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Retail: Finding Jean Baptiste de Marbot

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Outline of Presentation

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- Bio of John Zolidis / Quo Vadis Capital
- Introduction
- Premise for Talk
- Understanding the retail economic model
- Something went wrong
- New set of investment filters and examples
- Q&A

John Zolidis Biography

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- **Equity Analyst since 1999 (18 years covering consumer)**
- **Founded Quo Vadis in 2017**
- **Two years on the buy-side in a long-short environment; Managed ~$100M**
- **Named in Wall Street Journal's Best on the Street list – Specialty Stores in 2005**
- **Ph.D. candidate in Philosophy @ CUNY Grad Center**
- **Undergrad: Kenyon College & University of Oxford**
- **Series 7, 63, 87, 78 registered**
- **Wisconsin Native**

What is Quo Vadis?

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- **Boutique equity research firm – solving for the problems of content and form in the way research is created and distributed**
- **Focused on retail and restaurant industries**
- **Financial and strategic consulting services to companies**
- **Filing to become a registered investment advisor**
- **Mostly based out of Paris, France**

Introduction

- **Historically the retail business was like hand to hand combat. It was fought in the streets.**

Introduction

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- **Today, however, retail hand to hand combat is on its way to becoming a dying art form. And you all know the reason:**

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- **E commerce is like chemical warfare vs. an industry prepared for hand to hand combat. "Don't bring a knife to a gun fight"**

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- **Which brings to Jean Baptiste de Marbot:**

Introduction

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Stretched on the snow among the piles of dead and dying, unable to move in any way, I gradually and without pain lost consciousness…. I judge that my swoon lasted four hours, and when I came to my sense I found myself in this horrible position. I was completely naked, ***having nothing on but my hat and my right boot.*** *A man of the transport corps, thinking me dead, had stripped me in the usual fashion, and wishing to pull off the only boot that remained, was dragging me by one leg with his foot against my body. The jerk which the man gave me no doubt had restored me to my senses. I succeeded in sitting up and spitting out the clots of blood from my throat. My hat and my hair were full of bloodstained snow, and as I rolled my haggard eyes I must have been horrible to see. Anyhow, the transport man looked the other way, and went off with my property without my being able to say a single word to him, so utterly prostrate was I. (2)*

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Premise: Among the wreckage there will be a few retailers that still have a pulse. The market may leave these for dead creating an opportunity.

Second Premise of our talk: The traditional way of evaluating retailers is still necessary but is now insufficient. We need new filters to avoid buying something that really is only worth a hat and one boot.

Understanding the retail economic model

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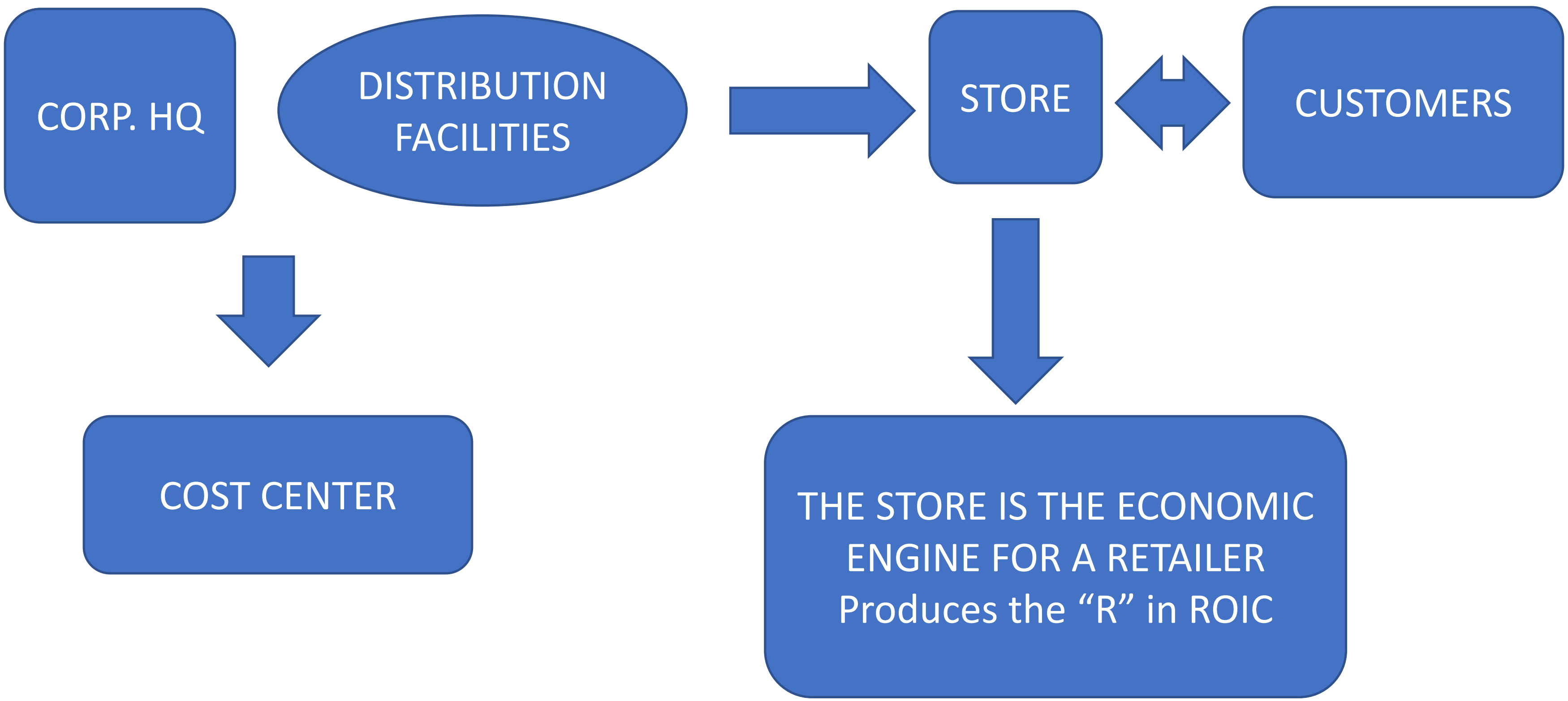

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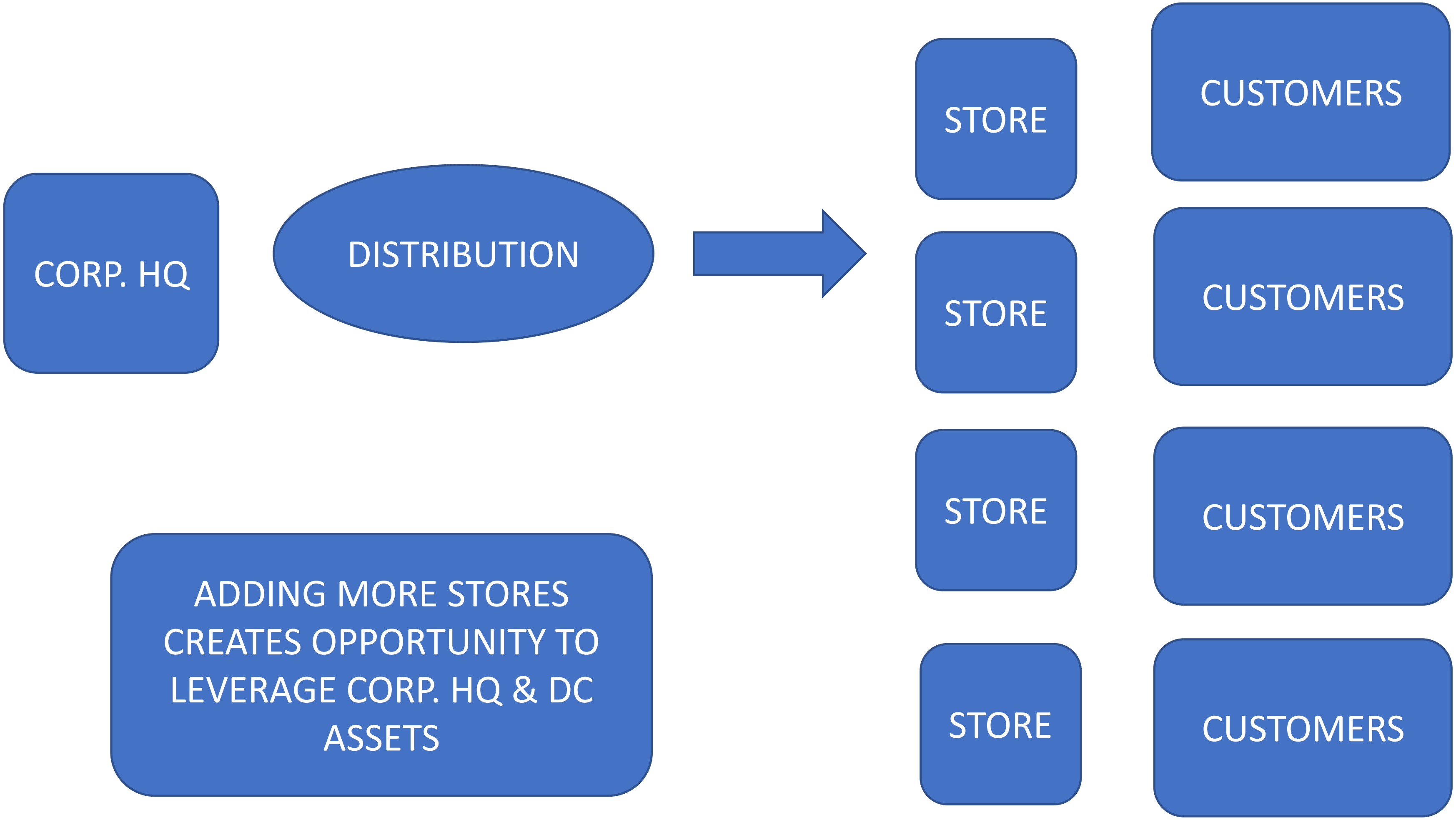

Understanding the retail economic model

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How the retail model creates value:

Growth was achieved by expanding access to addressable opportunity via opening more stores (the engine of economic value creation) and taking market share.

The companies created incremental value for shareholders' via generating a

1) return at the store level,
2) leverage of the corporate infrastructure, and
3) management of the capital structure

Understanding the retail economic model

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Retailers as investments could be roughly divided into three categories:

1. Growth/ Momentum: **Characterized by new store growth, same-store sales growth, and upward revisions to Street sales and earnings estimates.**

Earnings multiple tends to keep expanding as long as the company is beating. Stock looks "expensive".

2. GARP: **Also showing positive new unit growth and same-store sales growth. Typically earnings results are close to expected estimates.**

Earnings multiple is more a function of the rate of growth and the market multiple for similar companies. Stock screens "reasonably priced".

Understanding the retail economic model

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Retailers as investments could be roughly divided into three categories:

3. Value: ***Something went wrong*** **with the growth strategy and the company is now slowing unit growth or closing stores. Earnings estimates have likely been revised down. Alternatively, the company may be mature and not offer growth in its segment or investors could be very skeptical about its prospects.**

Earnings multiple is typically low. Stock looks "cheap".

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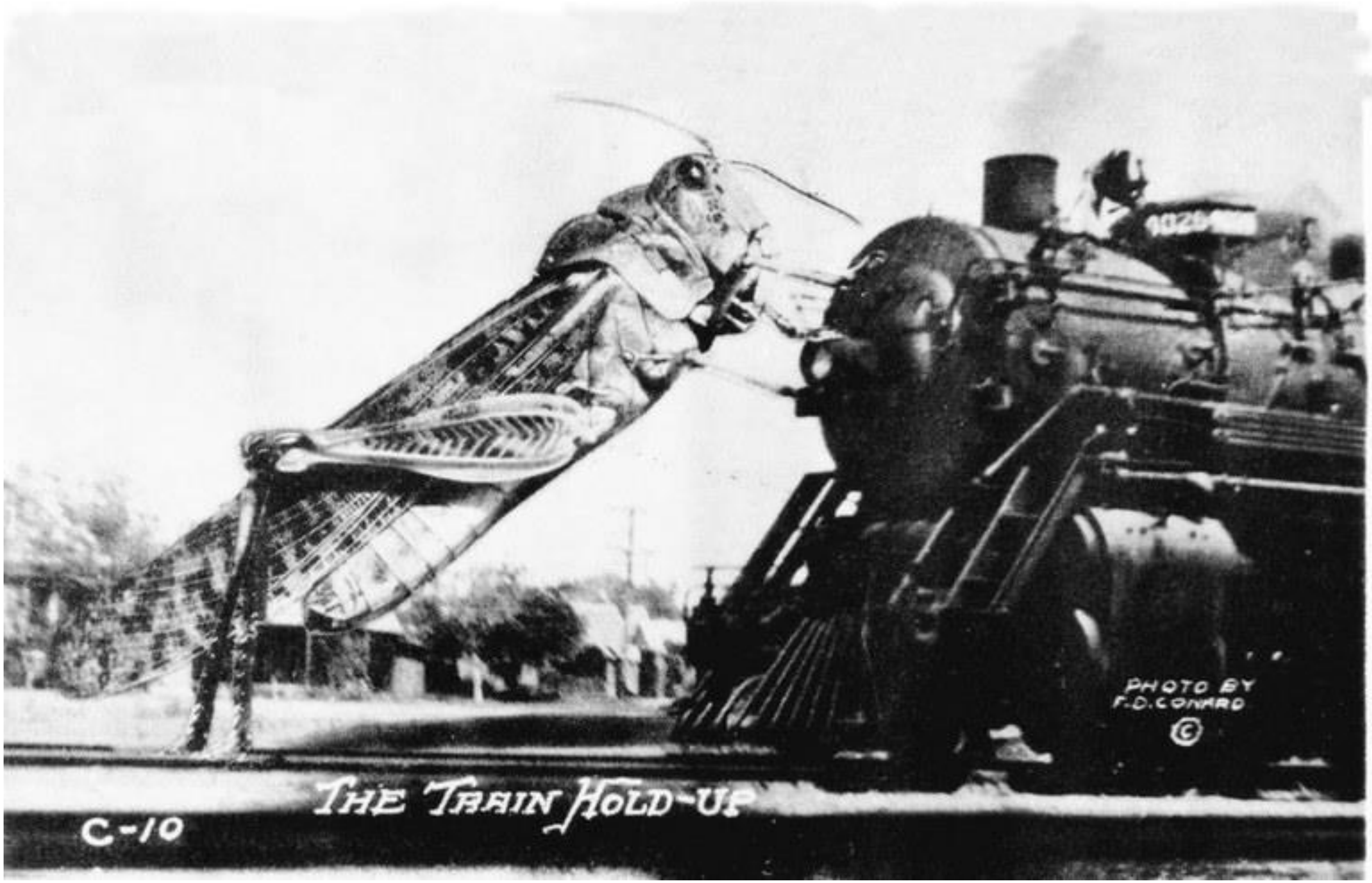
However in this case something has indeed gone very wrong:



Something went wrong

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Disintermediation

1. **Functionality of websites and especially mobile phones have eliminated the need to go to the store**

2. **Amazon has crushed traditional retail competition with a combination of low prices, an incredibly effective loyalty program (Prime) and huge assortment**

3. **Brands traditionally sold by third party retailers have increasingly gone direct to consumers: *Note today's Nike news***

Something went wrong

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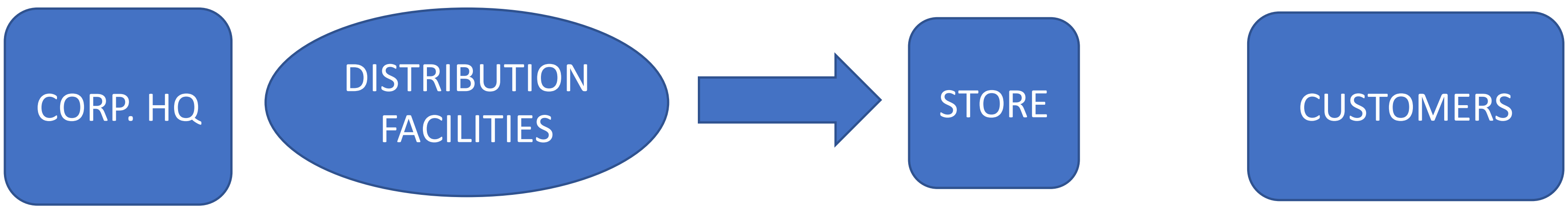

Something went wrong

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The market has figured this out:

Retail stocks are screening "cheap"

BUT

The model's engine of economic value creation may have been invalidated -- at a minimum we can't rely on it using past metrics

Therefore the traditional playbook of buying these names at low valuations and betting on better merchandising, execution, or secular or cyclical change is unlikely to work

Something went wrong -- The retail value trap

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The retail value trap -- IT'S EVEN WORSE THAN THAT

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Not only is the traditional retail model of selling stuff in stores under attack

We are also in a period of profound and dynamic changes in consumer preferences

Some of these changes include:

- **Clothing brands are less important**
- **Consumers increasingly demand personalization and convenience**
- **Want to share experiences with others via technology (but don't want to "talk to a person")**
- **Other stuff that is just getting started now and I haven't figured out yet**

Investors need to take these secular trends into account as well

Which brings us to the Coming Wreckage

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But MAYBE it’s not really that bad

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But MAYBE it's not really that bad

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Or maybe it is….

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Which brings us to a new set of filters to evaluate retailers

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1. **Don't count on the box:**

   Think it's best to start with the assumption that the return on invested capital generated by the store today will be lower for the same store in the future.

   Therefore, we need to seriously question retailers that continue to deploy new capital into existing store formats.

   Alternatively: retailers that are reimagining and redesigning their store formats to be integrated into an e-commerce offer and compete may be successful

   Want to hear that the retailer is thinking about their box format and investment in terms of maximizing the return on capital invested

Which brings us to a new set of filters to evaluate retailers

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1. **Example of where we are concerned:**

Retailer that operates over 10,000 stores
The company is accelerating unit growth on both an absolute and percentage basis
Meanwhile sales productivity, margins and returns are under pressure

Although this company is likely a retail survivor these trends point to the need to slow growth and reevaluate its store footprint

Which brings us to a new set of filters to evaluate retailers

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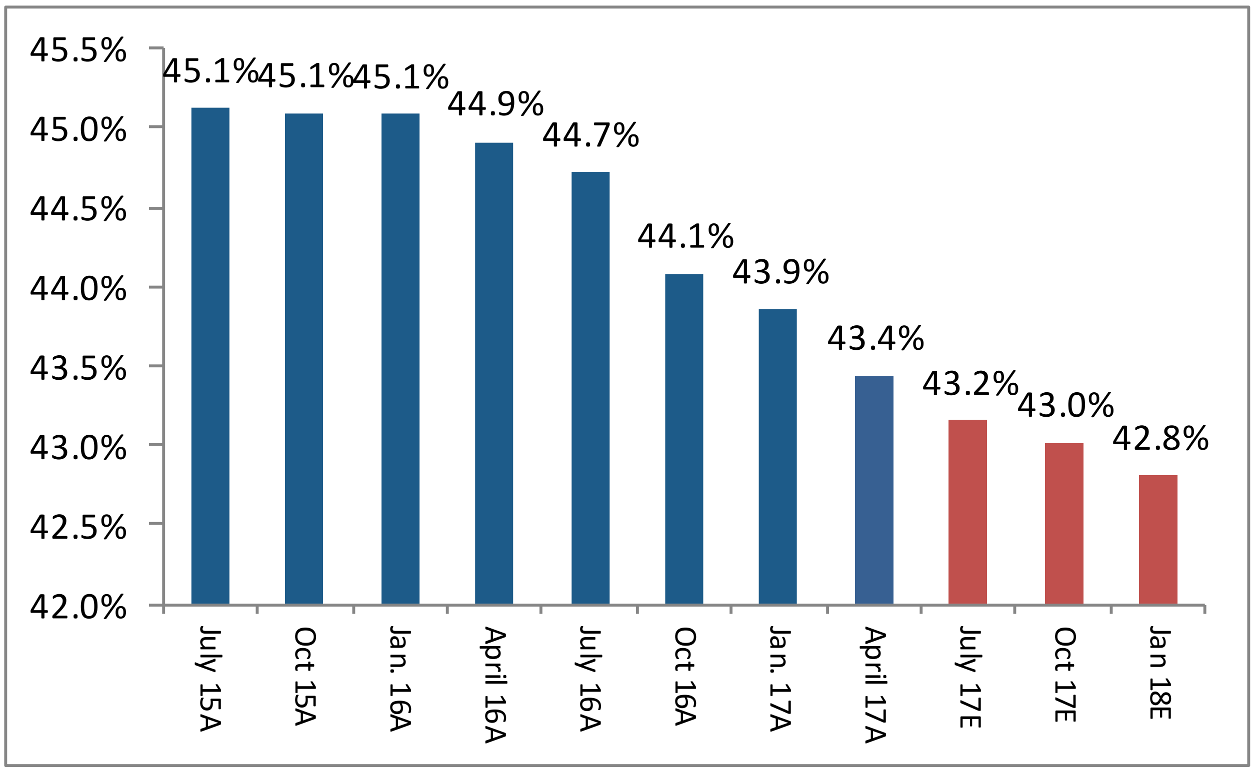
1. Example of where we are concerned:

Lease-adj. Store-Level Estimated Average Store TTM ROIC



Source: Company reports, Quo Vadis Capital, Inc. estimates

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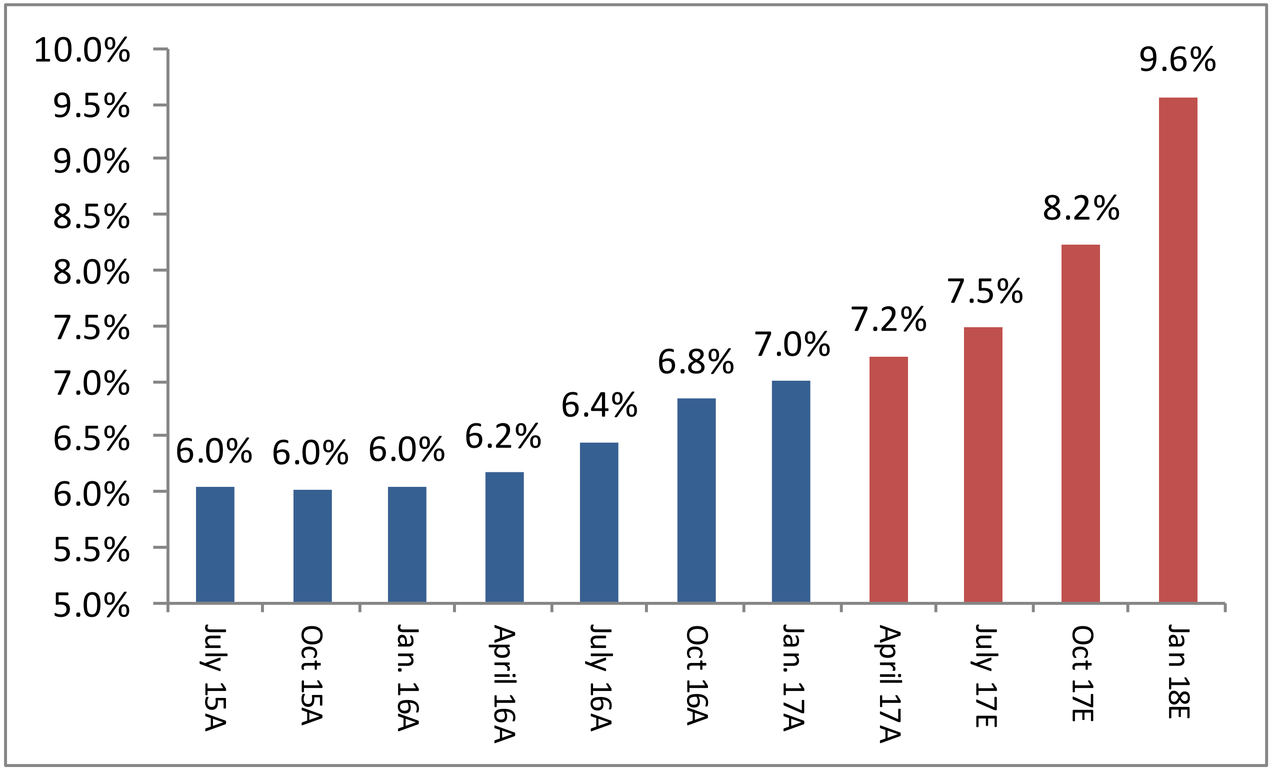
1. Example of where we are concerned:

Rate of Square Foot Growth YOY% Change



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2. Evaluate the incrementality of e-commerce

Retailers get that they need to have an omni-channel solution. Some are further along than others in developing this offer.

While there is always going to be an upfront cost associated with building the technology and infrastructure some retailers are better positioned than others to make money with e-commerce

Generally we want to own retailers which generate an incrementally higher margin in the e-commerce channel and which produce a higher return on capital invested to support this offer

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2. Examples:

Wal-Mart (WMT): The market is rewarding WMT for recent accelerated e-commerce growth. However, WMT lost over $1B related to its e-commerce offering, despite scale of $15B in revenues last year.

It's not clear, in my opinion, whether the company has a plan to generate a positive return on these investments or whether this is purely a defensive strategy.

Accordingly, I see WMT's e-commerce effort as dilutive to ROIC and EPS, which warrants caution on the stock, in my view.

Lululemon (LULU): E-commerce EBIT margins are 41% vs. 24% at store. E-commerce growth is accretive to both margins and returns, by my estimates. This suggests that its exposure to channel shift is beneficial to the company's economic model.

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3. Understand whether there is a secular tailwind or headwind:

Can't stress this enough: If you get the category wrong from a demand perspective, all the financial analysis in the world is unlikely to help

Secular trends can be driven by completely non-quantitative factors and don't have predictable lifespans

Can result from changes in technology, macroeconomics, fashion, celebrities

Be very careful about buying shares of retail companies in an unfavorable category or where the category is slowing/ inflecting negatively

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3. Examples:

Categories benefiting from secular consumer trends:

Home improvement (HD, LOW, POOL)
Cosmetics (ULTA)
Off price (BURL, TJX, ROST)

Categories suffering from secular consumer trends:

Traditional branded apparel companies (department stores, mall based specialty apparel retailers)
Athletic apparel and footwear (DKS, FL, FINL, HIBB, NKE, UA, LULU)

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4. Understand leases:

Leases are a form of off balance sheet debt given that they contain required periodic future payments

Rent (and other contractual occupancy costs) are normally hidden in a retailers COGS. However it is disclosed in a retailer's 10K.

This will change in 2018 when new accounting rules will require retailers to report lease obligations on the balance sheet

In the meantime, to evaluate a retailer that may be losing money or which has very thin margins, investors should take total leverage including lease obligations into account

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4. Examples:

Bebe Stores (BEBE) : Most recent balance sheet reported $56M of cash and zero short or long-term debt.

However, the company has been losing money and burning cash for some time. The company recently decided to cease all operations aside from operating its website and to close all stores.

Cost to exit all its leases came to $65M, effectively wiping out the "clean" BS

Another way is to use lease-adjusted EV to EBITDAR as a leverage ratio. Most high-quality names try to stay at 3.0x or lower. LBOs typically happen at 6-8x.

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5. Evaluate exposure to store closures

Retailers are closing 7,000+ stores in the current year. I've lost count.

Some categories are seeing more pressure than others but among the most impacted are department stores, mall and off-mall specialty apparel and footwear retailers and sporting goods retailers.

Impact can be positive if a retailer is positioned to take share. However, store closings can also be a negative if a retailer was depending on the other store to drive traffic. In general investors should expect the secular decline in traffic to retail to continue.

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5. Example: Dick's Sporting Goods (DKS)

The company's largest competitor (The Sports Authority) closed all locations. In addition, Sports Chalet closed, Eastern Mountain Sports closed and many independent retailers closed. Golf Galaxy closed. Gander Mountain is currently closing and converting many of its locations.

We estimated the potential tailwind from share gains to be in the $300M-$600M range annually.

However the benefit from these gains was more than offset by channel shift to e-commerce and the overall decline in sales of athletic gear.

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6. Has management figured it out?

2016 was a very difficult year for retailers. Many management teams were surprised by the acceleration in share shift to e-commerce and the depth of the traffic declines at retail, especially around the Holidays.

Yet many retail management teams continue express the view that future shopping will mostly take place in stores. While perhaps technically true this misses the point, in our opinion.

We want to own the shares of retailers who view the store as a location for order execution and a convenience option for customers, integrated into a mobile and online platform.

Avoid reckless store growth based on backward-looking return metrics that may not be sustainable

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6. Examples:

Wal-Mart (WMT): Our view is that WMT "gets it". The company has invested in price in its stores to be competitive and invested in labor to improve execution. It also understands that the growth opportunity and competitive threat are in e-commerce and is investing against this opportunity. The next logical step for WMT would be to stop dilutive store openings.

Best Buy (BBY): Similar to WMT, BBY retrenched on prices and matched competition. The company is using its stores to close the sale, rather than let its stores provide a price comparison to a better offer.

Growth retailers: We believe most retailers should slow growth. There is too much change in the market and visibility on future capital returns is too low.

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7. Return on incrementally invested capital:

This is a proprietary measure of the trend in a company's capital returns. Generally, we want to own the stocks of companies that are getting improved returns on the incremental dollar invested in the business and are not diluting returns by chasing lower return projects.

Instead, companies with only lower return projects available should return excess capital to shareholders on the assumption that they can reinvest it elsewhere at a better rate of return.

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7. Examples:

Two ways of measuring return on incrementally invested capital

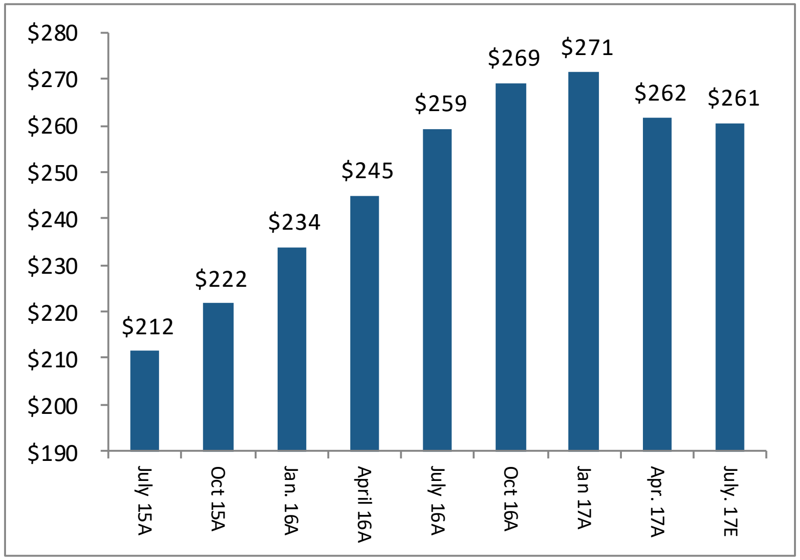
First, we estimate the return, at the unit level, of new stores opened and compare returns to historical levels. If returns are stable or rising (and the return profile looks sustainable) then it justifies incremental investment in more stores.

Second we look at it on a corporate level by comparing the rate of growth in operating profit to the rate of growth in total capital. Generally we want to see a ratio of 1.0 or higher indicating that profit growth exceeds accumulation or growth in total capital.

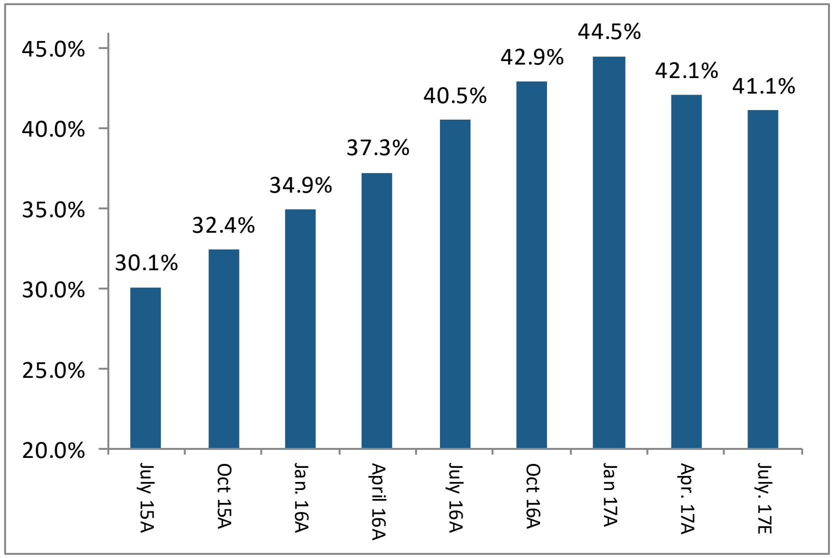
7. Examples:

New unit ROIC at Dollarama (DOL.CN) has been rising:

New (Non Comp) Store TTM Sales per Square Foot



Lease-Adj. Estimated New Store TTM ROIC



Source: Company reports and Quo Vadis Capital, Inc. estimates

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7. Examples:

Return on incrementally deployed capital:

One calculation (used by MCD):

ROIIC = Growth in after tax operating profit divided by CAPEX

Does this measure what we are looking for?

Which brings us to a new set of filters to evaluate retailers

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7. Examples:

Return on incrementally deployed capital:

I prefer:

ROIIC: Growth in after tax operating profit divided by growth in total capital

Lease adjusted: Use OPBRAT divided by lease-adjusted TC

Expressed as a ratio: 1.0x means OPBRAT is growing at the same rate as TC. More than 1.0x means the company is generating return leverage

Think about the mechanical advantage of a bicycle

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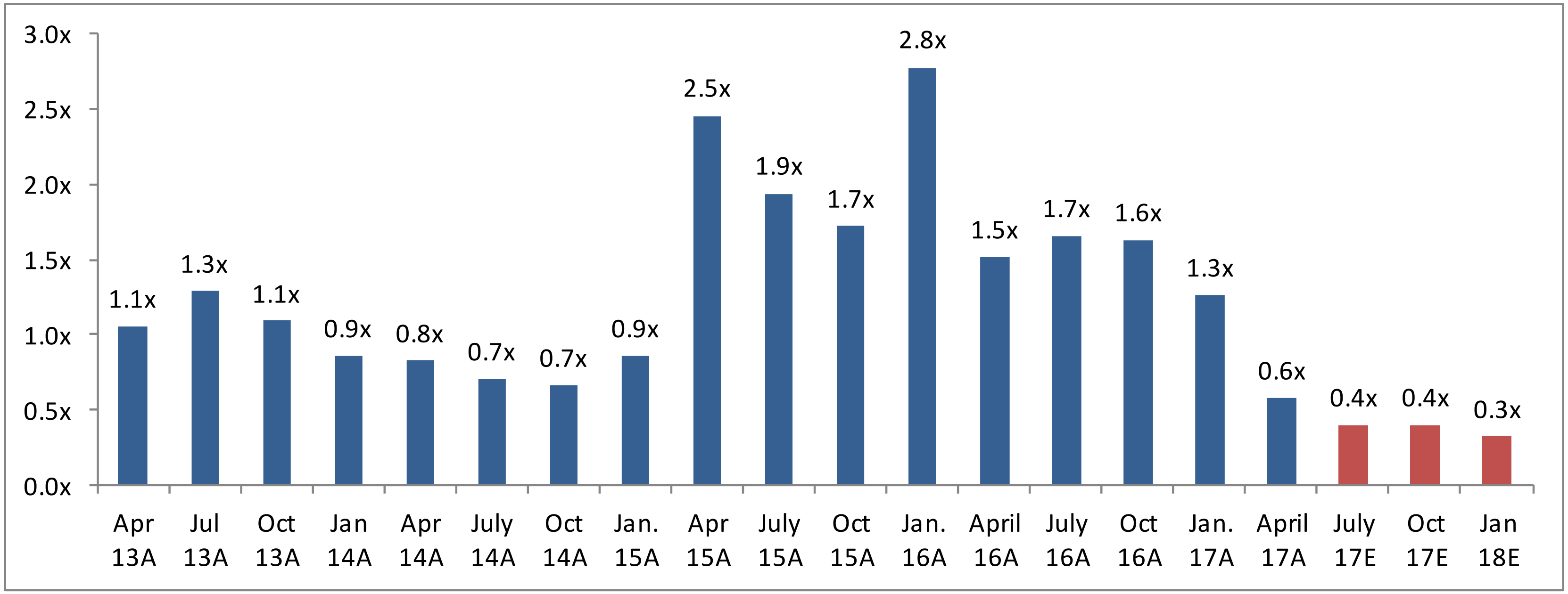
7. Examples:

Return on incrementally deployed capital:

Mechanical Advantage Ratio (Growth in Profit vs. Growth in Invested Capital)



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Q&A

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