Retail, Consumer and Food Outlook

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Retail: Challenges persist despite positive holiday outlook

Key themes: holiday kick start; e-commerce and margin risk

We expect retail will remain the most topical sector within the consumer suite in 2018, as the recent kick start from the 2017 holiday season is balanced against secular headwinds. While our best idea for the start of 2018 was pulled forward into 2017 – **PetSmart (PETM)** – we expect episodic opportunities to remain present over the course of next year. Below we list some of the key themes to monitor as we turn the calendar.

- Strong start to holiday season buoyed retail performance in November and December. Department store sales inflected positive in November (+1.7% YoY seasonally adjusted; +4.0% unadjusted) according to the latest U.S. Census Bureau's Advance Retail Sales report.

- E-commerce growth continues to far outpace overall growth in retail spending. First Data indicated Black Friday/Thanksgiving retail sales grew 9.3% YoY, compared to online sales growth of 17.4% YoY over the same period. In this context, **Neiman Marcus (NMG)** has outsized digital penetration, with online representing 32% of sales. While we are increasingly constructive on the F2018 outlook for NMG, we believe a restructuring of some form is necessary at some point.

- Retailers, across all categories, are likely to face increased pressure to compete on price or risk declining foot traffic and sales dollars. **The Fresh Market (TFM)**, **PetSmart (PETM)** and **Petco (PETC)** were the 2017 case studies for such pressure. Driven by either competitors investing in gross margin or online undercutting brick-and-mortar pricing and capturing market share, each saw decelerating SSS driven by foot traffic headwinds throughout 2017. Looking ahead to 2018, **Sally Beauty (SBH)** potentially fits the profile, though starting from a much better leverage position with healthy FCF currently. That said, gross margin is a robust 50% and SSS decelerated in F2017. We believe health & beauty competition is increasing from both online and brick-and-mortar, which could impact the secular outlook for a business once thought to be insulated from competition due to its professional category.

- Brands, and to a lesser extent specialty/apparel retailers, have proven resilient, and we expect the trend to continue. While defensive, **Wolverine Worldwide (WWW)**, **Levi Strauss (LEVI)** and **Hanesbrands (HBI)** were proven winners over the course of 2017. We expect retail channel disruption, if impactful, should prove more transient than secular. Aside from fashion missteps, we believe private label risk represents the greatest long term risk, particularly for basics. On a relative basis, **WWW** provides the best spread-per-turn of leverage.

- In 2017, we treaded lightly in retail and will do the same next year. We favored episodic, self-help stories from the long side and shorts with little margin of safety due to financial leverage and/or business model risk. Retail will remain a difficult sector to invest; particularly as it relates to picking winners outright. As such, we will continue to favor relative value opportunities, as was the case with our prior top pick **Tailored Brands (TLRD)**. Names of interest moving forward include **Staples (SPLS)** given its 100% e-commerce business model but still developing standalone story; **Rite Aid (RAD)** given potential turbulence on its path to deleveraging

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