

The Shifting Retail Landscape

CONSUMER DISCRETIONARY SECTOR REPORT

Stocks mentioned in this report

Buy-rated:

- **Amazon** (AMZN - \$169.51)
- **Lowe's** (LOW- \$226.85)
- **Nike Inc.** (NKE- \$103.51)
- **TJX Companies** (TJX- \$98.04)
- **Ulta Beauty** (ULTA- \$532.09)
- **Target** (TGT- \$149.61)
- **Home Depot** (HD- \$362.35)
- **VF Corp** (VFC- \$16.65)

Hold-rated:

- **Walmart** (WMT - \$180.15)

Source: Reuters. Prices and opinion ratings are as of market close on 2/16/24 and are subject to change.

For more information:

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Current Consumer Environment

Consumers have returned to more normal shopping habits, as the economy has moved past the pandemic, which caused significant growth in e-commerce sales and durable goods orders that was partly driven by massive government assistance. However, higher inflation is causing some shift in spending toward more staple items and away from discretionary items. We believe investors should focus on companies with strong financial positions, those gaining market share prior to the downturn, and companies rapidly investing in technology to be leading the way in the changing consumer landscape. We would avoid companies with high debt, those struggling prior to the consumer slowdown, and companies that have limited ability to invest in and use technology.

Changing Industry Dynamics Driving Retail Bankruptcies: The retail industry is undergoing structural shifts with more retailers filing for bankruptcy and closing stores. Over the past few years, retail bankruptcies have led to an elevated level of store closings. The retail industry is undergoing a seismic shift due to several issues: 1. The industry has been "overstored" (too many stores) for many years; 2. Technology has changed the way people communicate, find information and – very importantly – shop; and 3. Changing demographics.

In the past, many banks or private equity firms were willing to step in and provide financing to retailers filing for bankruptcy, but today that trend has changed. Due to the rapid growth in online, weak mall traffic, and consumers' shift in spending habits, among other issues facing the retail industry, it seems that many banks and private equity firms are reluctant to provide financing for the retailers filing for bankruptcy. Due to the lack of available financing, many retailers are being forced to liquidate and just close all their stores instead of restructuring debt and closing some of the stores.

Too much square footage: The retail industry has been overstored for many years, and the recent shift to consumers buying products online is lessening the need for so much retail square footage. According to the International Council of Shopping Centers, the U.S. has about 22 square feet of retail per person, with Canada being the next closest country at 16 square feet, and Australia third at 11 square feet. Also, most experts believe there are only 450 to 500 good malls, but there are currently around 1,000 enclosed malls in the U.S. We expect there will continue to be mall closures as more sales shift online. In general, we continue to believe online sales will take share from physical retail locations for the foreseeable future, which will most likely lead to more bankruptcies and store closings.

Analyst: Brian P Yarbrough, CFA

Please see important disclosures and analyst certification on page 4 of the report.

We believe the companies we follow all have solid financial and marketing positions and have fewer concerns around bankruptcy.

While we haven't seen the companies we currently cover announcing mass store closings, we do believe some of the more mature mass merchandisers, such as Walmart and Target could close stores over the coming years as online continues to gain as a percent of overall retail sales. With that being said, the companies we cover are all well capitalized and have lower debt levels, so we don't expect any bankruptcy filings in the foreseeable future.

Online growing rapidly and threatening retailers:

Online sales continue to grow and become a larger part of overall retail sales. According to the Census Bureau of the Department of Commerce, online sales now represent about 14% or so of total retail sales in the United States. We believe online sales growth rates will slow down over time, and we believe online sales will probably peak around 25%-30% of overall retail sales. While Amazon is the biggest player, there are many smaller online players also gaining market share. For example, sales in North America for Amazon have grown to \$315 billion in 2022 from \$16 billion in 2010.

The Internet has been one of the most disruptive threats to retailers in many years. Since most Internet-only retailers, like **Amazon**, don't have brick-and-mortar locations with rent, mortgages, or utility costs, they can offer cheaper prices and can compete at lower profitability levels. While we understand these threats, we believe most brick-and-mortar stores can stay competitive by developing an omnichannel presence.

The Omnichannel Opportunity: Omnichannel retailers have websites that consumers can use from all types of devices, from cell phones to tablets and desktops. True omnichannel retailers have the ability to ship from their stores or distribution centers to their stores for in-store pickup. Today, most brick-and-mortar retailers allow free shipping on returns, and all retailers allow items purchased on their websites to be returned to stores. This is a key differentiator because, recently, more Internet-only retailers are charging for returns. Another difference is that more robust websites allow some retailers to offer additional products online that aren't available in physical stores.

We believe retailers that have a wide variety of products online, seamless checkout, favorable product reviews, strong customer service in stores, and differentiated products will be successful over the longer term. In a creative effort, some retailers have started offering tablet and smartphone applications (apps) to provide consumers with coupons and deals, suggested item pairings, and social media integration to increase traffic into stores and the number of items purchased.

Investment Ideas: Amazon (AMZN) has an unmatched presence in online retail with the opportunity to continue above-average growth through third parties and fulfillment by Amazon. **Lowe's (LOW)** and **Nike (NKE)** have a strong Internet presence that is growing rapidly.

Retailers With a Competitive Advantage

Studies show that more and more products are now available on the Internet, but not all retail categories are equal. According to *Internet Retailer*, apparel, toys and mass consumables have reached double-digit market penetration, with office supplies and books/movies at 40% penetration (a measure of adoption compared with the total market for that product). But some items, by definition, are harder to buy online. Food, hardware, health and beauty, and auto parts have the lowest penetration online, which we see as a competitive advantage over retailers that sell products in higher-penetration categories.

Investment Ideas:

Lowe's (LOW), Home Depot (HD), TJX Companies (TJX), and Ross Stores (ROST) currently operate in industries with low online penetration.



Shift in consumer shopping habits: While more consumers continue to shift their retail spending online, they are also changing their shopping habits at malls. Historically, consumers would go to the mall and shop multiple stores. The consumer would return another day to narrow down choices and then return another day to purchase. During these multiple visits, consumers would be more tempted to pick up other items that were not the original intent. Today, many shoppers do all their research online and go into a specific store knowing exactly what they want and then leaving the mall, which provides less impulse buying. Also, we are seeing consumers more interested in spending on technology and experiences (examples: movies, travel, restaurants, etc.) versus apparel and footwear.

Demographics: What the Spending Shift to Millennials Means

The spending shift from baby boomers to millennials is also changing the retail landscape. While baby boomers are more interested in visiting brick-and-mortar stores, purchasing cruises, and going to the movies, millennials seem to be more focused on social media, socially and environmentally friendly products, healthier lifestyles, online travel, and convenience. As the boomer crowd retires and spends less, the consumer-spending burden is shifting to millennials, who are driving an even greater need for true omnichannel retailers.

A More Educated Consumer Should Mean More Spending Power

Born between 1981 and 1996, there are roughly 71 million millennials in the U.S., about 21% of the population. The number of millennials in the workforce exceeds the number of baby boomer workers by about 15 million. Millennials are the highest-educated among all generations and use technology not just for communication but also as a way to improve life, make better choices, and contribute to society.

Due to their higher levels of education, we believe millennials overall will have greater spending power than baby boomers, and we expect this generation to be the future driver of consumer spending. We believe retailers will need to aggressively invest in technology to cater to the millennial crowd.

Millennials still like to visit brick-and-mortar stores too, so these physical locations will remain important. A survey by the Urban Land Institute showed two-thirds of millennials like to visit the mall at least once a month because they see it as a way to enjoy time with friends and family. Millennials can be fickle, however, so retailers will need to invest in stores to make sure they don't lack freshness, newness and excitement.

Investment Ideas:

TJX Companies (TJX), Nike (NKE), Ross Stores (ROST), and Ulta Beauty (ULTA) offer brands we believe will remain in favor with the millennial crowd.

Retail Investment Ideas

Edward Jones provides coverage on a good mix of growth retailers as well as mature retailers. The chart below highlights our Buy-rated retailers and where they fit into today's evolving retail landscape.

| Buy-Rated Retail Investment Ideas | |
|--|---|
| Technologically Advanced Retailers-Investing More in e-Commerce | |
| Amazon (AMZN) | <ul style="list-style-type: none"> • Dominant online presence • Subscription Revenue Model (Prime) • Innovation industry-leading mobile apps, price comparison and website deals |
| Target (TGT) | |
| Millennial-Reaching Retailers-Relate to Millennials Unique Tastes | |
| TJX Corporation (TJX) | <ul style="list-style-type: none"> • Treasure hunt shopping experience that can't be replicated online • Exclusive products and unique shopping experience |
| Ross Stores (ROST) | |
| Ulta Beauty (ULTA) | |
| VF Corp. (VFC) | |
| Competitively Advantaged Retailers- Operate in Industries with Low Internet Penetration | |
| Home Depot (HD) | <ul style="list-style-type: none"> • Operate in product categories with low levels of online purchases • Strong brick-and-mortar locations and an omnichannel presence |
| Lowe's (LOW) | |

Source: Edward Jones Estimates and Company Reports

How We Value and Recommend Stocks

When valuing consumer companies, we use various methods that include comparing price-to-earnings ratios and PEGY ratios (price-to-earnings ratio divided by growth plus dividend yield) with historical and peer averages and more. We also use discounted cash flow models to incorporate long-term growth expectations.

Investment Risks

Risks to investing in retail companies include deteriorating economic conditions, a slowdown in consumer spending, failure to adapt to the changing retail landscape, higher commodity prices, and currency fluctuations.

Actions for Investors

We understand that technology and evolving demographics will impact the retail industry, but such change can create opportunities for differentiated companies with competitive advantages, good real estate locations, and a strong online presence. Retail stores and the shopping experience will continue to be a presence in American lives for the foreseeable future. We do believe some of the companies we follow will be beneficiaries as more retailers close stores and those shoppers move to other retailers for their shopping needs. We do believe the shrinking of retail square footage will occur over the next five-plus years, so we probably won't see a material impact to surviving retailers in the near term. We believe investors should own a mix of retailers that invest in an online strategy, have a product offering that provides a competitive advantage, or offer a customer experience that can't be replicated online. And we believe stocks in this industry still have a place in a diversified stock portfolio. Talk to your Edward Jones financial advisor today about how retail stocks may help you work toward your long-term financial goals.

Please see the individual research reports for additional information, including disclosures, analyst certifications, valuation and risks specific to each company.

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Brian P Yarbrough, CFA

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