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Ross Stores Inc ROST |

PDF Report

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Ross posts strong comparable sales growth despite weather headwinds.



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Analyst Note 08/17/2017

Narrow-moat Ross' second-quarter results further support our belief that off-price retail market share gains are still intact, with comparable sales growth of 4% (combined with TJX's 3% comparable sales growth and Nordstrom Rack's 3% comparable sales growth) well ahead of the comparable sales declines at no-moat broad-line competitors Macy's and Kohl's. Further supporting this notion was that sales were driven by traffic and basket size increases. We continue to believe that players in this space possess competitive advantages given fast inventory turnover and lowest-price offerings and that there are slight barriers to entry given scale and vendor relationships.

We see our \$66 fair value estimate increasing by 2% to 3% to account for the time value of money and the second quarter's above expectation comp growth (a 4% increase versus our 2% fiscal 2017 expectation excluding the 53rd week). In the long run, we still think this company can post average annual revenue growth of 6% to 7% over the next five years (versus an 8% three year historical average) and that margin will remain in the upper 13% to low 14% range (versus a 13.7% historical average). We continue to view Ross shares as undervalued.

Investment Thesis 04/10/2017

Off-price retailers like Ross have increased their customer bases throughout the recession and weak recovery. This has come largely at the expense of other apparel retailers, with department-store retail sales down almost 6% in 2016, compared with 8% revenue growth (and a 4% same-store sales increase) for Ross. We think consumers have become more price-oriented and willing to trade customer service and an expensive store design for 20%-60% discounts on the same brand-name merchandise. With consumer spending on apparel still less than robust, we think Ross will maintain its new market share and benefit from suppliers' excess inventory. That said, we also believe that this model will work in a positive economic environment.

We have awarded Ross Stores a narrow moat rating because we believe that success in the off-price retailing model requires significant scale to support a large buying force, warehousing, and distribution. Additionally, Ross' proprietary inventory management system allows for merchandise to be differentiated for local preferences, providing a powerful intangible asset and thus enabling the company to target a broad market. As such, we think it is slightly protected from the intense competition of more traditional retailers and can sustain higher-than-average growth.

Management has strategically executed its growth strategy, opening clusters of new stores in markets to take advantage of operational efficiencies. Because the company only operates in 36 states, we think plans to grow the store base to 2,500 (versus 1,533 in 2016) are reasonable.

Morningstar's Take ROST

Analyst

Price 09-21-2017	Fair Value Estimate	Uncertainty
60.91 USD	66 USD	Medium
Consider Buy	Consider Sell	Economic Moat
46.2 USD	89.1 USD	Narrow

Stewardship Rating
Standard

Bulls Say

- Ross Stores performs better in a promotional environment than many other apparel retailers, as it gains access to more inventory.
- Ross's inventory management system and pack-away/close-outs mix allow the company to maximize value but still buy into a season.
- Complex inventory management systems and a large buying team with deeply established vendor relationships differentiate it from competition and provide localization capabilities as well as a barrier to entry.

Bears Say

- An improvement in the economy could mean that customers might trade back up to full-price department and specialty stores.
- As the company expands its store base it might compete more heavily with TJ Maxx and Marshalls stores that have been lowering their average unit retail. Additionally, the entry of Macy's to the off-price space could add to the competition.
- If the economy worsens, consumers may pull back on discretionary purchases, making same-store sales comp growth more difficult to achieve.

Competitors ROST

More...

Name	Price	% Chg	TTM Sales \$ mil
Ross Stores Inc	\$60.91	-0.02	13,335
TJX Companies Inc	\$72.82	0.55	33,901
Industria De Diseno Textil SA	\$39.30	1.16	28,750
Industria De Diseno Textil SA ADR	\$19.14	-1.24	28,750
Fast Retailing Co Ltd ADR	\$29.75	0.81	16,425
Fast Retailing Co Ltd	\$298.00	2.58	16,425

We view Ross as a compelling long-term idea in the apparel retail space. Over the next five years, we think Ross can achieve 7% average annual revenue growth on 3% comparable sales and a 5% increase in stores. We expect wage inflation to be a headwind in the near term but to eventually moderate.

Economic Moat 04/10/2017

The apparel retail space is characterized by low barriers to entry and intense pricing competition, exacerbated by the heavy economic pressures facing consumers. However, it is an environment in which Ross Stores has managed to thrive. With the exception of one quarter, Ross has posted flat or positive same-store sales growth since the beginning of fiscal 2008. We think this consistent outperformance is an indication that the company has managed to dig itself a moat in the apparel retailing space via cost advantages. As such, we are maintaining our narrow moat rating.

The off-price retailing space has made significant inroads during the recession and slow recovery, with TJX and Ross reporting an average 7.5% growth in 2016 versus a 1% increase for total national apparel sales. But, despite its appeal, it is not an easy space for new entrants to invade, giving off-price retailers a sustainable cost advantage. Much of Ross' success is due to its significant buyer fleet, with about 760 merchants scouring more than 8,000 vendors for attractively discounted designer staples and inventory reflecting the season's hottest trends. With six distribution processing facilities, the company can get the right merchandise to the right store at the right time in a cost-effective way. Seven warehouse facilities enable the company to take advantage of deep discounts on designer staples at each season's end and to store them until the next season. Investments in planning and allocation have reduced markdowns and increased inventory turns. Ross had only 60 days of inventory outstanding in 2016, versus our estimate of department stores averaging 105 days. We think that this level of inventory control benefits the company in numerous ways. First, constant inventory replenishment increases the number of visits per customer. Second, it reduces the need for end-of-season markdowns. Third, it decreases the capacity requirements for inventory storage.

Because scale is essential to success, there are few players in the space, and some, such as Filene's Basement and Syms, could not survive. Although TJ Maxx is the largest corporate entity, with about 3,800 stores worldwide and under various brand names, Ross is the largest single brand in the U.S., with 1,340 stores as of fiscal 2016. TJ Maxx trails this store count (1,186), and Marshalls ranks third, with 1,035. Other specialty apparel stores, such as Kohl's, H&M, and Zara, offer attractive prices but not the same designer names that can be found at Ross. We think there is more than enough room in the market for two or three large competitors and think that Ross' scale will allow it to continue to offer better prices and merchandise than small market entrants can.

We have awarded Ross a narrow moat rating, based primarily on the cost advantages inherent in its scale. We expect that the company will continue to post above-average revenue and EBIT growth for at least the next 10 years and are modeling a five-year average annual adjusted ROIC of 26%, well above the 9% cost of capital used in our DCF analysis. Although we are comfortable with projecting 10 years of above-average returns, we do acknowledge that other competitors may scale over time and become a threat. As such, we are not assigning the company a wide moat rating.

Valuation 07/17/2017

We are increasing our fair value estimate to \$66 from \$60 to reflect the impact of the time value of money and our assumption of tax reform in 2018 resulting in a 25% federal corporate tax rate. Our discounted cash flow analysis continues to use a 9% weighted average cost of capital. We think that Ross can deliver 7% revenue growth and 12% adjusted earnings per share growth in fiscal 2017. Our fiscal 2017 assumptions include top-line growth driven by a 4% increase in comparable sales (including the impact of the 53rd week) and a 6% increase in new stores. Although we still think operating margin will be muted at 13.9%, versus 14.0% last year (includes a 15 basis point impact from the 53rd week), owing to wage inflation, we

think share buybacks will drive the bottom-line growth. We are still modeling revenue to grow at a compound annual rate of 7% over the next five years, on top of an average of 8% growth over the last three years. This is in line with our prior estimate. Our revenue estimate is driven by new-store growth continuing at the existing rate of approximately 5%-6% per year, a number we are comfortable with, given management's belief that there is room to grow the store base from 1,533 in 2016 to about 2,500 in the U.S. Additionally, we are modeling same-store sales growth of 3% over the next five years, slightly below the 4% average we have seen over the past three years. We think growth can be sustained at this level through increased traffic, thanks to continuing market share gains and increases in ticket value as customers increase their baskets. We expect operating income growth to be in line with that of the top line owing to improved merchandise margin, but offset by wage pressure. Our model has operating income growing at a compound annual rate of 7% over the next five years. We are modeling an operating margin of 14.1% by the end of fiscal 2021, versus 14.0% in fiscal 2016.

Risk 04/10/2017

The apparel retail sector is fraught with competition, given the low barriers to entry. Recent volatility in consumer demand and poor inventory management has put even more pressure on retailers to attract consumers, making pricing wars a norm. That said, barriers to the off-price retailing subsector and a distinct cost advantage have allowed Ross to achieve a strong and consistent performance. As such, we are awarding the company a medium uncertainty rating.

There are a few potential risks to our revenue growth assumptions. Topping our list is the tenuous economy. Although employment has improved, rent and healthcare costs are climbing. We think this remains a threat to consumer confidence. Offsetting this is our belief that Ross is strategically positioned to take advantage of consumers looking for a discount. More uncertainty could cause more customers to trade down to a Ross store from full-priced retailers.

We also see risk in the company's supply chain. We think Ross's buying force of over 700 merchants and broad supplier base of over 8,000 vendors enable the company to get the inventory it needs. However, as the company increases its inventory needs and more competitors develop in the space, there could be more competition for inventory. The company may not be able to source enough, or it could be forced to reduce its margin or the discount at which the merchandise is offered. Alternatively, the company could benefit from an even more diverse apparel selection as competition in apparel retail increases and more unsold inventory becomes available. We believe Ross's pack-away strategy lowers this threat and gives merchant a bit of a hedge to last-minute inventory availability. We acknowledge that a large store base is a risk with shifts to online purchasing. Finally, we are modeling a federal corporate tax rate reduction to 25% in 2018. Any change in the size or timing of tax reform could have an impact on our fair value.

Management 07/17/2017

The Ross management team has extensive retail experience, both within and outside of the company. Barbara Rentler was appointed CEO and a member of the board in June 2014. From 2009 to May 2014, she was president and chief merchandising officer of Ross Dress for Less, and executive vice president, Merchandising, from 2006 to 2009. She also served at dd's Discounts as executive vice president and chief merchandising officer from 2005 to 2006 and senior vice president and chief merchandising officer from 2004 to 2005. Prior to that, she held various merchandising positions since joining the company in 1986. Michael Balmuth served as the company's CEO from 1996 to 2014 and is now continuing his service as executive chairman of the board.

The 10-member board is composed of Rentler, Balmuth, President and COO Michael O'Sullivan, and seven independent directors. With this high level of independent participation, we consider this corporate governance structure to be fair. Management has actively participated in shareholder-friendly activities in the form of

dividends and share repurchases. Over the past five years (ending in 2016), total return to stockholders averaged 22% annually versus 14% for the S&P 500. Overall, we assign the firm a Standard stewardship rating.

Overview

Profile:

Ross Stores operates one of the largest off-price apparel and home fashion chains in the U.S., selling name-brand and designer apparel, accessories, footwear, and home fashions to middle-income consumers at prices generally 20%-60% lower than regular prices. In addition to the 1,340 Ross Dress for Less stores, the company operates 193 dd's Discounts stores, which target customers with more moderate incomes with prices 20%-70% off moderate department and discount store regular prices.

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