifferentiated value proposition, and a real estate footprint that need to be reduced by as much as 50% for some players.

**Portfolio Considerations:** We are fans of all four off-price businesses, but due to valuation concerns we would only be comfortable owning Ross and a small position in Ollie's.

For further reading on off-price, two articles on TJX and Ollie's provide excellent color.

## Long: Rollins (ROL) and ServiceMaster (SERV)

**Company Overview:** Rollins and ServiceMaster are the two dominant players in the pest control industry. ROL operates primarily under the Orkin brand, and SERV under Terminix.

At the highest level, there are two segments within pest control: commercial (dominated by Rollins) and residential (dominated by Terminix). The commercial segment is a far better one, and Rollins trades at a substantial and well-deserved premium to Terminix.

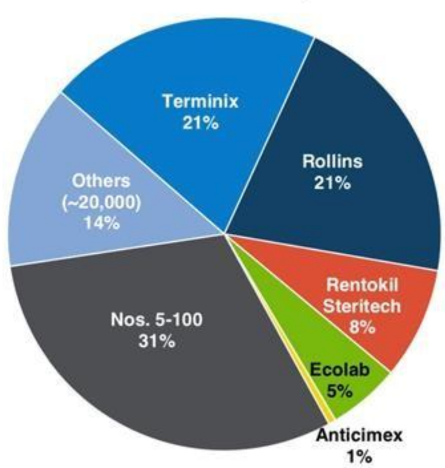
**Why We Like ROL & SERV: Pest Control Is As Good As It Gets.** Over time we have learned that when you find a fast-growing industry with a duopoly/oligopoly structure, there is no need to get cute and choose between the players. When the 'pie' is growing fast enough, both can make great investments. We would be comfortable owning both ROL and SERV here.

**Secular Industry Growth.** The domestic pest control market is ~$9B in size and grows 5% annually. Pest activity is rising driven by denser populations, higher market adoption rates and increased regulation. Rollins and ServiceMaster both have ~20% market share, a number that continues to grow as they consolidate what is a highly fragmented industry.

**Low Economic Sensitivity.** The pest control market is largely noncyclical and has proven organic growth throughout multiple economic downturns.

Rollins' stock – not just the business – delivers huge outperformance in recessions. To quote ROL's CEO, Gary Rollins, **"Rats and roaches don't read the Wall Street Journal."**

North American Pest Control Industry: Market Share Data




Relative Stock Price Performance - ROL

| | ROL | S&P | Relative Performance |
|---|---|---|---|
| Mar-07 | 4% | 10% | -6% |
| Jun-07 | -2% | 18% | -21% |
| Sep-07 | 12% | 14% | -2% |
| Dec-07 | 27% | 4% | 23% |
| Mar-08 | 22% | -7% | 29% |
| Jun-08 | 12% | -15% | 27% |
| Sep-08 | 30% | -24% | 54% |
| Dec-08 | 33% | -38% | 71% |
| Mar-09 | 37% | -40% | 76% |
| Jun-09 | 45% | -28% | 73% |
| Sep-09 | 9% | -9% | 18% |
| Dec-09 | -17% | 23% | -40% |
| Mar-10 | -20% | 47% | -67% |
| Jun-10 | 7% | 12% | -5% |
| Sep-10 | 16% | 8% | 8% |
| Dec-10 | 41% | 13% | 28% |

Source: Factset and William Blair estimates

## Long: Rollins (ROL) and ServiceMaster (SERV)

**Recurring Revenue: 80-90%.** Pest invasions are not usually a one-off occurrence for both residential and commercial. Services are provided anywhere from quarterly to bi-weekly. Residential customers sign one-year contracts that automatically renew. Commercial is even better with 3-5 year contracts that have long sales cycles but are extremely sticky.

**Pricing Power.** Residential customers have low price elasticity. When termites or bed bugs invade your house, you want them gone immediately. For commercial customers, the service itself is simply nondiscretionary and a cost of doing business. If a rat appears in one Taco Bell it can have catastrophic effects for the brand's equity. This dynamic is only accelerating with the advent of social media, to the benefit of Rollins and Terminix.

**Why Rollins?** Rollins is an expensive stock, and for good reason: it may be the highest quality business we see available for purchase in public markets.

- **Inside Ownership:** Around 60% of the float is owned by the Rollins family. We gravitate towards family-owned firms, which historically outperform the indices.
- **Balance Sheet & Capital Allocation:** Rollins consistently carries net cash on their balance sheet and does an outstanding job allocating free cash flow between bolt-on M&A, dividends and share repurchases. Returns on equity are north of 30%.
- **Shareholder Return:** ROL has delivered incredible shareholder returns on all timeframes, with annual returns of 20-25% over decades versus 6-8% for the S&P.

**Why ServiceMaster?** For years, ServiceMaster was a horribly mismanaged business and Terminix was barely growing despite an industry expanding 4-5%.

In 2017, Terminix installed an entirely new management team. We spent a considerable amount of time diligencing and meeting with CEO Nik Varty and are comfortable backing him. The brand itself is well-known and most fixes consist of basic blocking and tackling. These efforts are just now bearing fruit and organic growth has accelerated from flattish to mid-single digits, with multi-year margin upside as cost initiatives roll off the P&L.

**Portfolio Considerations:** Similar to ROST, we have valuation concerns on both ROL and SERV. Investors are overpaying for companies that offer defensive growth. We plan to size the positions accordingly, leaving ourselves plenty of room to average down in each stock.

Further reading on SERV's turnaround-in-progress can be found here.

## Long: Copart (CPRT)

Copart fits the same mold as other 'core' longs: recession-resistant, unexciting, hard-to-kill, excellent management with family ownership and a pristine balance sheet. If we could own 100% of any publicly traded enterprise, it's a close call between Rollins and Copart.

**Company Overview:** Copart is the dominant player in the junkyard/auto salvage auction industry with ~40% share. If cars are getting into major accidents (deemed "total loss" by insurers), Copart is making money. The firm began with one junkyard in 1982 and now has over 200 nationwide with a growing presence internationally. On their website, Copart.com offers an eBay-style auction service which matches buyers and sellers of cars and parts.

**Recession-Resistance:** The salvage auction industry is stable and generally not dependent on new vehicle sales or the economic cycle. Copart passes our favorite test with ease: during the Great Financial Crisis, EBITDA fell less than 3% while margins expanded every year.

**Copart (CPRT) - Financial Crisis Performance**

| *Summary Financials ($m)* | **2008** | **2009** | **2010** |
|---|---|---|---|
| Revenue | 784.8 | 743.1 | 772.9 |
| Gross Margin % | 41.1% | 42.0% | 45.2% |
| **EBITDA** | **280.7** | **265.7** | **285.7** |
| **EBITDA Margin %** | **35.8%** | **35.8%** | **37.0%** |
| Earnings Per Share | $0.44 | $0.41 | $0.46 |
| Free Cash Flow | 80.7 | 124.4 | 123.6 |

**High Barriers To Entry Due to 'NIMBY' Politics:** Local zoning laws provide a powerful and natural barrier. To become a player in salvage, a new entrant needs hundreds of acres of junkyard real estate to store scrapped vehicles. Municipal governments are highly reluctant to approve new junkyards due to unsightliness. As a result, approvals take several years and there is virtually no new junkyard supply coming online. Copart's assets are irreplaceable.

**Secular Industry Tailwinds:** The salvage industry grows mid-single digits annually. This is driven by an increase in old cars on the road plus repair costs growing in excess of inflation. A macabre tailwind is distracted driving, which has spiked in recent years as people apparently feel the urgent need to take Snapchat videos of themselves driving. This has led to more crashes, higher total loss frequency and accelerating volume growth for Copart.

*"Nobody ever went broke underestimating the intelligence of the American public."*
**H. L. Mencken**

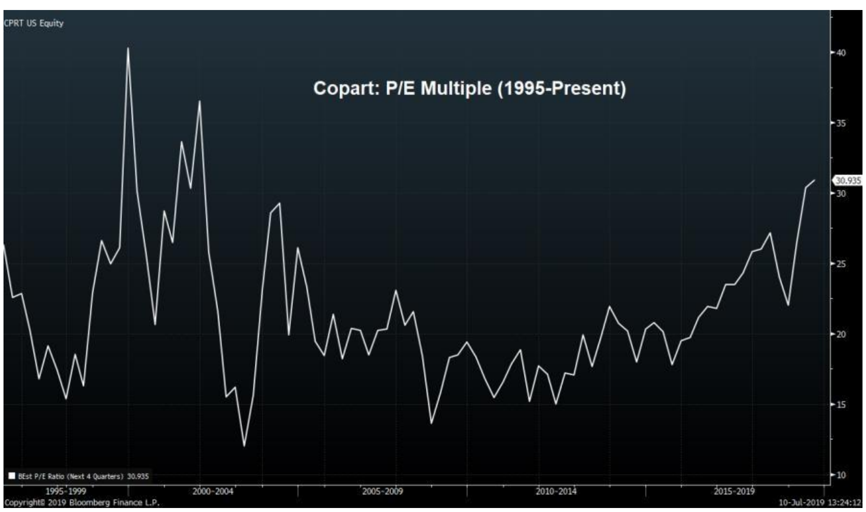
## Long: Copart (CPRT)

**Duopoly Industry Structure:** The salvage industry has consolidated into a duopoly, with Copart and Insurance Auto Auctions (IAA) holding ~75-80% market share. There are no other scale players that can handle the volumes that large insurers require: 80% of Copart's revenue is derived from long-term contracts with insurance giants such as Allstate and Nationwide. As a result, CPRT and IAA are competitive yet rational and raise prices regularly.

**Family Business with Aligned Incentives:** Founder and former CEO Willis Johnson has instilled an owner-operator mentality at Copart. The current CEO, Jay Adair, is Johnson's sonin-law and the two combined own ~12% of the float. Corporate governance is excellent: Most senior executives are paid a $1.00 annual salary with the rest in the form of equity incentives.

**Balance Sheet & Capital Allocation:** Like Ross Stores, Copart runs the business with a 'depression-era' mentality and a balance sheet consistently is in a net cash position. Management's capital allocation is stellar, with well-timed repurchases that have reduced shares outstanding by 35% in the past 15 years. Returns on equity are in the ~30% range and Copart has massively outperformed the S&P on all timeframes, annualizing at 20-25%.

**Portfolio Considerations:** Risk/reward just isn't there for CPRT to be a large position. Street numbers appear too low, but any upside is likely to be offset by multiple compression.
CPRT is trading at the highest valuation in decades and we'll patiently wait for a better entry.




For further reading on Copart, we enjoyed founder Willis Johnson's book [Junk to Gold: From Salvage to the World's Largest Online Auto Auction](#).

**Long: Activision-Blizzard (ATVI) and Take-Two Interactive (TTWO)**

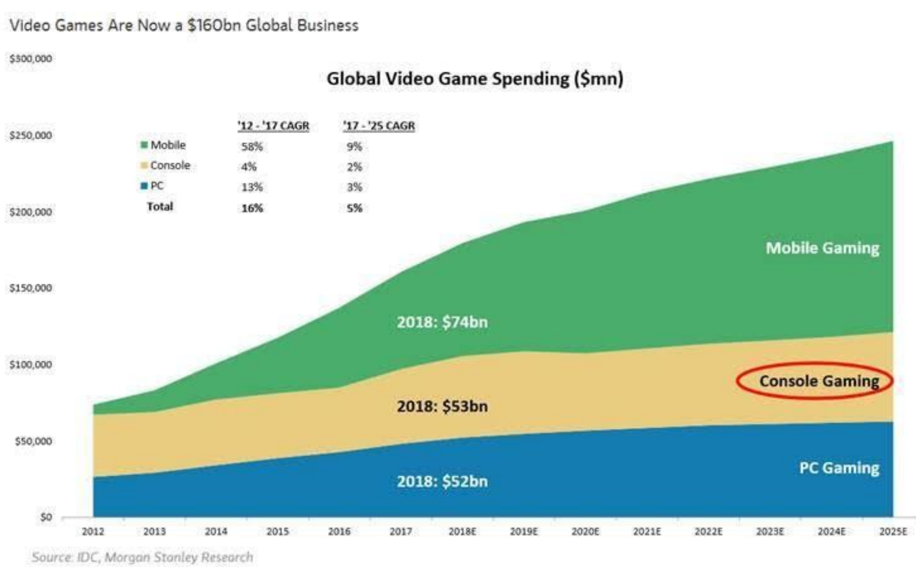
**Company Overview:** Activision and Take-Two are two of the dominant players in the video game industry. Their IP libraries are unparalleled:

- Activision owns Call of Duty, Warcraft, Starcraft, Diablo and Candy Crush. They are also the leader in e-sports, driven by their Overwatch title (Overwatch League).
- Take-Two's Grand Theft Auto franchise (a JV with Rockstar) is top three all-time in unit sales. Other TTWO titles include Red Dead Redemption, Borderlands and NBA2K.

**Why We Like ATVI & TTWO:** Similar to Rollins and ServiceMaster, we don't feel the need to choose between Activision and Take-Two. The video game industry is a fantastic one and these are two high-quality businesses operated by management teams we respect.

**Balance Sheet & Capital Allocation:** Both businesses are highly cash-flow generative and carry net cash on the balance sheet. TTWO in particular has ~12% of its market cap in cash.

**Secular Industry Growth:** The video game industry is $160B in size and has grown at a 16% CAGR, which should slow to 5% over the next decade. Mobile grows faster than Console/PC and Activision is well-positioned in this channel following their acquisition of King Digital (publisher of Candy Crush). Over time, ATVI has combined King's mobile expertise with Activision's vast IP library to produce a wide array of portable content.



## Long: Activision-Blizzard (ATVI) and Take-Two Interactive (TTWO)

**Why Activision?** The stock is well off highs and we see an attractive entry point for the dominant player in a fantastic industry with best-in-class management.

- Activision entered a perfect storm at the end of 2018. Fortnite fears swept across the industry, pushing down sector multiples. ATVI then made uncharacteristic missteps on messaging and in-game monetization, followed by internal disarray (sweeping cost cuts and management turnover). 2019 is an 'investment year' for ATVI with no new titles and the stock has been left for dead by hedge funds.
- **Having traded the sector for many years, we know one thing: you generally want to own these stocks when there is nothing exciting on the horizon.** As soon as a new title enters the 'hype cycle,' gaming stocks appreciate and it happens rapidly.
- **Valuation:** We think 2021-2022 earnings power for this business is 50-75% higher than today's and believe that Activision could easily double over the next three years.

**Why Take-Two?** The risk/reward is perhaps the most compelling in our entire coverage.

- Over the next several years, Take-Two will announce the next installment of the Grand Theft Auto series. No one knows when. What we do know is that the stock will begin moving higher immediately and you have to be there in advance.
- TTWO's current earnings power is in the $4.00 range. Grand Theft Auto should add $3.00 base case and could double their earnings in a bull case scenario. TTWO is trading at $110, has $14/share in cash and produces $5/share in free cash annually.
- **Valuation:** In a bull case scenario and stripping out net cash, TTWO is trading as low as 12x future earnings power - as earnings are doubling. This is a mispriced bet.
- Bear case, assuming Grand Theft Auto is a complete dud, we still see $4.50-$5.00 in run-rate earnings and a rock-solid balance sheet as downside protection.
- Take-Two could very easily be a $200 stock in three years (~80% up) and it takes draconian assumptions to get below an $85 bear case (~25% down).
- We see very few 3:1 propositions in this market and TTWO is one of them.

**Portfolio Considerations:** We would not be surprised if both stocks are "dead money" near-term. When they do move higher it will happen quickly and we see enough valuation support today that we would comfortably own both and add on market weakness.

For further reading on TTWO, we enjoyed "Jacked: The Outlaw Story Of Grand Theft Auto."

> *"My largest positions aren't the ones I think I'm going to make the most money in. My largest positions where I don't think I'm going to lose money."* **Joel Greenblatt**

## Short: Michael's Stores (MIK)

**Company Overview:** Michael's is a specialty retailer that sells art supplies, crafting materials and custom frames. The firm was founded in 1973 and now has 1,250 stores nationwide. Michael's was taken private by Bain and Blackstone (who still own ~50% of the float) in a 2006 LBO, and nearly went under in 2009 as a result of the crippling debt load. After cleaning up MIK's cost structure, the company came public again in 2014.

**Why We Like The Short:** We are bearish on Michael's Stores and believe the equity could end up worthless. We have a long history with MIK and actually owned the stock earlier in our career. The business appeared to be somewhat Amazon-resistant, with low unit pricing (average item is $3.00) deterring e-commerce as a threat.

Since then, we have watched management ruin what was a decent company with a series of poor strategic and capital allocation decisions. These were compounded by the accelerating secular headwinds that have put countless brick and mortar retailers out of business.

Michael's Stores as it stands today has everything we look for in a short:

**Deteriorating Fundamentals + Operating Leverage + Financial Leverage.** Over the past five years, MIK's sales growth has slowed from 5% to (2%) and continues getting worse quarter by quarter. Michael's was overearning for years, with some of the highest margins in retail (40% gross / 17% EBITDA) and those are compressing at the same time sales decline. In retail, high margins are often a curse as the industry has low barriers to entry and competition quickly emerges. As Jeff Bezos once said: "your margin is my opportunity."

When a retailer like MIK has sales declining while gross margins compress, it is a huge red flag. Most retailers can trade sales for margin and vice versa. When promotional activity is no longer able to drive in-store traffic, it signals to us that the business may be fully broken.

MIK also has huge tariff exposure, is behind on labor (wages are too low vs competition) and has substantial exposure to freight prices. The fixed cost deleverage on this business gets ugly fast, and we think operating income could easily decline 15-20% the next few years on sales that are only slightly negative. This is before taking their debt burden into account.

*"The liabilities are always 100% good. It's the assets you have to worry about."*
**Charlie Munger**

## Short: Michael's Stores (MIK)

**Poor Capital Allocation & Paper Thin Balance Sheet.** Michael's came public with a substantial debt load in the neighborhood of 5x net debt/EBITDA. Initially, MIK was a deleveraging story and management was committed to paying down debt – the correct move.

Despite decaying fundamentals, management stopped paying down debt nearly four years ago and began funneling all free cash into share repurchases to buoy EPS growth. Now that fundamentals have rolled over, MIK's weak balance sheet is emerging as a cause of concern.

**Credit Market Red Flags.** Leverage ratios currently stand at 3.0x-3.5x LTM and in the 5.0x6.0x range when including operating leases as debt. MIK recently tapped the high-yield markets to refinance $500m of 5.875% debt.

Initially marketed at a 7% yield, investor demand wasn't there and MIK is now paying 8%, causing a spike in interest costs. The bond indenture also introduced new restrictions on dividend payments and asset sales. In a market starved for yield, MIK's inability to refi their debt cheaply signals that this balance sheet could quickly become problematic.

**High Executive Turnover.** MIK's former CEO was recently fired and the firm is operating with an interim CEO who came from Office Depot and has no interest in the full-time role. Most of our former contacts at the business have left for greener pastures, most recently being Investor Relations who jumped ship to go to Ulta. The business is potentially on the verge of collapse at the same time there is no one in the C-suite.

**Questionable Strategic Decisions**. Initially, MIK stuck to the party line that the business was e-commerce proof. They had no interest in building out omnichannel given that it wasn't a threat. Over time this narrative shifted and management started pouring capex into their omnichannel platform. MIK has lost their way and it is unfortunate given that the business could have carved out a niche for itself via forms of in-store experiences to drive traffic.

**No Reason To Exist.** With a clean balance sheet, MIK could probably survive a downturn. As it stands today we don't see it happening, particularly without a competent CEO who can right the ship before sales declines accelerate.

**Valuation:** It doesn't take drastic assumptions to triangulate the equity being worthless; 4x EBITDA (normal for challenged retailers) on our estimates gets us there.

## Short: Gap Stores (GPS) and Macy's (M)

Readers are likely familiar with both of these businesses. Our thesis on the two is fairly simple, and somewhat similar to one another.

**Why We Like The Short:** Both fit the mold of a textbook struggling retailer and have become increasingly irrelevant in today's retail world. There is no differentiated proposition and traffic is rolling over as a result. Each business is overstored and needs to reduce their footprint by 25-50%.

**Why Macy's?**

Macy's is in worse shape than Gap, and the business has only survived this long due to their valuable real estate holdings. Macy's reports asset sales within their operating margin, making it difficult to ascertain the profitability of the retail operation itself. Our guess is breakeven or close to it.

Over the next five years, it is unlikely but possible that Macy's goes out of business. The leverage burden adds substantial risk and we see more downside than GPS, but with more risk to the short in the event that Macy's is able to continue monetizing assets to buy themselves time.

**Why Gap?**

Gap is a composition of three brands: Gap Global, Banana Republic, and Old Navy.

The first two – Gap Global and Banana – are fully broken businesses. Same-store sales are declining 5-10%. Management doesn't break out operating margin by segment, but we suspect both are deeply unprofitable.

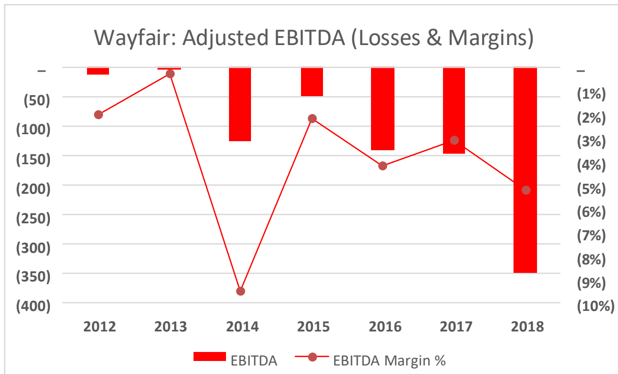
Old Navy has been the only segment supporting the enterprise value. In recent quarters, the segment finally rolled over. Consolidated gross margins have continued lower simultaneously and we think the business has hit a negative inflection point.

Gap has a clean balance sheet and we doubt that they go out of business in a downturn. However, we are fairly confident that earnings power three to five years out is somewhere between 55% and 60% lower than today ($1.00 or less in earnings per share).

## Short: Wayfair

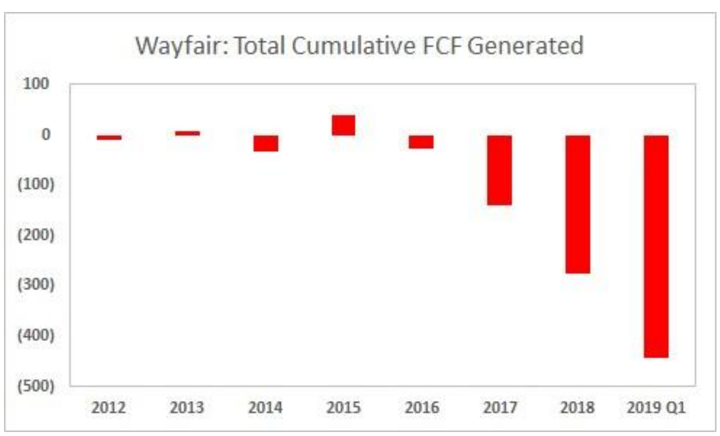
**Company Overview:** Wayfair sells home goods and furniture over the Internet.

**Why We Like The Short:** Wayfair is a 'bull market business model' with fundamentally broken unit economics. The company's revenue model consists of selling dollar bills for 75 cents. Gross margins are in the low 20%'s and decline annually. Wayfair has never reported a dollar of positive EBITDA (adjusted or otherwise) since their IPO.

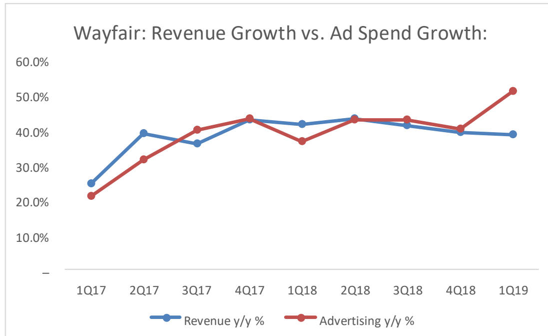



Over this timeframe above, Wayfair's revenues have grown from $600m to $7B. Put simply: this business does not scale. Selling heavy furniture with free two-day shipping is wonderful for consumers, but we suspect the unit economics fail to make sense at any level of revenue. This company has existed since 2006. If there was operating leverage, we would see it by now. Instead, all Wayfair does is consistently rack up operating losses.

Bulls often compare Wayfair to an early-stage version of Amazon. The two don't belong in the same sentence. Amazon generated free cash flow every single year of its existence. We think the chart below sums up this business perfectly.




Why have revenue increases failed to flow to the bottom line? Discounting and advertising play a role. This is most obvious by charting Wayfair's quarterly revenue growth against their quarterly growth in advertising spend. When Wayfair pulls back on ad spend, revenues fall. When they boost advertising, revenues increase. The correlation is almost one-to-one:




We note that in the most recent quarter (1Q19) Wayfair's ad spend growth of 50% was only matched by a 40% increase in revenue – the widest diversion we have seen in our time covering the stock and a potential red flag. Wayfair has run out of levers to boost revenue growth right at the same time they reported their slowest growth in two years.

We expect revenue growth to continue decelerating and for the stock to follow. We believe Wayfair's CEO does as well, given the acceleration in insider sales as of late.

| Ticker | Owner | Relationship | Date | Transaction | Cost | #Shares | Value ($) | #Shares Total | SEC Form 4 |
|---|---|---|---|---|---|---|---|---|---|
| W | Shah Niraj | Chief Executive Officer | Apr 24 | Sale | 152.03 | 4,658 | 708,156 | 0 | Apr 26 04:29 PM |
| W | Shah Niraj | Chief Executive Officer | Apr 22 | Sale | 146.71 | 26,000 | 3,814,576 | 0 | Apr 24 04:41 PM |
| W | Shah Niraj | Chief Executive Officer | Apr 23 | Sale | 152.03 | 342 | 51,994 | 0 | Apr 24 04:41 PM |
| W | Shah Niraj | Chief Executive Officer | Apr 15 | Sale | 147.96 | 26,000 | 3,846,976 | 0 | Apr 17 06:57 PM |
| W | Shah Niraj | Chief Executive Officer | Apr 08 | Sale | 150.20 | 26,128 | 3,924,300 | 7,652 | Apr 10 04:34 PM |
| W | Shah Niraj | Chief Executive Officer | Apr 03 | Sale | 154.03 | 5,000 | 770,162 | 2,780 | Apr 05 04:47 PM |
| W | Shah Niraj | Chief Executive Officer | Apr 01 | Sale | 148.67 | 26,000 | 3,865,337 | 2,780 | Apr 03 04:29 PM |
| W | Shah Niraj | Chief Executive Officer | Mar 25 | Sale | 161.44 | 31,000 | 5,004,658 | 28,780 | Mar 27 05:01 PM |
| W | Shah Niraj | Chief Executive Officer | Mar 18 | Sale | 167.32 | 31,000 | 5,186,978 | 59,780 | Mar 20 05:55 PM |
| W | Shah Niraj | Chief Executive Officer | Mar 11 | Sale | 168.82 | 31,000 | 5,233,561 | 90,780 | Mar 13 05:01 PM |
| W | Shah Niraj | Chief Executive Officer | Feb 25 | Sale | 159.36 | 31,000 | 4,940,023 | 62,780 | Feb 27 04:52 PM |
| W | Shah Niraj | Chief Executive Officer | Feb 19 | Sale | 123.10 | 17,000 | 2,092,701 | 93,780 | Feb 21 04:28 PM |
| W | Shah Niraj | Chief Executive Officer | Feb 11 | Sale | 119.56 | 14,000 | 1,673,815 | 26,780 | Feb 13 08:40 PM |
| W | Shah Niraj | Chief Executive Officer | Feb 04 | Sale | 111.26 | 14,000 | 1,557,655 | 40,780 | Feb 06 05:16 PM |
| W | Shah Niraj | Chief Executive Officer | Jan 28 | Sale | 104.10 | 9,000 | 936,897 | 54,780 | Jan 30 04:35 PM |
| W | Shah Niraj | Chief Executive Officer | Jan 22 | Sale | 97.92 | 4,000 | 391,693 | 63,780 | Jan 24 05:24 PM |
| W | Shah Niraj | Chief Executive Officer | Jan 14 | Sale | 94.34 | 4,000 | 377,346 | 67,780 | Jan 16 05:19 PM |
| W | Shah Niraj | Chief Executive Officer | Jan 07 | Sale | 95.53 | 4,000 | 382,110 | 71,780 | Jan 09 05:06 PM |
| W | Shah Niraj | Chief Executive Officer | Dec 31 | Sale | 92.70 | 800 | 74,160 | 75,980 | Jan 03 06:00 PM |
| W | Shah Niraj | Chief Executive Officer | Jan 02 | Sale | 92.03 | 200 | 18,406 | 75,780 | Jan 03 06:00 PM |
| W | Shah Niraj | Chief Executive Officer | Dec 27 | Sale | 92.06 | 4,000 | 368,240 | 76,780 | Dec 28 08:39 PM |
| W | Shah Niraj | Chief Executive Officer | Dec 17 | Sale | 95.80 | 4,000 | 383,219 | 80,780 | Dec 19 04:44 PM |
| W | Shah Niraj | Chief Executive Officer | Dec 10 | Sale | 106.65 | 9,000 | 959,876 | 85,080 | Dec 12 07:58 PM |
| W | Shah Niraj | Chief Executive Officer | Dec 12 | Sale | 112.12 | 300 | 33,636 | 84,780 | Dec 12 07:58 PM |
| W | Shah Niraj | Chief Executive Officer | Dec 03 | Sale | 109.82 | 14,000 | 1,537,523 | 22,080 | Dec 06 04:35 PM |
| W | Shah Niraj | Chief Executive Officer | Nov 28 | Sale | 103.63 | 5,450 | 564,773 | 36,080 | Nov 30 05:29 PM |
| W | Shah Niraj | Chief Executive Officer | Nov 26 | Sale | 92.76 | 900 | 83,483 | 44,180 | Nov 28 04:23 PM |
| W | Shah Niraj | Chief Executive Officer | Nov 27 | Sale | 93.11 | 2,650 | 246,731 | 41,530 | Nov 28 04:23 PM |
| W | Shah Niraj | Chief Executive Officer | Nov 05 | Sale | 95.01 | 4,000 | 380,038 | 49,080 | Nov 07 05:07 PM |
| W | Shah Niraj | Chief Executive Officer | Oct 29 | Sale | 106.96 | 9,501 | 1,016,237 | 55,280 | Oct 31 07:52 PM |
| W | Shah Niraj | Chief Executive Officer | Oct 31 | Sale | 112.20 | 2,200 | 246,840 | 53,080 | Oct 31 07:52 PM |
| W | Shah Niraj | Chief Executive Officer | Oct 22 | Sale | 124.30 | 17,000 | 2,113,109 | 64,781 | Oct 24 08:28 PM |
| W | Shah Niraj | Chief Executive Officer | Oct 15 | Sale | 120.05 | 16,408 | 1,969,754 | 83,531 | Oct 17 07:29 PM |
| W | Shah Niraj | Chief Executive Officer | Oct 16 | Sale | 123.84 | 1,750 | 216,728 | 81,781 | Oct 17 07:29 PM |
| W | Shah Niraj | Chief Executive Officer | Oct 08 | Sale | 131.10 | 17,600 | 2,307,300 | 97,438 | Oct 10 07:30 PM |
| W | Shah Niraj | Chief Executive Officer | Oct 01 | Sale | 144.18 | 26,000 | 3,748,748 | 115,038 | Oct 03 08:30 PM |
| W | Shah Niraj | Chief Executive Officer | Sep 24 | Sale | 137.04 | 21,000 | 2,877,930 | 146,038 | Sep 26 09:03 PM |
| W | Shah Niraj | Chief Executive Officer | Sep 26 | Sale | 142.08 | 5,000 | 710,400 | 141,038 | Sep 26 09:03 PM |
| W | Shah Niraj | Chief Executive Officer | Sep 17 | Sale | 144.63 | 26,000 | 3,760,294 | 164,538 | Sep 19 09:21 PM |
| W | Shah Niraj | Chief Executive Officer | Sep 17 | Sale | 146.56 | 1,168 | 171,182 | 30,838 | Sep 18 09:02 PM |
| W | Shah Niraj | Chief Executive Officer | Sep 10 | Sale | 135.75 | 21,000 | 2,850,675 | 34,506 | Sep 12 04:33 PM |
| W | Shah Niraj | Chief Executive Officer | Sep 11 | Sale | 142.81 | 5,000 | 714,073 | 29,506 | Sep 12 04:33 PM |
| W | Shah Niraj | Chief Executive Officer | Sep 04 | Sale | 136.57 | 21,000 | 2,868,065 | 55,506 | Sep 05 05:09 PM |
| W | Shah Niraj | Chief Executive Officer | Aug 27 | Sale | 128.91 | 17,000 | 2,191,512 | 76,506 | Aug 28 08:07 PM |
| W | Shah Niraj | Chief Executive Officer | Aug 20 | Sale | 121.56 | 17,000 | 2,066,578 | 42,506 | Aug 21 05:15 PM |
| W | Shah Niraj | Chief Executive Officer | Aug 15 | Sale | 121.19 | 1,145 | 138,763 | 59,506 | Aug 16 06:10 PM |
| W | Shah Niraj | Chief Executive Officer | Aug 13 | Sale | 122.98 | 17,000 | 2,090,659 | 58,151 | Aug 14 08:42 PM |
| W | Shah Niraj | Chief Executive Officer | Aug 06 | Sale | 112.98 | 14,000 | 1,581,699 | 75,151 | Aug 08 05:55 PM |
| W | Shah Niraj | Chief Executive Officer | Jul 30 | Sale | 113.83 | 14,000 | 1,593,592 | 38,151 | Aug 01 07:26 PM |
| W | Shah Niraj | Chief Executive Officer | Jul 23 | Sale | 127.06 | 17,000 | 2,160,068 | 52,151 | Jul 25 06:45 PM |

## Long: Gildan (GIL)

**Company Overview:** Gildan is a Canadian manufacturer of t-shirts and socks. It is a sleepy, unsexy and outright boring business: the kind that is directly in our wheelhouse.

**Why We Like GIL:** Aside from Ross Stores, Gildan is one of the best-run businesses we cover. GIL is the low-cost producer and has a near monopoly in the "business of blanks," with a customer list that spans most of big box retail (Wal-Mart, Target, etc). Most importantly, Gildan's current valuation is reasonable and we see material upside to street numbers all throughout the P&L. In a market devoid of value, we like Gildan quite a lot.

**Structural Cost Advantages:** GIL is vertically integrated and controls the entire value chain aside from owning cotton fields outright. Their manufacturing capacity is decentralized and 90% of their employee base is spread across the Caribbean and Central America. As a result, Gildan undercuts Chinese manufacturers on price while also fulfilling domestic orders faster.

**The margin differential between Gildan and the competition is stark.** GIL's main competitor Hanesbrands (HBI) carries 40% gross margins versus Gildan at 28%. However, GIL's EBITDA margins are ~21% versus HBI at 16% - a testament to GIL's cost discipline.

| Gross Margins (%) - 2018 | |
|---|---|
| Hanesbrands (HBI): | 39.6% |
| **Gildan (GIL):** | **27.7%** |
| **GIL Margin Deficit: ~1200 bps** | |

| EBITDA Margins (%) - 2018 | |
|---|---|
| Hanesbrands (HBI): | 15.9% |
| **Gildan (GIL):** | **20.5%** |
| **GIL Margin Premium: ~460 bps** | |

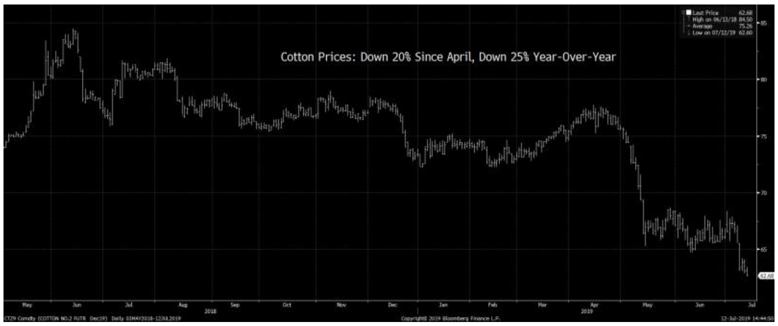
Above: Gildan's EBITDA margins are well in excess of their competition despite lower gross margins

**Exceptional Management & Favorable Industry Structure.** We've owned this stock on and off throughout our career and spoken to many of GIL's customers and competitors. Everyone knows to find a niche where you don't compete directly with Gildan - their scale is simply unassailable. GIL is aided by an oligopolistic industry structure, with two scale players (HBI and Fruit Of The Loom) who behave rationally, allowing for regular price hikes.

**Capital Allocation:** GIL is highly cash flow generative and in recent years has reduced share count by 5% per annum, while also paying a 1.5% dividend. Their balance sheet is underlevered relative to the stability of the business, at just 1.5x-2.0x EBITDA versus Hanes at 4.0x EBITDA. Finally, Gildan has a structurally-advantaged effective tax rate of just 4%.

## Long: Gildan (GIL)

**Why Now: Input Costs Collapsing.** Cotton prices have slipped to three-year lows. Global demand is weak and inventories have piled up to highs unseen since 2008-2009. Spot price is down 20% in the past three months and ~10% in July alone. This caught our eye and made us re-sharpen our pencils on one of the world's largest buyers of cotton: Gildan.




**We don't forecast future commodity prices.** However, we're certain on these three things:

1. Cotton prices are down 25% year-over-year and are ~35% of GIL's cost of goods sold.
2. GIL raised prices at the end of 2018 and indicated they'd likely take further price in 2019. This was done to offset input cost headwinds – which have become tailwinds.
3. The street is modeling Gildan's gross margins flat through 2021.

**On a business like Gildan with heavy fixed costs, the combination of pricing power and input cost deflation has a multiplicative effect on earnings.** For whatever reason, the street almost always mismodels operating leverage (fixed versus variable costs) and we think Gildan fits this "inefficiency" framework as a long.

**Earnings Upside:** Consensus estimates appear way too low for Gildan 18-24 months out. Management recently gave multi-year guidance of 30% gross and 18% operating margins. We're inclined to believe them – particularly when factoring in the gross margin lift from cotton prices declining – and think ~$700-750m of 2020 EBITDA is doable.

**Valuation/Risk-Reward:** Backing out maintenance capex and assuming continued 4-5% reduction in shares, GIL should produce close to $3.50/share in 2020 free cash flow. At a 5-6% free cash flow yield, we see potential for a $55+ stock currently trading in the mid-$30's. Downside, putting an 8% yield on below-street numbers on flat share count gets us to ~$25.

**We think Gildan is a mispriced bet.** Uncovering a 2.5:1 risk/reward proposition on a business of this quality is rare in today's market, and we're swinging the bat.

## Long: L Brands (LB)

**L Brands is the parent company of Victoria's Secret and Bath & Body Works**. LB was one of the best-performing stocks this cycle, trading from $6 in 2009 to $101 in 2015 - a 17x return or ~50% annualized. The business stumbled in 2016 and shares are ~75% off highs.


**Why We're Intrigued:** LB is an enigma of a situation. It could triple or it could get cut in half. Our analysis boils down to a simple question: "What do we make if we're right, versus what do we lose if we're wrong?" In LB's case, the probability-weighted math pencils out favorably and we see a lot more value within this enterprise than the market is currently ascribing.

**L Brands is comprised of two segments:** Bath & Body Works and Victoria's Secret. Bath & Body Works is a shockingly good business. Victoria's Secret is a shockingly bad one.

- <u>Bath & Body Works (BBW):</u> Since 2015, revenues have increased 30% with operating profits up 26%. This segment has reliably delivered mid/high-single digit SSS% each year at 60-70% gross margin and industry-leading 23-24% operating margins.

- <u>Victoria's Secret (VS):</u> Since 2015, revenues have declined 4%, but operating profit has declined 66%. SSS% has decelerated from +5% to (2%). The segment has been hit by a combo of declining mall traffic (which hasn't seemed to affect Bath & Body), overly aggressive discounting/promotions and a shift in consumer tastes away from traditional push-up bras into casual and lower-priced bralettes and sports bras.

**We see two possible event paths for L Brands:** Either Bath & Body decelerates and the stock falls apart, or Victoria's Secret accelerates and LB explodes higher. That's about it.

**Our eyes are wide open with L Brands, and we have a quick trigger finger.** The situation is binary. We like the long setup today, but if Bath & Body rolls over we'll cut our losses immediately and contemplate whether it makes sense to get short the stock.

<u>**Long: L Brands (LB)**</u>

**The bull/bear debate centers around what valuation Bath & Body would garner as a standalone entity.** We think this is a pretty good business. Not many retailers are delivering 3-5% SSS% at 60% gross and 23% operating margins. The closest comp is ULTA, which trades at 16x EBITDA and offers 5-7% SSS% growth, 36% gross and 13% operating margins. ULTA is a far better business, and 8-10x EBITDA feels like a fair ballpark for Bath & Body.

**Backing into implied Victoria's Secret valuation:** LB's enterprise value is $12B, with ~$5B in net debt. Run-rate EBITDA is in the $2B range with 60-70% of the contribution from Bath & Body. Putting 8x on Bath & Body EBITDA implies just ~$2B in value for VS. Using 10x Bath & Body EBITDA covers LB's entire enterprise value – giving us Victoria's Secret for free.

**The Million Dollar Question: What's Victoria's Secret Worth?** Our answer is imprecise. We do think it's more than $2B (implies just ~3x EBITDA) and it's definitely more than zero.

- <u>Victoria's Secret is not dead or irrelevant.</u> VS still has 60-70% domestic market share in bras, and their Instagram account has 67m followers – second only in retail to Nike.
- <u>Most recent damage to the business has been self-inflicted.</u> Mall traffic is a structural headwind, but management completely missed the boat on shifting public tastes, discounted too aggressively and scored multiple 'own goals' like discontinuing Swim.
- <u>VS' image can't be fixed overnight, but it can be fixed.</u> We know nothing about wearing lingerie and are unqualified to plan VS' turnaround. However, we know a valuable brand when we see it and are confident Victoria's Secret will exist decades from now. CEO Les Wexner likely needs to step down and we'd view his departure as a positive. If LB can get the right people in place, there is tremendous potential for value creation.

**Bull Case:** If Victoria's Secret recovers, the LB upside math is extraordinarily compelling. SSS% decelerated but the real culprit was VS operating margins collapsing from 18% to 5%. Even modest margin recapture over several years plus flattish SSS% could double segment profits. If Bath & Body can hold up – a big if – we see a $60+ stock currently trading at $25.

**Bear Case:** Unless Bath & Body implodes, we have a hard time triangulating worse than 3040% downside. LB is ~3x levered, but has no pressing debt maturities, generates $600-700m of free cash and pays a 4% dividend while we wait. At a low enough price, we think private equity or a strategic would be interested in acquiring LB, helping to protect our downside.

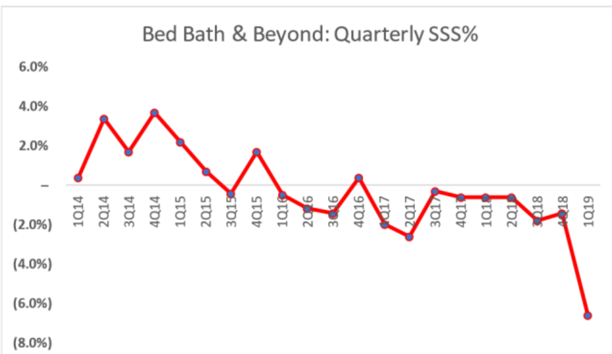
**Portfolio Considerations:** A successful turnaround is the less likely scenario. However, the potential for 2.5x returns skews the expected value math favorably. While small to start, we'll gladly add at to the position at higher prices if we see signs of a positive VS inflection.

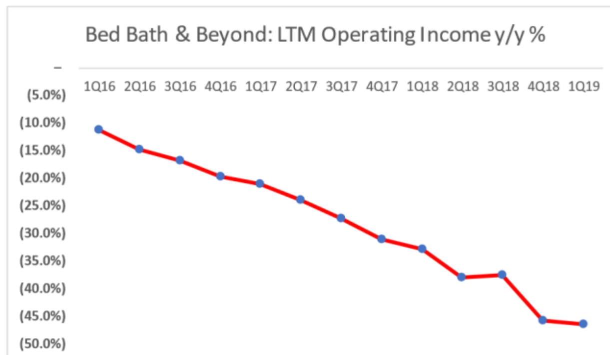
## Short: Bed Bath & Beyond (BBBY)

**Why We Like The Short:** Bed Bath & Beyond is a textbook value trap that fits our favorite framework: Deteriorating Fundamentals + Operating Leverage + Financial Leverage. We don't see much equity value here and believe BBBY shares end up worthless over 3-5 years.

**Negative Inflection Point:** Bed Bath has been a slowly melting ice cube, but declines are now accelerating. Similar to MIK, BBBY attempted to pull back on discounting to preserve gross margin in 1Q, and similar to MIK, same-store sales immediately collapsed.

**Bed Bath reported a (6.6%) SSS% decline in Q1, even worse than the (5.6%) they reported in the 3rd quarter of 2008.** Bed Bath's fixed cost deleverage is stunning: on a 6.6% decline in SSS%, EBITDA fell 28%, operating income fell 50% and EPS declined 68%.




**When a highly-promotional retailer loses traffic, they are dead**. We've seen this movie countless times. Years of aggressive discounting trains customers to only "shop on deal." Removing discounts results in a permanent exodus of traffic. Promotions are quickly reinstated, but customers have moved on and SSS% and gross margins decline in perpetuity.

We see this taking place today at Gap (GPS), but the most prominent case study is J.C. Penney in 2012. Newly-hired CEO Ron Johnson made the ill-fated choice to cut all discounts. Same-store sales fell 25%, JCP stock shed 90% and now the enterprise is on the brink of extinction.

**Structural Share Donor With No Reason To Exist.** Bed Bath's product mix is commoditized and amenable to e-commerce. BBBY over-earned for years with gross margins north of 40%. Bezos was happy to do it for less. Bed Bath's operating margins have collapsed from 17% to 3% since 2012, with their market share also accruing to Ross Stores and TJX/HomeGoods.

**It's unclear to us what Bed Bath's value proposition is today.** With SSS% down 6.6%, it's unclear to others as well. If Bed Bath disappeared tomorrow, we doubt anyone would notice.

**Short: Bed Bath & Beyond (BBBY)**

**Value Destruction: Hall Of Fame.** As the business bled market share, management did nothing to ameliorate the situation**.** Rather than focusing free cash flow on capex – remodels, omnichannel, anything to stay relevant – management spent $5B+ on buybacks with the stock trading at $60-70. Shares trade at $10 today. As the stock fell 80%, Bed Bath's CEO was paid ~$15m per year. He finally resigned in 2019 and collected another $22m in severance for good measure. Bed Bath's current interim CEO has been with the firm for three months.

**Balance Sheet Looming.** Bed Bath's leverage appears healthy at ~1.0x LTM EBITDA ($600m net debt) but is misleading. All of Bed Bath's stores are leased. Adjusting for operating leases, Bed Bath has $3.8B of gross debt ($2.9B net) on $1.2B of EBITDAR. With EBITDA declining 30%, BBBY's balance sheet may quickly become cause for concern.

**Cash Flow Drying Up.** BBBY is taking measures to improve liquidity. Capex is being cut and asset sales are ongoing, freeing up cash but ensuring Bed Bath isn't making the requisite investments to survive today's retail shakeout. Buybacks have all but stopped and we view it as a foregone conclusion that BBBY eventually suspends their dividend (6% current yield).

**We expect the pressure on Bed Bath's P&L to accelerate over the next 18-24 months.** On low/mid-single digit declines in SSS% paired with fixed cost deleverage, Bed Bath is likely to produce $400-450m in EBITDA next year and free cash flow of $100-150m. We don't know if BBBY is worth 3x free cash (current multiple) or 5x, and we don't think it matters much. Both are far below today's market cap of $1.4B, and both triangulate 50-80% downside.

**Ultimately, our price target is zero.** In our time covering the Retail sector, we've never seen a business that has survived this level of accelerating margin declines:

<u>**Long: Boyd Group (BYD-U.CN)**</u>

<u>**Company Overview:**</u> Boyd Group is the largest operator of non-franchised collision repair centers in North America. The firm is based in Winnipeg, Manitoba and operates 648 repair shops under Gerber Collision in the U.S. (85% of revenue) and Boyd Autobody in Canada.

We are annoyed we didn't discover Boyd sooner given our affinity for Copart.

- The two businesses benefit from identical tailwinds: miles driven, age of the used car parc, increased accident frequency and repair costs growing in excess of inflation.
- Both share common characteristics: recession-resistance, excellent management, underlevered balance sheets and highly cash-flow generative business models.
- Both stocks are complementary as portfolio longs. When a car crashes, there are two outcomes: either the vehicle is taken in for repair (to Boyd's benefit) or it is deemed a *total loss* and sent to the junkyard (to Copart's benefit). This is a rock-solid industry and owning both Boyd and Copart gives us exposure to the entire "collision funnel."

**While Copart has been a great investment, it pales in comparison to Boyd.** Boyd shares traded for $1.50 in 2008. Today, Boyd trades at $170 - a gain of 11,500%, or 55% annualized:

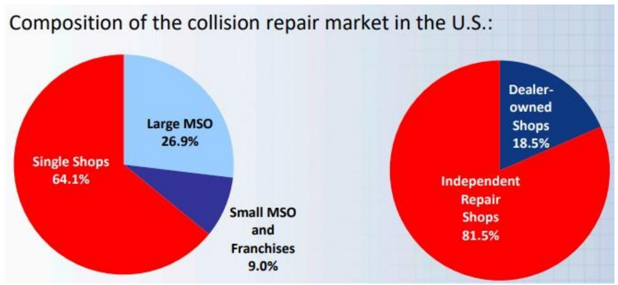

<u>**What Happened Here?**</u> Boyd has benefitted from the explosive combination of earnings upside and multiple expansion, driven by aggressive industry consolidation through M&A.

- In 2011, Boyd produced 50 cents in earnings per share and $20m in EBITDA. Next year, Boyd will produce close to $6.00 in earnings and $300m in EBITDA.
- As earnings power grew by orders of magnitude (12-15x), Boyd's multiple expanded. Shares traded for 10x NTM earnings in 2011 and today fetch close to 30x.

<u>**Is There Still Upside?**</u> We believe Boyd's business has potential to double in size over the five years. Despite the meteoric rise in shares, Boyd's market cap is only $3.4B CAD ($2.5B USD) and their $2B of sales equates to just 5% market share within a highly-fragmented $40B industry.

## Long: Boyd Group (BYD-U.CN)

**Decades Of Growth Runway:** Boyd grows primarily through acquisition and 64% of collision repair shops are still mom-and-pop operations. The top three multi-shop operators (MSO's) – inclusive of Boyd – have less than 20% market share in total. The pie is large enough where these scale players can consolidate the industry without battling one another.




**Favorable Acquisition Economics & Multiple Arbitrage:** Boyd targets 25% pre-tax ROIC on deals and acquires single shops at 4-5x seller EBITDA (7-8x for larger MSO's). Multiples are reduced 1-2x on a fully-synergized basis given improved purchasing efficiencies, store profitability and corporate overhead leverage. As with all successful roll-ups, Boyd arbitrages public/private valuation inefficiencies: 4-5x EBITDA assets instantly garner much higher multiples under Boyd ownership as store-level economics ramp to chain averages.

**Cash Flow Generation Aided By Low Capital Requirements:**

- **Capex runs at just 1% of sales** and cash flow is aided by a persistent D&A mismatch that results in "cash EPS" sustainably outpacing reported earnings on the P&L.
- **Boyd benefits from a negative working capital cycle.** Inventory is ordered on an as-needed basis and turns are rapid (~10 days). Receivables are also collected quickly (~20 days) from the large insurers who comprise 90% of Boyd's revenue. Payables, however, are stretched up to 90 days and Boyd enjoys ~60 days of "float" as a result.

**Valuation:** On a free cash flow basis, Boyd is attractively valued relative to the quality of the business. We see $350m of 2020 EBITDA as doable, less $30m of interest, $30m of taxes and $40m of maintenance capex for an end result of $250m in free cash flow ($12.50 per share).

**Risk/Reward:** Applying a 5% FCF yield results in a $250 stock now trading in the $120's (~50% upside), with a 6% yield resulting in 20% upside. Boyd hasn't traded to an 8% yield since 2012, but in this bear case scenario Boyd would trade 25% lower based on ~$10 in free cash.

**Overall:** On a probability-weighted basis, we think the expected value math skews nicely in our favor. Boyd is likely to be a core long and one we add to on market weakness.

## Long: Nordstrom (JWN)

**Company Overview:** Investors are likely familiar with Nordstrom. We view the business as materially undervalued in the mid-$20's and see 40% upside to the stock over 6-12 months.

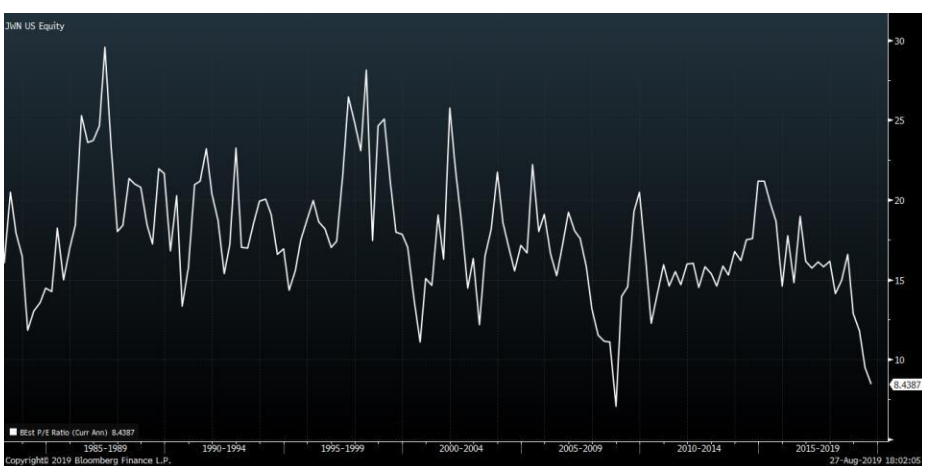
**Why Nordstrom?** We've always been fans of JWN's management. The Nordstrom family owns ~25% of shares out and is universally respected by their retail industry peers.

- **Nordstrom has always been a step ahead of the sector.** They think long-term, take chances and focus intensely on customer service above all else. Nordstrom was early to e-commerce and continues to refine their off-price division, Nordstrom Rack.
- **Unlike peers, JWN's square footage has been well-managed.** JWN operates just 118 full-price stores and 248 Racks. A new Manhattan flagship is opening in October.
- **Nordstrom is far from irrelevant.** Young and affluent consumers consistently rank Nordstrom as the best premium fashion retailer. They will survive the retail shakeout.
- **What makes JWN an enigma is that their financials are consistently underwhelming.** We've never seen such a wide divergence between strategy and results. Whether from bad luck or mis-execution, this dynamic creates opportunity.

We've covered JWN our whole career and traded it both long and short many times. Our hit rate is above-average when it comes to calling inflection points in JWN. We see one today.

**Nordstrom shares traded at 18x earnings in November. Today, they trade at just 8x. This is too cheap on both a relative and absolute basis.** Nordstrom now trades at a discount to lowly Kohl's (9x) and at parity with Macy's on an EBITDA basis (5.5x). Over 35 years, JWN has traded at these levels just once: during the Great Financial Crisis. We're as bearish as they come on retail, but JWN's future simply isn't as bleak as the market implies.

***Below: Nordstrom hasn't traded at 8x earnings since the Financial Crisis***



## Long: Nordstrom (JWN)

**While we think JWN's multiple is too low, this alone is not a thesis.** We also see upside to street numbers and believe mismodeled expenses are obscuring JWN's earnings power.

I. **Nordstrom is coming off a heavy investment cycle**. Capex has run at nearly 150% of D&A annually since 2013 while SG&A has grown from 28% of sales to 32%. Store growth is slowing and the Manhattan flagship (cost: $500m) is almost complete.
II. **As these one-off costs roll off the P&L, we think free cash flow generation could explode higher.** Maintenance capex is lower than what recent financials would indicate. With conservative assumptions on sales and gross margin plus minor help on the SG&A line, we think JWN could do $750m in free cash flow next year. This equates to $5.00/share in FCF on a stock trading mid-$20's. While JWN is challenged, it isn't nearly as challenged as a 20% free cash flow yield would indicate.
III. **Management buyout optionality.** The Nordstrom family tried to take the business private at $50/share in 2017 but was rebuffed by the board of directors who said the price was too low. Shares are now 50% cheaper, interest rates have plummeted and the credit market is as frothy as it gets. We're not banking on it, but we think M&A spec helps cover our downside. JWN pays a ~6% dividend while we wait.
IV. **Hidden asset value.** Nordstrom Rack is a $5B business (35% of revenue). It isn't Ross or TJX, but it's not a terrible asset and is likely undervalued within the entity. Even 1.0x Rack sales covers 80% of JWN's enterprise value. Finally, Nordstrom owns some valuable land and buildings, with 15 million square feet of property in class A malls.

**<u>Valuation:</u>** Nordstrom has generally traded to an 8-10% free cash flow yield over the past decade. If we're correct on our forecasts, Nordstrom stock is available at nearly a 20% yield. If we're slightly off on free cash flow, we still have no problem underwriting a 15% FCF yield.

I. **Bull Case:** We doubt JWN and peers ever trade to a single-digit FCF yield again. However, even a 10% yield on $5.00 per share is a $50 stock; a near-double from here.
II. **Base Case:** $4.50 in free cash at a 12% yield is close to $40, or ~50% upside.
III. **Bear Case:** JWN's valuation likely implies downside to numbers. Management reaffirmed $3.30 last week. If earnings come in at $3.00, 8x results in a $24 stock or 10-20% downside. We can stomach that for 50-100% upside. The math required to get a $20-$22 stock takes draconian assumptions (6x EPS) and feels unlikely to us.

**Risk Management:** Like our other contrarian or idiosyncratic long ideas within retail, we are not married to JWN. If fundamentals break, we're out, and if the retail sector collapses, we'll lose money in JWN but should make it up on the short side. In any other scenario, we think Nordstrom shares could work higher while the rest of our retail shorts works lower.

## **Short: LoveSac (LOVE)**

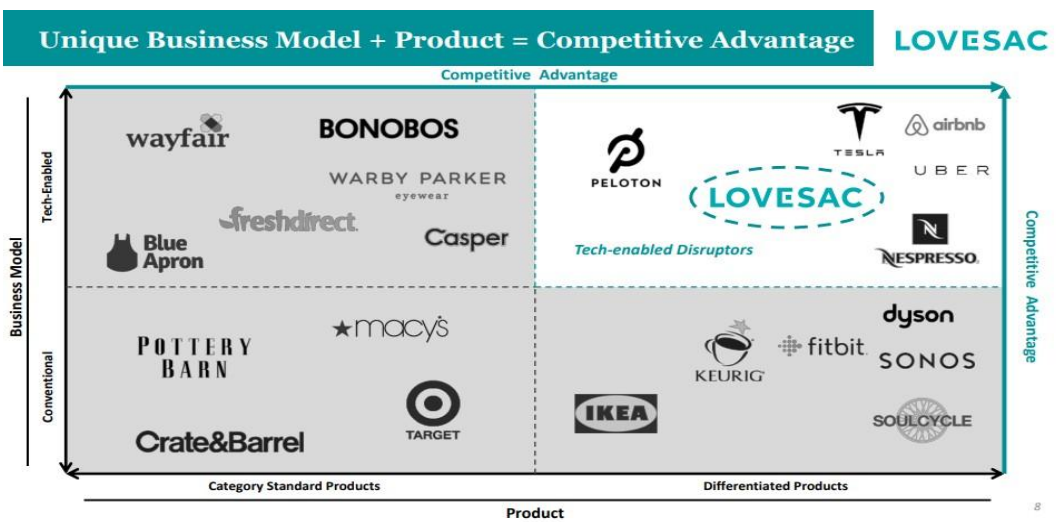
**Company Overview:** LoveSac is a faddish furniture retailer that sells one product: modular "Sactional" couches which comprise almost 80% of revenue. LoveSac is a brick-and-mortar retailer at its core and 70% of sales are generated in-store at LOVE's mall-based showrooms.

The company went public in mid-2018 but has been around for two decades, having already managed to file Chapter 11 once in 2006. Trading at 35x 2021 EBITDA, we believe LOVE is overvalued by as much as 50-70% and view Chapter 22 as a possibility within three years.

**Why We Like The Short:** LOVE is most akin to Wayfair, offering 40% revenue growth with negative operating margins and zero signs of ever generating positive free cash flow. LoveSac also fits our wheelhouse perfectly at under $500m in market capitalization. Our larger competitors cannot participate in these small-cap short sale candidates. We can.

**Only In A Bull Market:** With zero earnings or cash flow, LOVE attempts to sell itself as a recurring-revenue tech company that deserves valuation using sales multiples. The result is a comical peer group of *"Tech-Enabled Disruptors"* that includes Uber, Tesla and Airbnb:

***Below: This comp set appears flawed unless LOVE pivots into Sactionals-as-a-Service***




**Questionable Value Proposition:** We were stunned to see that each Sactional costs nearly $3000. The addressable market for this type of product (wealthy millennials) appears limited, but we had to go visit their Manhattan showroom on Broadway to see what we could be missing. Not only was the store empty, but we found the Sactionals to be cheap-looking, uncomfortable and certainly not worth $3,000. Each felt like it could be sold on Amazon for 1/10th the price. Reviews online (YouTube) largely echo our sentiment on the product.

## Short: LoveSac (LOVE)

**Poor Corporate Governance:** LOVE's CEO owns no stock and is paid on adjusted EBITDA. This figure bears no resemblance to cash flow and adds back all sorts of cash and non-cash costs: sponsor fees, inventory writedowns and stock-based comp at ~50% of EBITDA. Last, LOVE has raised dilutive equity twice in the past 18 months and we expect this to continue.

**Substantial Gross Margin Downside:** LOVE's gross margins have compressed from 56% to 50% over the past two years. Over the next two, we think they settle well below 40%.

- Rising tariff headwind: Sactionals are manufactured in China, and tariffs reduce gross margins by ~400 bps while doubling LOVE's operating loss from ($10m) to ($20m).
- Working capital metrics deteriorating: Inventory is growing 120% year-over-year, far faster than LoveSac's revenues and/or square footage growth.
- Promotional intensity has increased: Sactionals are 30% off on LoveSac's website. Identical products are available on Amazon or Wayfair for 90% less. With no true differentiation or moat, we expect competitors to eat into LoveSac's market share.

**Below: Which of these sectionals costs $300 on Amazon and which costs $3,000 at LoveSac?**

**Valuation:** Sub-40% gross margins may sound draconian for LOVE, but are squarely in-line with their profitable peer group of Williams-Sonoma (WSM) and Restoration Hardware (RH). Both carry 37-39% gross margins, 8-12% operating margins, and trade at 10-12x EBIT.

- **Bull Case:** LOVE produced $166m of revenue last year and is guiding to 40-45% growth in 2019 (down from 60% in 2018). We generously assume sales grow 250% over three years to $400m in 2022. Using peer margins and multiples, this yields $30-$40m in EBIT or $300m-$450m in enterprise value – a ~$30 stock in three years now trading mid-$20's. This analysis ignores future funding needs, $100m in lease debt and 15%+ equity dilution from warrants and stock-based compensation.
- **Base/Bear Case:** It's unlikely LOVE doubles their revenue and/or gets to RH/WSM operating margins of 8%. Base case, we think 4% margins on $300m of revenue is realistic ($10-15m of EBIT) and bear case breakeven EBIT on $250m of revenue.

**Risk/Reward:** We believe LoveSac is a $7-8 stock at best (50%+ down), with the risk of 25-30% upside offset by the odds that this company ends up in bankruptcy for a second time.

## Short: Grocery Outlet (GO)

**Company Overview:** Grocery Outlet is a supermarket chain with 320 locations offering discount, overstocked and closeout products from name brand and private label suppliers. We were pitched it as a long prior to their IPO, with the narrative of "off-price but for grocery." We couldn't make the math work at the IPO price of $25 and passed.

**Fundamentals Disconnected From Valuation:** Two months later, shares trade north of $40 and valuation is obscene for a supermarket: 30x EBITDA, 60x EPS and 80x free cash flow.

Their earnings algorithm is respectable: 10% unit growth, 5% same-store sales, 30% gross margins and 3.5% operating margins for 10-15% earnings growth. Returns on invested capital are in the 9-10% range. Is the stock going to zero? Probably not. Is it worth paying 60x for low double-digit earnings growth and single-digit ROIC? Definitely not.

**Even looking out to 2021, GO is still only forecasted to earn $50m in FCF or a 1% yield.** We can name ten retailers that are far better businesses and trade at half GO's multiple.

**Industry Overview: Grocery is as bad as it gets.**

- **Operating margins tend to be in the 1-4% range (GO: 3.5%) and leave little room for error.** When same-store sales or gross margins come in light, fixed cost deleverage can quickly lead to 30-50% declines in a grocer's operating income.
- **Competition is brutal and has gotten exponentially worse in our time covering the sector.** Wal-Mart has become a grocery behemoth. Target is improving. Kroger is Kroger and Costco is Costco. Whole Foods is now Amazon-owned. Last, the private players like Trader Joe's, Wegman's, Aldi and Lidl are all unbelievably well-run and growing rapidly.
- **The industry is plagued by excess capacity and high barriers to exit.** Supermarkets are like cockroaches. They never die. The landscape is full of conventionals who operate at breakeven, generating just enough cash to keep the lights on through aggressive discounting and promotional activity to keep the lights on. None are rational on price.

**The wizard from Omaha has said *"time is the friend of the wonderful company, the enemy of the mediocre."*** Buffett himself re-learned this lesson in 2015, taking a $500m loss in shares of British grocer Tesco. Shorting supermarket chains with a cost basis of 60x earnings tends to be a bet with positive expected value and one where time is on your side.

*"We'd rather find easier things to do. The Buffett grocery stores started in Omaha in 1869 and lasted 100 years. There were two competitors. In 1950, one went out of business. In 1960, the other closed. We had the whole town to ourselves and still didn't make any money."*

## Short: Grocery Outlet (GO)

**We've seen this movie before in a business named Sprouts Farmers Market (SFM).**

- We've covered SFM since their 2013 IPO and expect GO to follow a similar event path. The narrative was almost identical: fast-growing grocer, white space opportunity and the ability to undercut players like Wal-Mart and Costco on price.
- Keep in mind this is a category that Wal-Mart and Costco mostly use as a loss leader to drive traffic. Costco does $150B in revenues at a 12% gross margin. Grocery Outlet does $2B of revenue at 30% gross margin while claiming to be as much as 40% cheaper. It didn't make sense to us then with Sprouts and it still doesn't now with Grocery Outlet.

**Unit growth supermarket stories almost always fail to meet elevated expectations.**

- **Scaling a grocery chain is <u>much</u> harder than people assume, particularly an offprice/closeout model.** Traffic and inventory turns are paramount. When customers see spoiled perishables, they leave and they don't come back. Traffic declines and more perishables spoil. This negative feedback loop puts a halt on future unit growth, and the business fails to reach the level of scale required to compete with Wal-Mart or Costco.
- **Sprouts traded at an even higher multiple than Grocery Outlet at IPO.** Shares were valued at nearly 90x earnings in 2013. This fell to 35x in 2014 and settled in in the realm of fair value (20-25x) by 2015. SFM shares declined 50% in the process.


**<u>Valuation:</u>** We expect Grocery Outlet to play out in a similar fashion. Street estimates in 2022 are for $1.00 in earnings power, which at 20-30x earnings yields 40-60% downside.