



RETAIL

REFLATION = ANNIHILATION

January 4, 2017

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KEY CONCLUSIONS

1

NEWSFLASH: PROTECTIONIST POLICY MATTERS

People are placing bets on a) likelihood of policy changes, b) where Trump will be most focused, and c) who loses most/least. But math matters here, and we don't think the market is doing it. People appear to be shooting with a Red Ryder BB gun, when it might need to be more targeted and with stronger artillery.

2

THE ULTIMATE RE-FLATION TRADE?

Deflation in Consumer Non-durables due to the elimination of an arcane protectionist policy took down cost by 50% and took up per capita UNIT consumption by 100% over 20 years. This is the most powerful consumption trend most of us will see in our careers. This resulted in more mediocre brands and retailers being 'allowed' to exist – simply because consumption increased so rapidly regardless of elasticity.

3

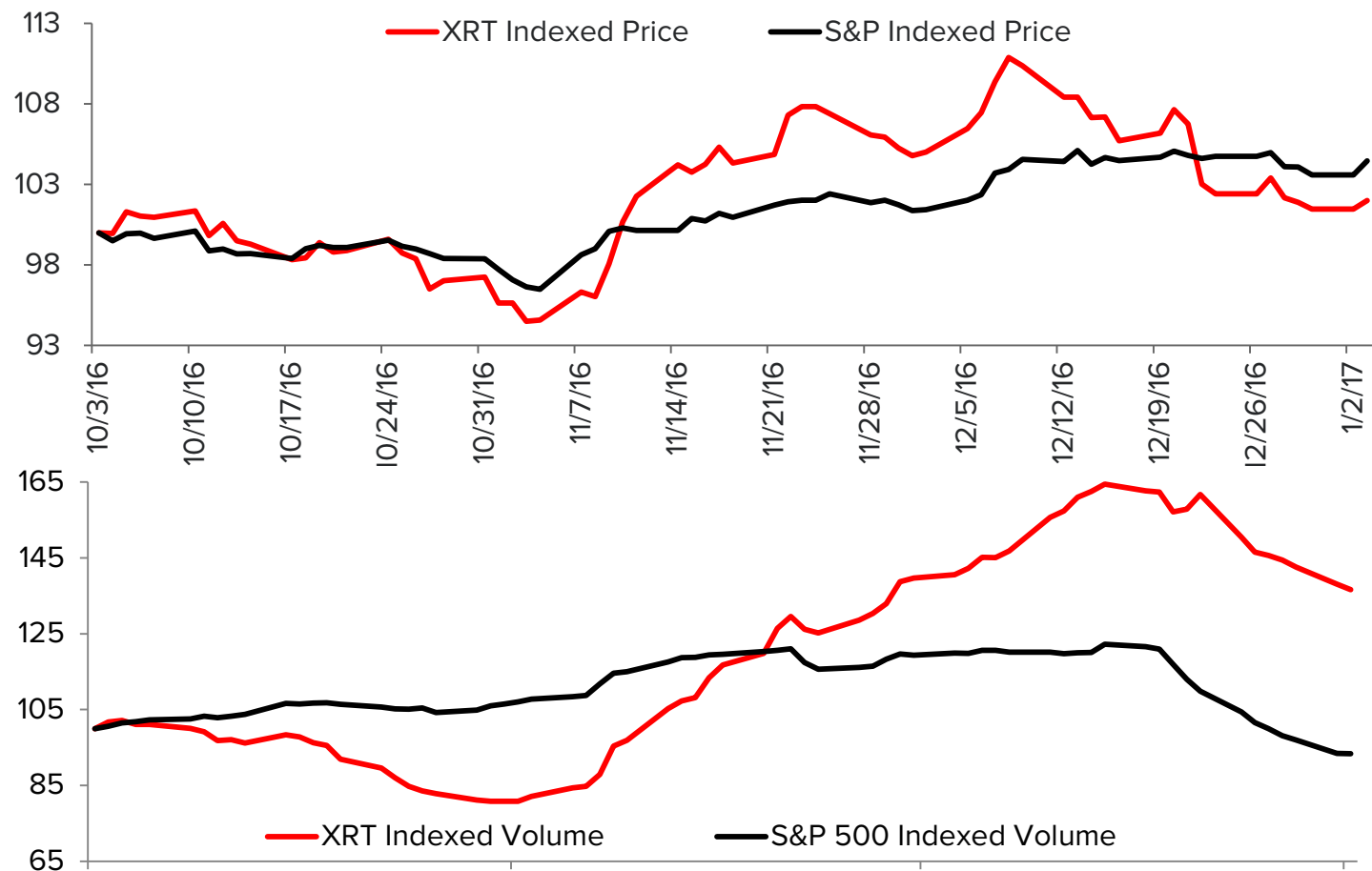
BIG TREND/TAIL BIFURCATION

In 2017, everyone should lose – even (and especially) Amazon. Hedgeye's policy team pegs a 30% chance that we'll see these measures pass – with cost increases of 15% or higher. The impact will skew heavily towards non-durables that are a) discretionary, b) high frequency, and c) low transaction value (i.e. any thing you wear). Durables (furniture, autos/parts) should be least impacted.

A close-up, low-angle shot of a man with dark, wavy hair, wearing a dark suit, white shirt, and patterned tie. He is looking down and slightly to the right with a serious, intense expression. His right hand is visible, holding a dark handgun. The background is a bright, clear blue sky.

THE 'SHOOT FIRST' REACTION

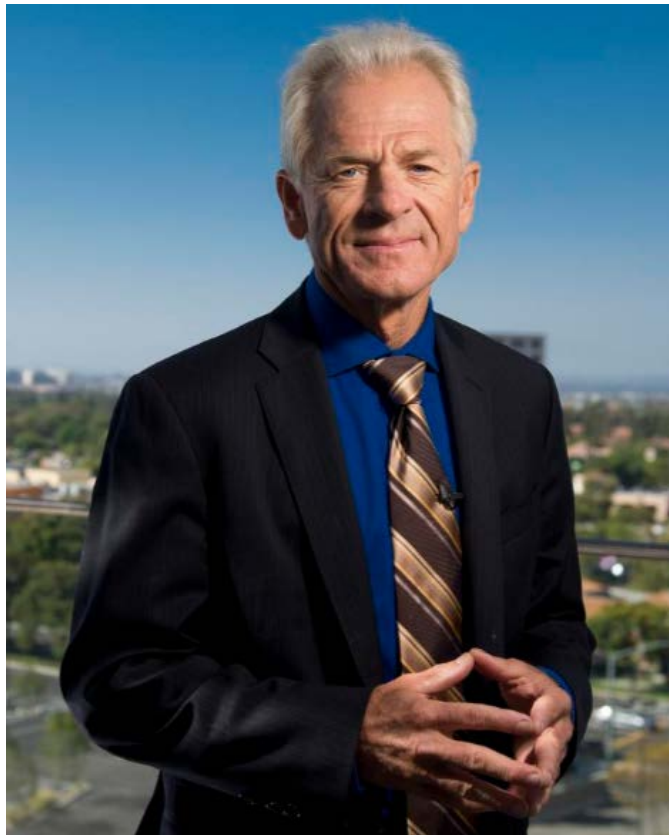
RETAIL VOLATILITY STEPPING UP, FOR GOOD REASON



Once Trump was elected, people started to place bets policy changes and the impact on margins.

GAME CHANGING APPOINTMENT

PETER NAVARRO BIO



- Harvard PHD
- UC Irvine Professor
- Author of Death by China
- Trump Campaign Advisor
- Appointed Assistant to the President, and a new role of Director of Trade and Industrial Policy

The appointment of Navarro gave more credibility to the suggestion of a border adjustment that had been proposed within the House Republican tax reform plan.

Yesterday's appointment of Robert Lighthizer as U.S. Trade Representative reiterated the thought that the administration will be tough on China and is serious about action.

CONTEXT ON NAVARRO'S CHINA VIEWPOINT

Death By China: How America Lost Its Manufacturing Base (Official Version)



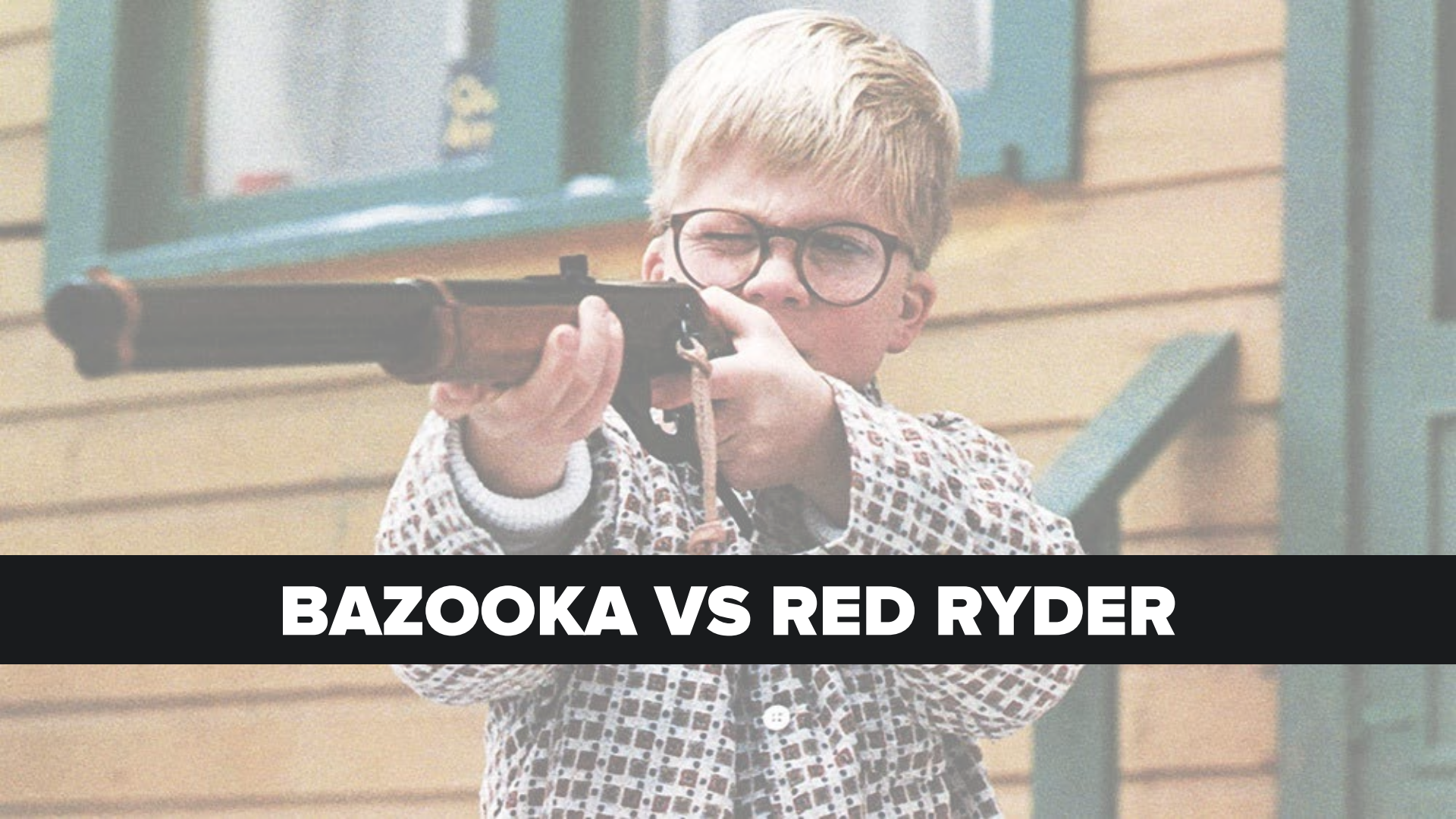
Official Version: www.deathbychina.com



WWW.CROUCHINGTIGER.NET

HEDGEYE | POTOMAC MACRO POLICY COMMENTS

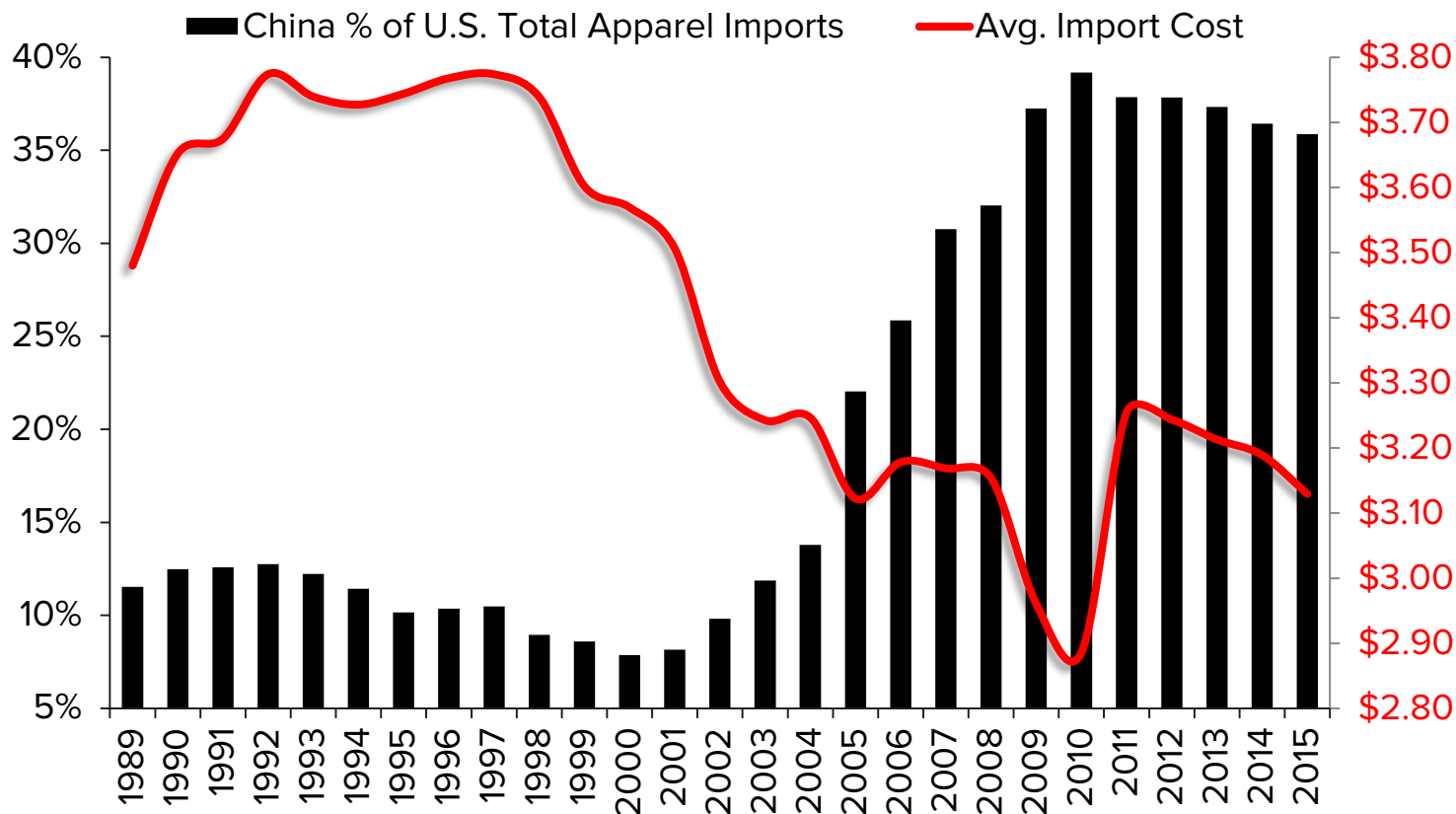
- This prospective tax reform debate will be a battle royale, one of the biggest ever. Tax reform is Speaker Ryan's baby, so the bill will most likely be written in the Speaker's office, in conjunction with the Ways and Means Committee and Chairman Brady. **The House will likely see some skirmishes, but the Senate is where the battle lines will be drawn and combat will take place.**
- The probability of a bill getting through the House with some sort of border adjustment is very likely. However, as it stands today the probability of getting one through the Senate is less likely – we'd put the odds at 30%. There are several states, with Republican Senators, who have large employers in the retail/consumer space (AR, GA, TN, among others), companies which would work hard (executives, lobbying efforts in DC and in the States – not to mention consumers who will experience price increases – think Rust Belt, etc) to prevent this component of tax reform.
- It's very likely that tax reform effort in the House will be partisan, relying almost solely on R votes – and a smattering of D votes - for passage. The Senate approach currently aims to be bipartisan, but should that fail, Majority Leader McConnell will look to a second reconciliation process (requiring only 51 as opposed to 60 votes) to pass. Border adjustment makes the Republican effort that much more difficult in the Senate.
- **Estimates put the potential consumer price impact of a border adjustment at upwards of 15%, with specialty apparel being the category most at risk given the mix of imported merchandise.**



BAZOOKA VS RED RYDER

REMEMBER IMPORT QUOTAS?

CHINA % OF U.S. TOTAL APPAREL IMPORTS



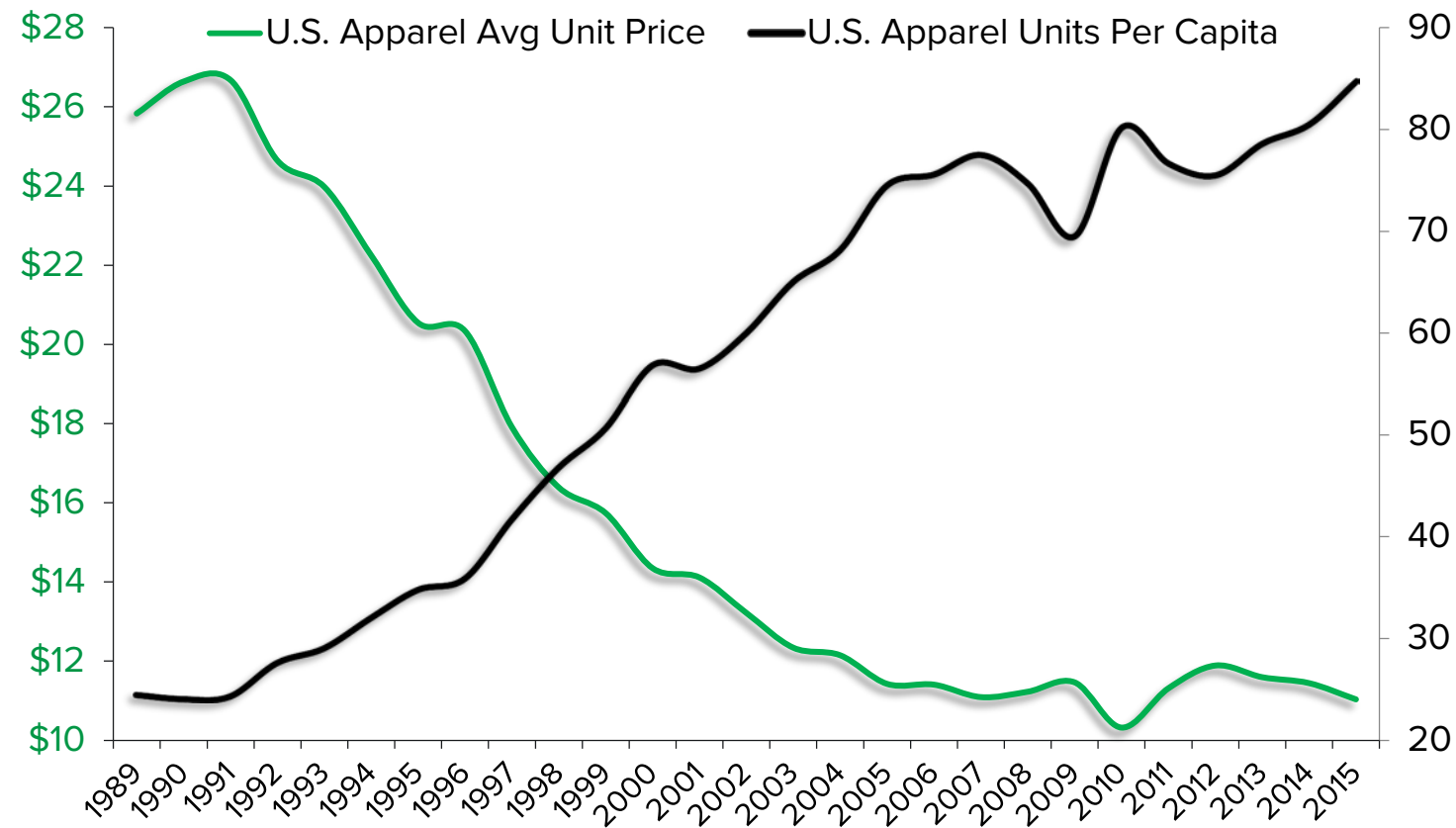
- January 1 2005 – apparel import quotas completely gone out after a decade of phasing.

- They were reinstated temporarily to prevent flooding – limited to 7.5% per year for t-shirts, cotton pants, and underwear (just before HBI went public). But by 2010 these temp safeguards were totally gone.

- In 2006, for example, imports of Chinese cotton pants surged 1,500% and cotton shirts were up 1,300%.

HERE'S THE TREND PEOPLE MISS

U.S. AVG. APPAREL UNIT PRICE VS UNITS PER CAPITA



OTEXA uses a standardized unit. (SME, or M2).

The number comes from qty of different types of garments, that are converted with standard conversion factors

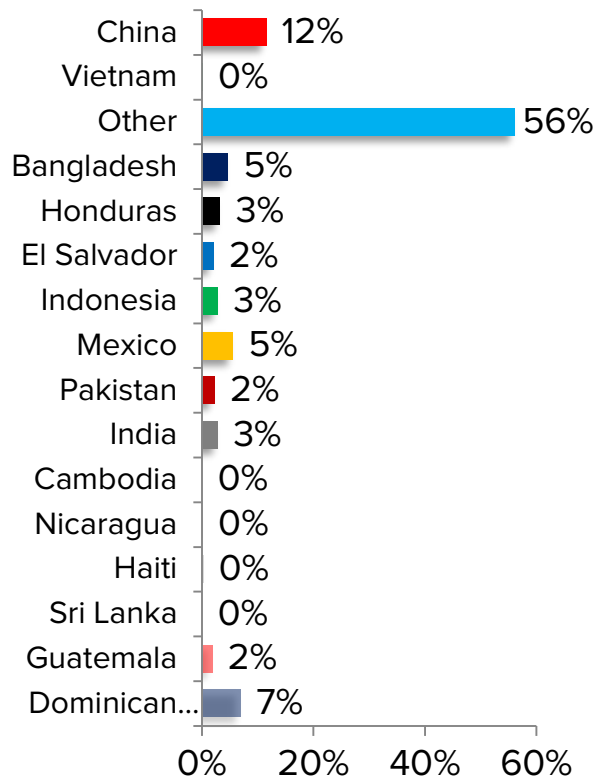
<http://otexa.trade.gov/corr.htm>

For example 1 Dozen women's/girls knit shirts/blouses = 12.5 SME, or 1 shirt = ~1 SME.
1 Dress is about 3 SME, 1 pair of socks is about 0.2 SME.

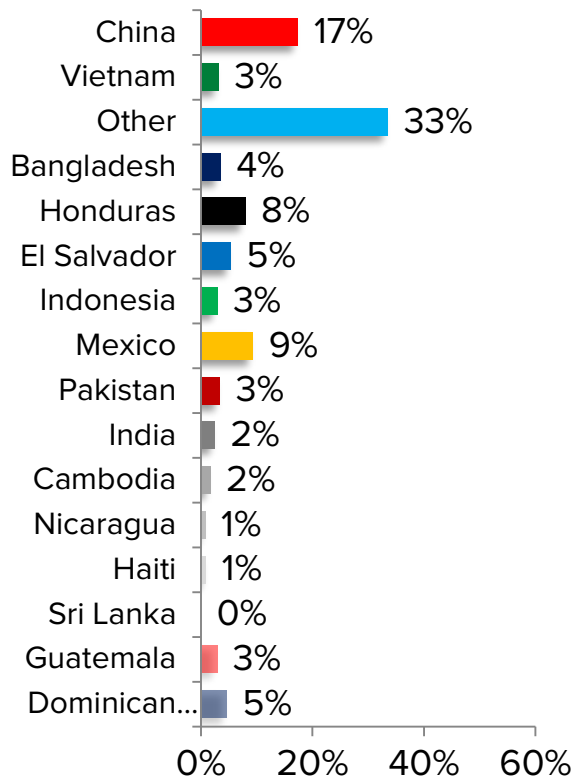
*Assuming imported units = Consumed units

U.S. TOTAL APPAREL IMPORTS UNIT % BY COUNTRY

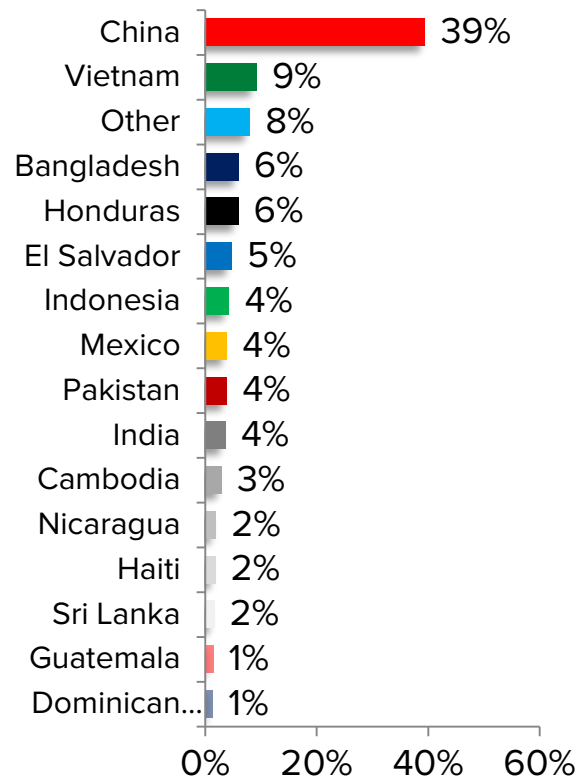
1995



2005

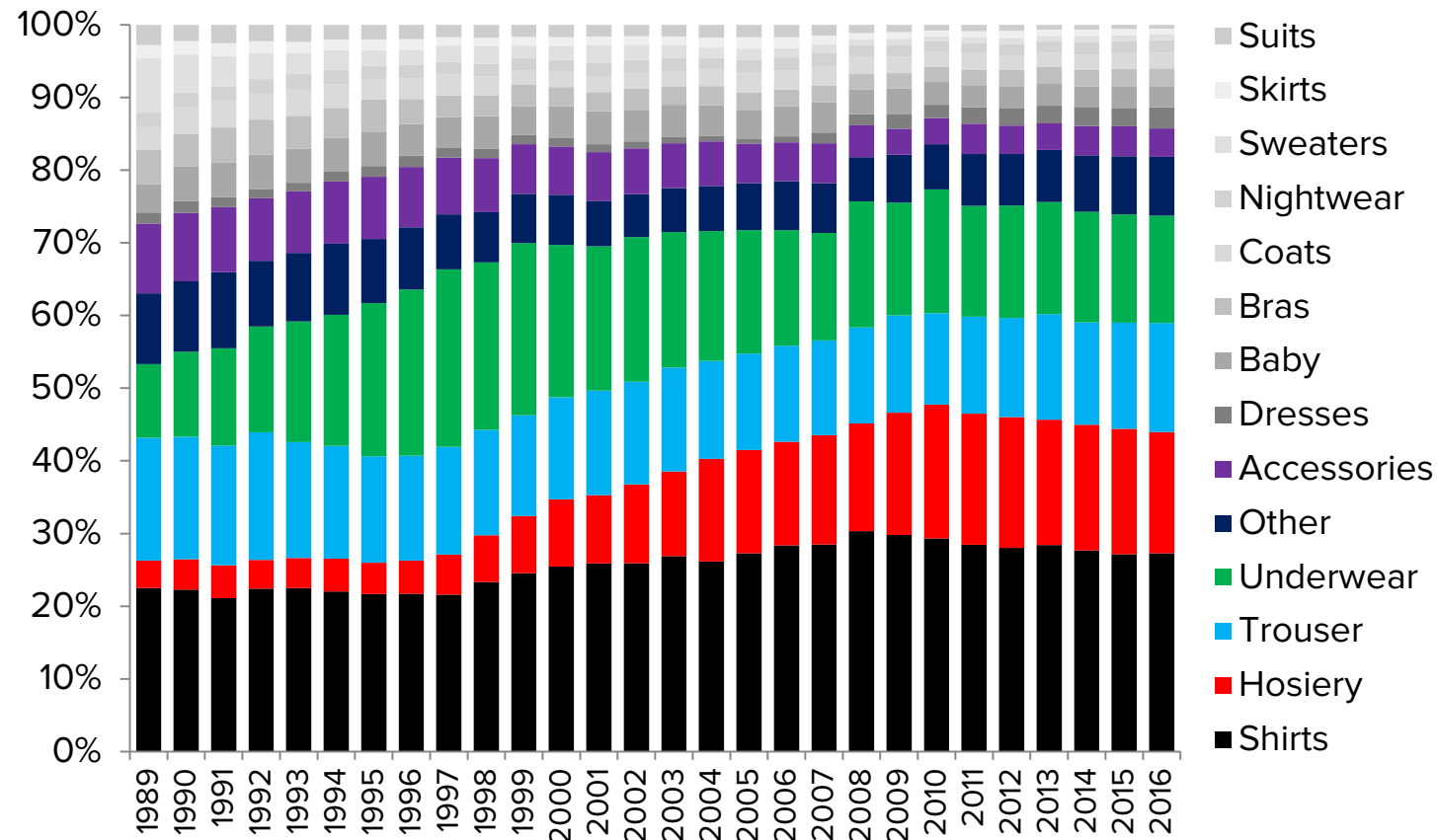


2015



CERTAIN CATEGORIES DROVE CONSUMPTION

CLOTHING CATEGORIES % OF TOTAL APPAREL UNITS

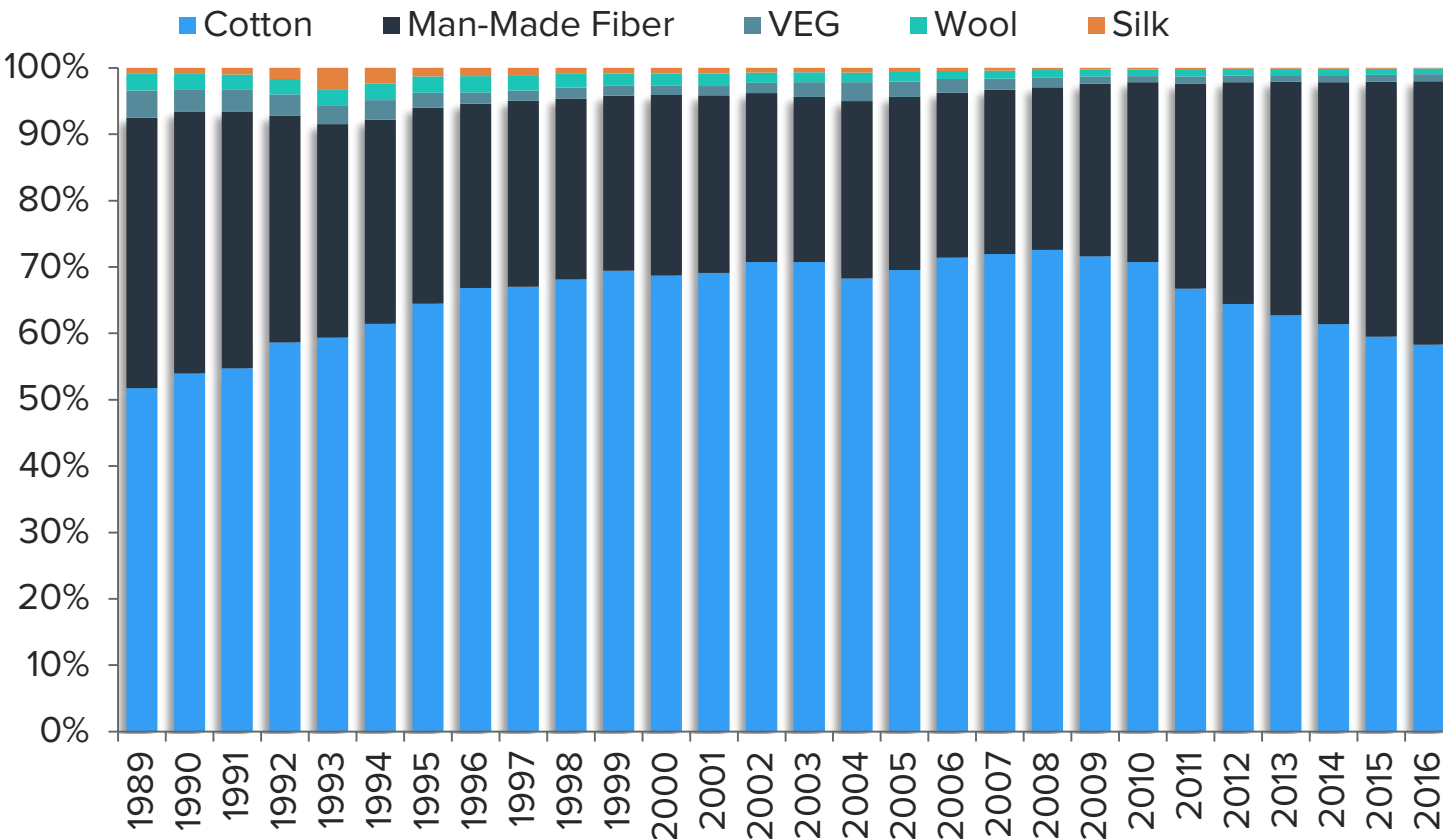


The biggest beneficiaries have been the more discretionary categories like shirts, underwear, hosiery (socks).

*2016 Through Oct

MATERIALS MIX, FYI...

MATERIAL CATEGORIES % OF TOTAL APPAREL UNITS



Though Cotton still dominates the raw materials input costs, we've seen a clear shift to synthetics.

(i.e. more Under Armour, less cotton bend).

*2016 Through Oct



DE/RE-FLATION MATH

THE BASICS...COST PER GARMENT

THEN-2000



Consumer Cost: \$10.00
Retailer Profit: \$6.35

Vertical/FOB: \$3.65

Materials: \$1.50
Labor: \$1.00
Transport: \$0.20
Duties/Other: \$0.95

NOW-2016



Consumer Cost: \$8.91
Retailer Profit: \$6.03

Vertical/FOB: \$2.88

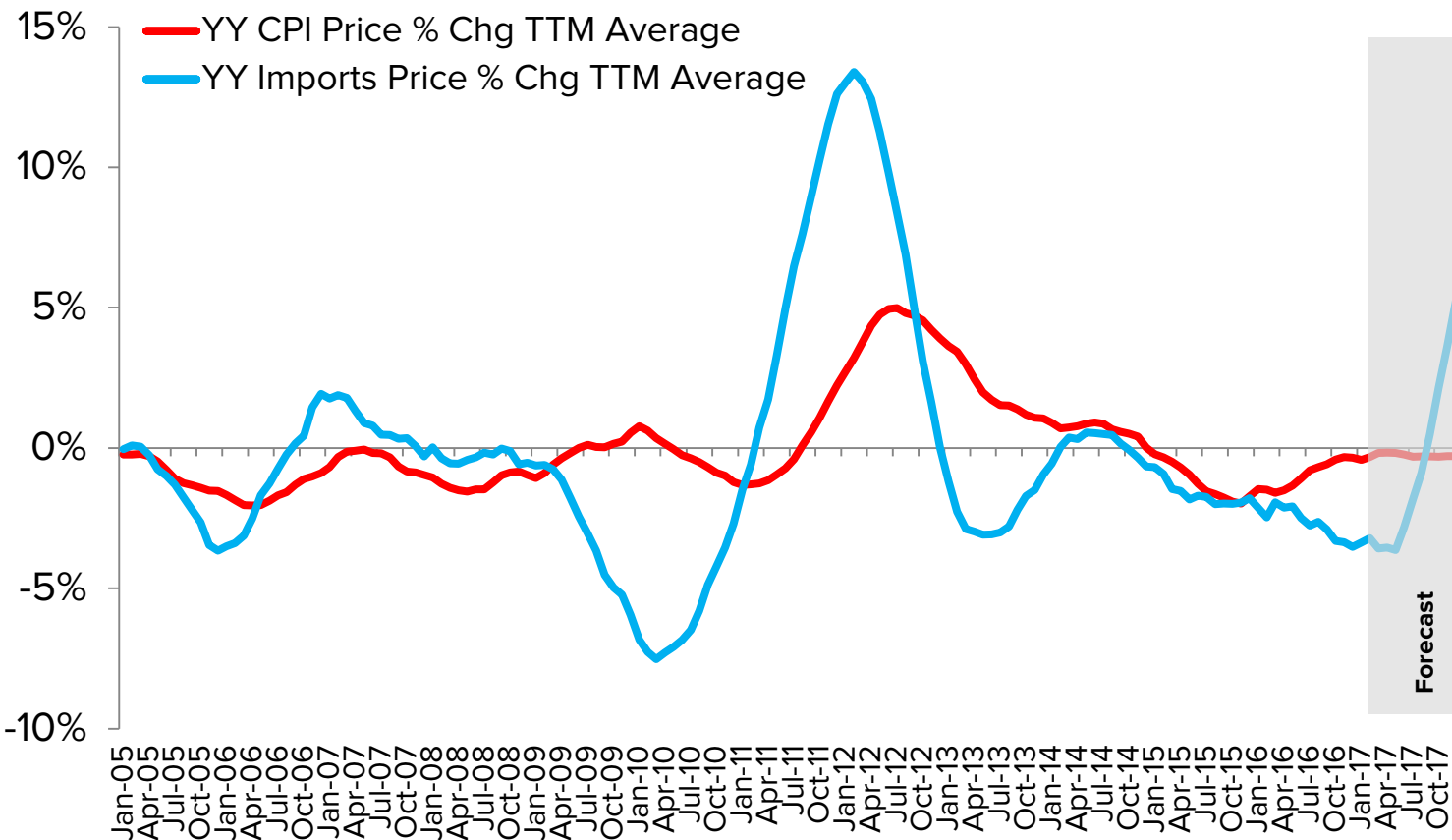
Materials: \$1.50
Labor: \$0.35
Transport: \$0.40
Duties/Other: \$0.68

UNIT COST BREAKDOWN – 2000 VS 2016

Labor was the biggest source of margin upside for the supply chain. Interestingly duties largely came down as different countries relaxed standards in the form of export taxes to compete against China for US consumption.

COST/PRICE, TRACKS WELL OVER TIME

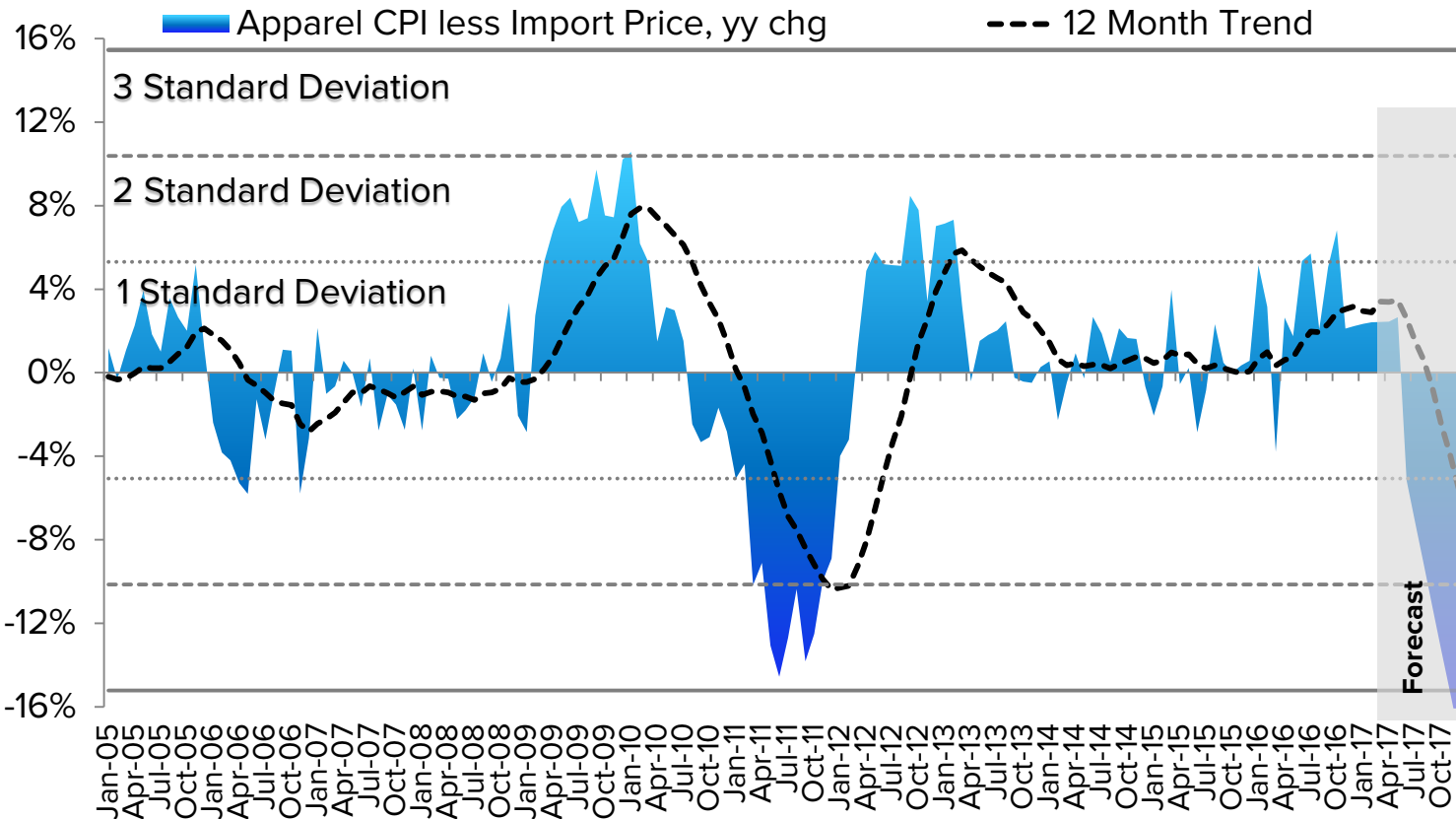
CPI VS IMPORT COST, YY CHG



This is common sense.
Retail price generally
tracks wholesale cost.

THE SPREAD IS WHAT MATTERS, BUT...

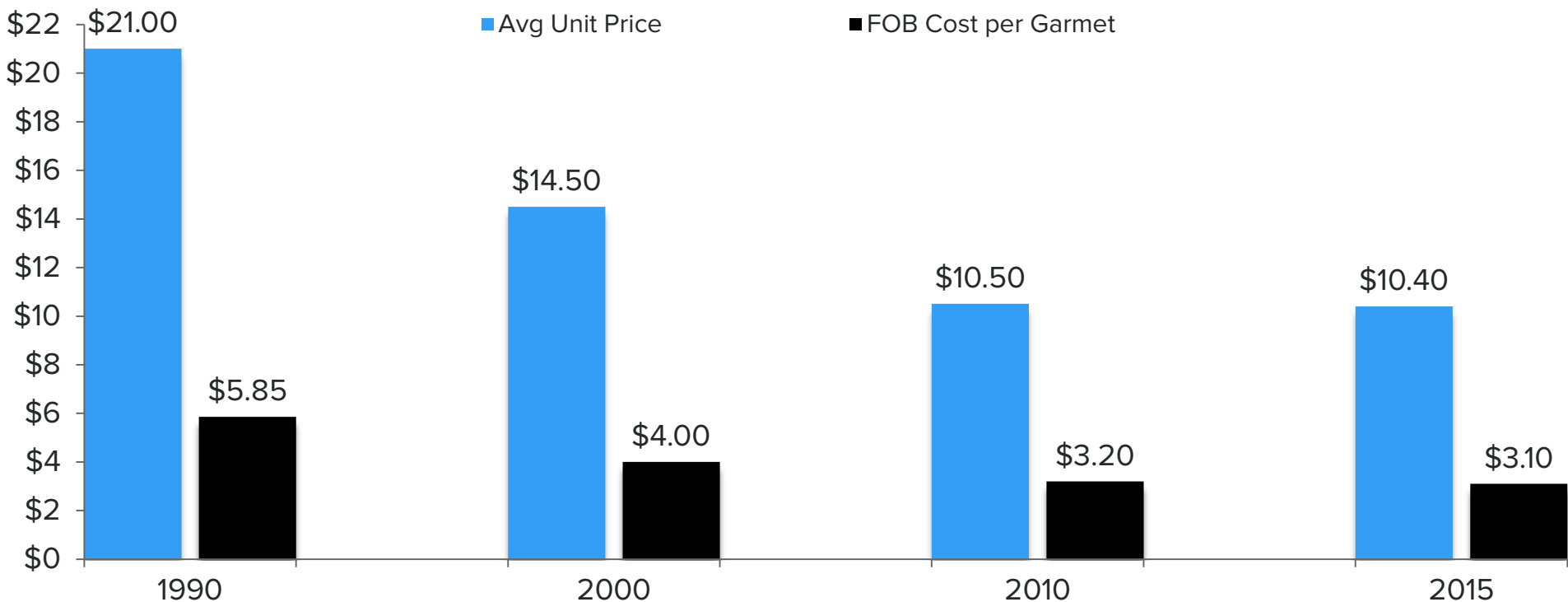
APPAREL PRICE LESS COST



We care about the spread between consumer price and wholesale cost.

There's the supply chain margin opportunity/challenge.

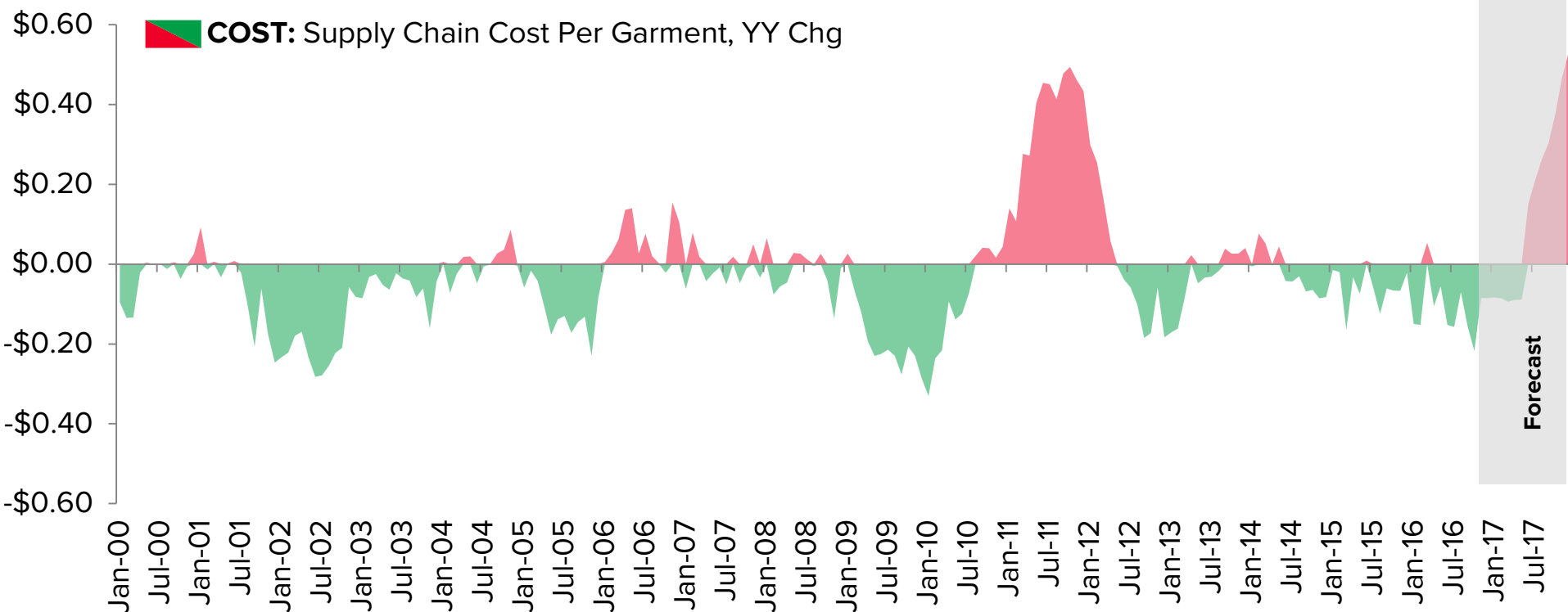
BUT TRACK THE DOLLARS, NOT PERCENTAGES



UNIT ECONOMICS TREND

At face value, this spread should be a huge margin lift.

DOLLAR SPREAD TRUMPS PERCENT SPREAD ANY DAY



LOOK AT THE \$ CHANGE IN COST, VS THE \$ CHANGE IN PRICE

With a \$8-\$9 average consumer price, and \$3 average cost, 'all 1% changes' are not created equal. In general, a 3.5% change in wholesale cost = about a 1% change in CPI.

THE MATH ADDS UP FAST

\$0.57 X 2.22 BILLION UNITS ADDS UP



X

=

**\$1.27 Billion
in margin at
risk**

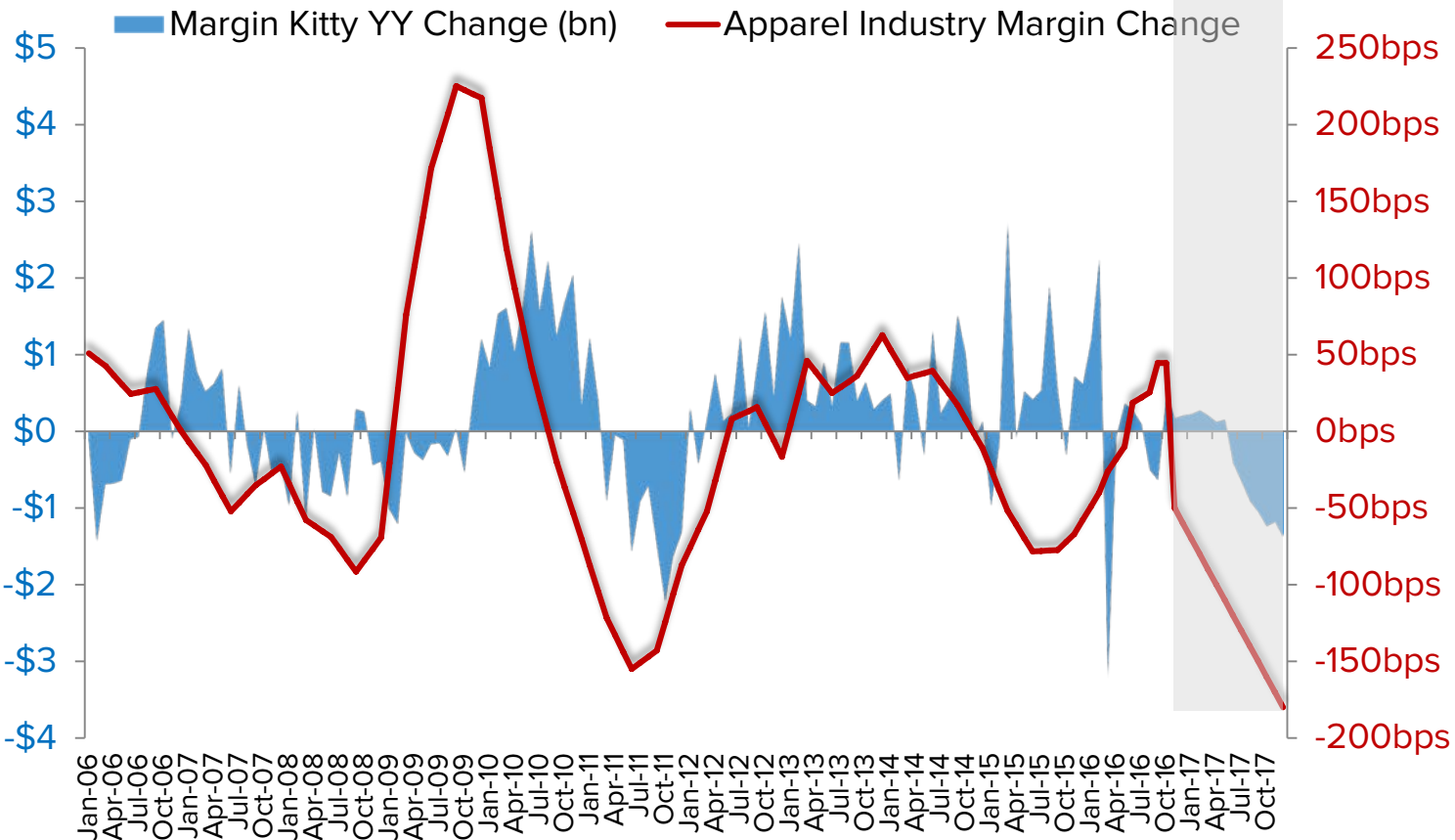


WE'RE TALKING AT LEAST \$1BN MARGIN RISK – PER YEAR...

...or about 130bp this year on a 6% industry EBIT margin.

...AND YES, THIS IMPACTED MARGINS DIRECTLY

MARGIN KITTY (NET PRICE LESS SUPPLY CHAIN COSTS)



Here's your key slide...

Industry margins track the supply chain/import-export spread with a $0.9R^2$.

Our assumption is for a 15% increase in import costs, with minimal ground cover in the form of higher consumer pricing.

IF there is higher pricing, then we're likely to see per capita unit consumption (ie 84 SME for Apparel) retreat.

Volume hurts much more than pricing.

\$46 BN IN MARGIN IN ONE DECADE!

TO PUT THIS INTO CONTEXT...

In a decade, this segment generated

≈ \$2 trillion in retail revenue

≈ \$46 billion in margin, or 230bps

Total Supply Chain Margins

Up from 63.5% to 64.0%, or just 50bps

In other words, the cost/price spread (ie the deflation consumption wave) accounted for ALL of industry margin expansion x4.



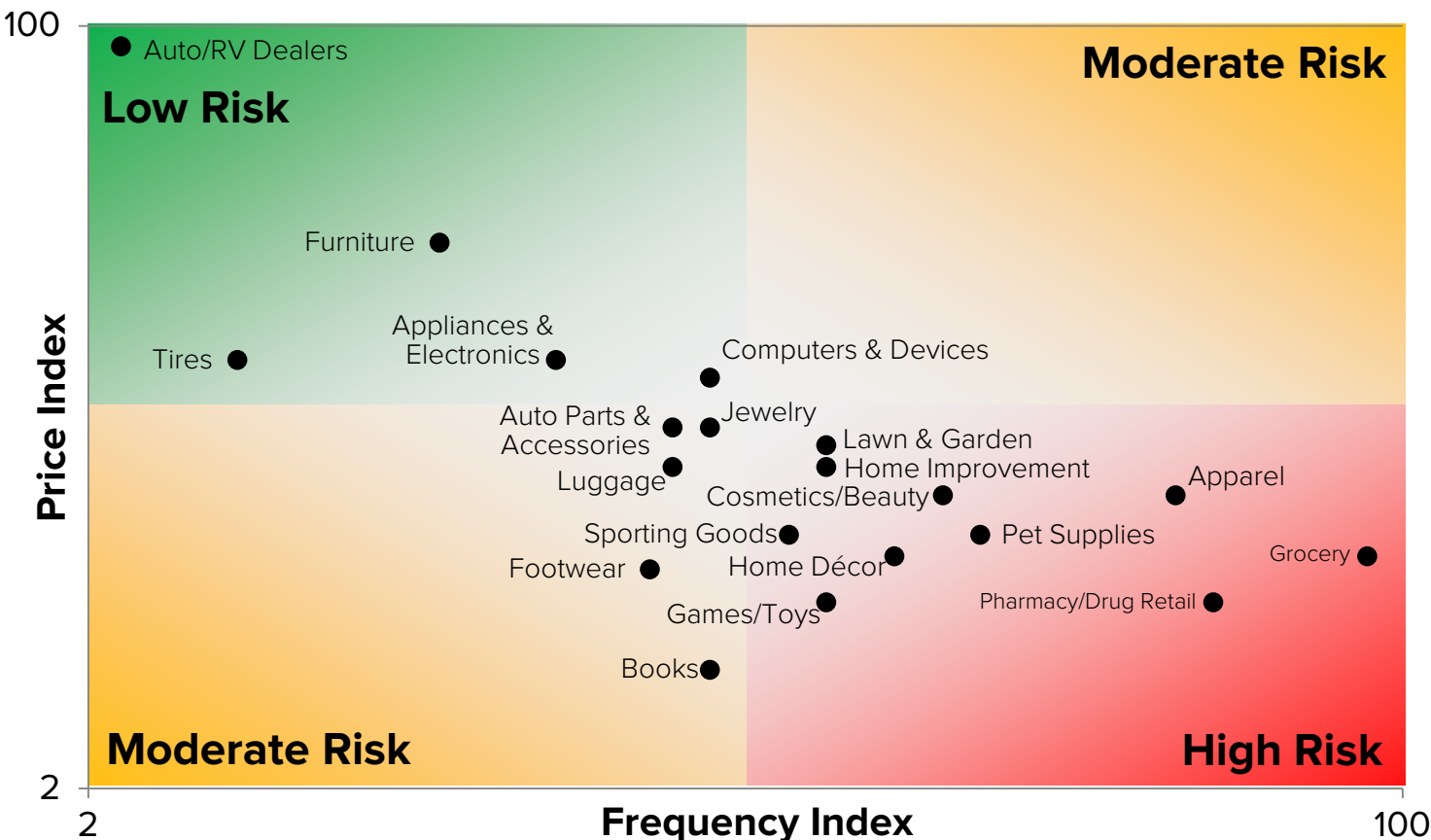
LOSERS

WINNERS

WINNERS/LOSERS

CLEAR BIFURCATION BY SUB-SECTOR

WANT VS NEED...



Last variable to consider % of category made overseas.

Biggest Risk

- High Frequency
- Highly Disposable
- Low Ticket

Lowest Risk

- High Ticket
- Low Frequency
- Long Replacement Cycle
- Housing-Linked

NOTE: Grocery and RX are obviously not at high risk. We won't reduce spending on eggs and Viagra just bc of import duties. But interesting to see where they fall in the price/frequency spectrum.

GOOD COMPANIES WIN, BAD ONES LOSE...



- Nearly 2 Billion units produced
- 53,000 employees
- 25 countries
- 3 main clusters
- 50 owned manufacturing facilities
- In-sourcing high volume styles lowers costs by ~15% - 20%
- Averaged over \$35 – \$40 million per year in savings from efficiency gains



HANES Brands Inc

GOOD COMPANIES HAVE DIVERSIFIED TECH, BAD ONES HAVE CHASED TREND

HBI has spent a decade closing down US plants and shifted capacity outside of the US. At the same time it also took its tax rate from 32% down to 6%. #horribletiming. Flip side -- Nike is changing up a 40-year paradigm of making shoes in China with vertical manufacturing using 90% fewer hands touching each pair of kicks. New process is US-based and show rear its head in 2017.

TIMING...

POSSIBLE TIMELINE FOR BORDER ADJUSTMENT BILL

- Jan 20, 2017 - Trump Takes Office
- February– April 2017 - House Ways and Means introduces bill
- Full vote in the House anticipated late Spring
 - Likely to see border adjustment passed in the House.
- Early Summer 2017 – Senate introduction/ consideration of tax reform bill begins.
 - Less likely to see border adjustment (in current form) pass in the Senate.
- If it is going to pass, it likely happens by August.
- Implementation starting in 2018 or later.

Forces are already aligning to prevent a border adjustment provision in any tax reform bill.



HUMOR ME FOR A MINUTE

BUZZWORD HISTORY

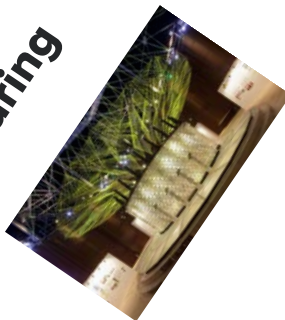
WHAT BUZZWORDS DO WE NOT KNOW ABOUT YET?

Back Then

Outsourcing



Lean Manufacturing



Now

BOPIS



What's Next?

???

Offshoring



Supply Chain



Omnichannel



E-comm



SERIOUSLY MCGOUGH?

VIRTUAL SHOPPING?



I get it...this is so far out there and uninvestable today. But it will matter in 5-years or less.

No longer will you shop in a store, or from your iPad in your boxers...but in a virtual environment with an unlimited number of branded stores.

Cheap mid-priced retailers and brands are toast.
Good bye JCPenney, Kohl's and even Target/softgoods.

HEDGEYE RETAIL IDEA LIST

©HEDGEYE RISK MANAGEMENT

BEST LONG IDEAS

		TRADE	TREND	TAIL
NKE	Nike, Inc.	✓	✓	✓
RH	Restoration Hardware	✓	✓	✓

OTHER ACTIVE LONGS

WMT	Wal-Mart	✓	✓	✓
DKS	Dick's Sporting Goods	✓	✓	-
KATE	Kate Spade	-	✓	✓
RL	Ralph Lauren	-	-	✓

LONG VETTING BENCH

LB	L Brands
TSCO	Tractor Supply
ABF-GB	ABF/Primark
ULTA	Ulta Salon
WWW	Wolverine Worldwide

BEST SHORT IDEAS

		TRADE	TREND	TAIL
HBI	HanesBrands	X	X	X
TGT	Target	-	X	X
KSS	Kohl's	-	X	X
LULU	Lululemon	✓	-	X
FL	Foot Locker	X	X	X

OTHER ACTIVE SHORTS

CRI	Carters Inc.	-	X	X
TIF	Tiffany	X	X	X
HIBB	Hibbett Sports	-	X	X
BBBY	Bed, Bath & Beyond	X	X	X
WSM	Williams-Sonoma	X	X	X

SHORT VETTING BENCH

AMZN	Amazon.com
CTC.A	Canadian Tire Corp
GPS	Gap, Inc
JWN	Nordstrom
JCP	JC Penney
FINL	Finish Line
LUX	Luxottica
M	Macy's
PRTY	Party City
ELY	Callaway Golf
COLM	Columbia
GNC	GNC Inc
VSI	Vitamin Shoppe
FRAN	Francesca's

Bench = timing is not right, or research is in progress.

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