American Century Investments®

Retail: Thinking Outside of the Brick and Mortar

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Traditional retailers have been experiencing significant performance pressures. The secular trends toward online shopping and off-price retailing have been disruptive. A new normal for retailers is evolving where online and off-price retailers continue to take market share while traditional brick and mortar retailers struggle to find their way.

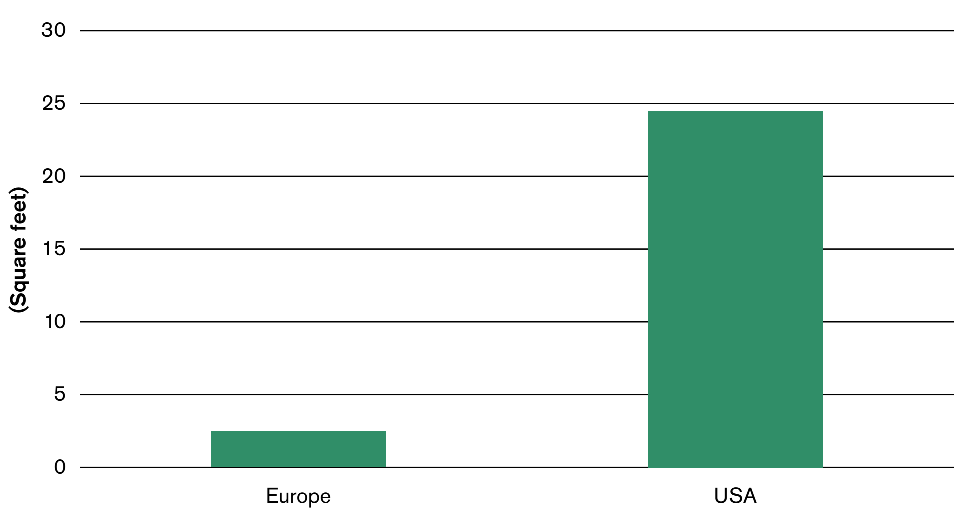
Nonetheless, our U.S. Value Equity Team believes there are opportunities in well-managed retailers whose business models will enable them to successfully withstand or incorporate secular trends into their business models. Below we describe key secular trends and issues and discuss some of our current best ideas for value investors, including Walmart, Target, Lowes, Advance Auto Parts, Mattel and Coach.

Excessive Retail Capacity Has Provoked Discounting

Since 1995, the number of shopping centers in the U.S. has grown by more than 23% cumulatively and GLA (total gross leasable area) by almost 30%, while the population has grown by less than 14%. Currently there is close to 25 square feet of retail space per capita. In contrast, Europe has about 2.5 square feet per capita.

Figure 1: The USA has nearly 25 square feet of retail space per capita while Europe has about 2.5 square feet.

Figure 1: USA Has Excessive Retail Capacity



Data as of January 2016.
Source: Robin Lewis, "Retail 2015: A Reality Check," Forbes, March 17, 2015.

This overcapacity has led to discounting, predatory pricing, and a generally deflationary effect on the prices of retail goods. Once-stable department stores Nordstrom, Saks Fifth Avenue, Neiman Marcus, and Macy's have ramped up brick-and-mortar off-price locations, creating pressure on financial returns and potentially harming their respective brand reputations.

Off-Price Store Capacity Expands While Full-Price Stores Languish

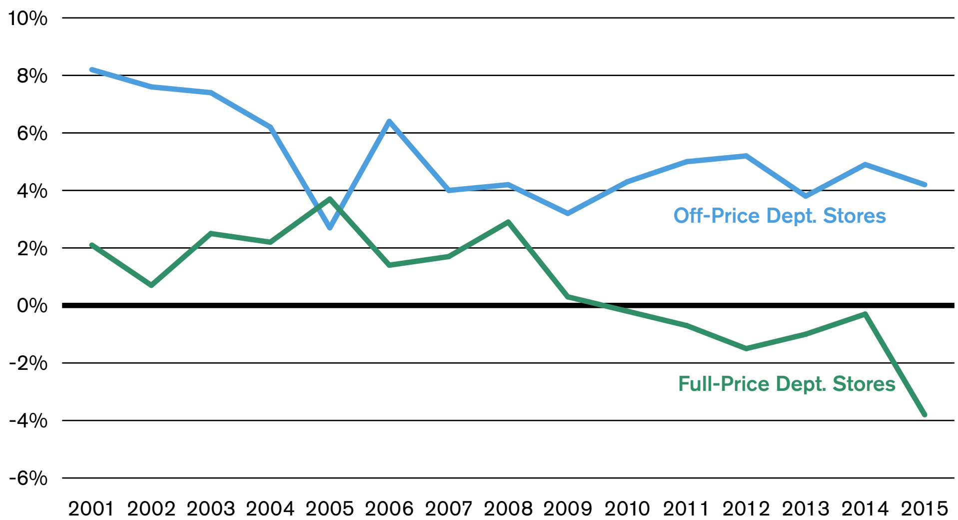
As traditional retailers have faltered, off-price retailers are growing and taking market share. Their business model is as follows: When designers make more clothes than traditional shops will sell at full price, TJX (T.J. Maxx and Marshalls), Ross, and others buy them at a deep discount, then resell them. T.J. Maxx and Marshalls plan for about 1,500 additional locations each in the next five years, while Ross has a goal of 2,500 locations.

The off-price retailers are thriving for many of the same reasons traditional retailers are not. Fast-moving trends, price-conscious consumers, and even global warming are making it harder for shops to predict which clothes will sell at what price. As forecasts become less accurate, there are more clothes available for TJX and Ross to buy at a discount.

Additionally, off-price retailers do not share traditional retailers' biggest headaches. Consumers' obsession with sales does not hurt them because TJX and Ross offer brand-name clothes at a bargain each day. And online competitors are less threatening: Shops have a constantly changing assortment, so consumers like coming to stores to hunt for deals. Notably, TJX and Marshalls relatively high valuations do not currently meet our U.S. Value Equity process.

To cope with declining in-store sales, Sears, Macy's, JCPenney, and others have recently been closing brick-and-mortar stores. Sears has closed hundreds of Sears and Kmart stores in the past few years. Macy's closed 36 stores earlier in 2016 and in August it announced plans to close about 100 more stores. JCPenney has closed 33 stores in 2014, 40 stores in 2015, and seven so far this year.

Figure 2: Department Store Capacity Declines While Off-Price Rises



Data as of 12/31/2015.
Source: Paul Howanitz, American Century Investments Investment Analyst

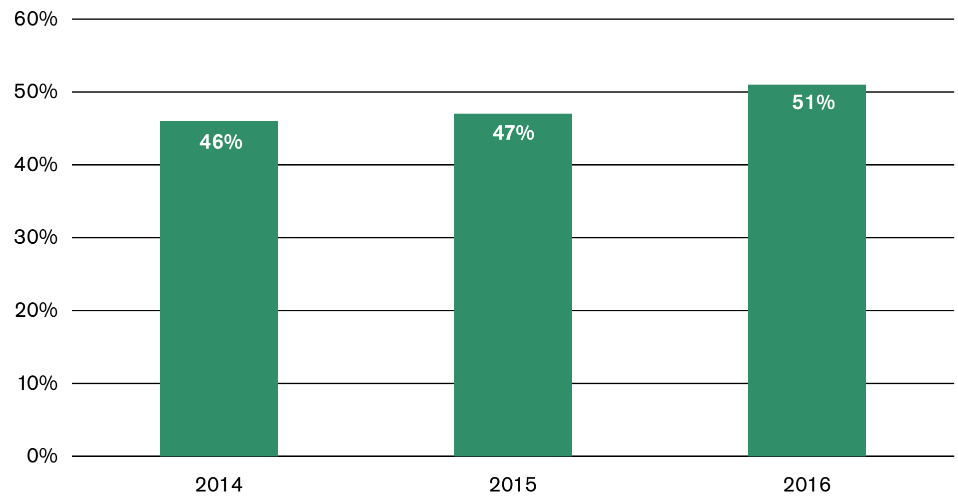
Online Shopping Is Growing Dramatically

Online shopping is about 12% of all apparel and footwear sales in the U.S., as compared to about 1% in 2001. Market leader Amazon accounted for 60% of total U.S. online sales growth last year alone and currently holds about 16% of online apparel and footwear sales.

According to the Department of Commerce, total online spending comprised 7.8% of all retail purchases in the first quarter of 2016, and Forrester reports that more than half the population, or about 190 million U.S. consumers, will shop online this year.

Additionally, mobile devices are increasingly the shopping tool of choice. An annual survey of more than 5,000 online shoppers by United Parcel Service indicates many online purchases are made with smartphones, especially by millennials (63%) and Gen Xers (41%).

Figure 3: Online Shoppers Bought More Than Half of Their Purchases Online



Data as of 2/02/2016.
Source: Fifth Annual UPS Pulse of the Online Shopper Study, United Parcel Service of America, Inc.

Figure 3: For the first time ever, online shoppers bought more than half of their purchases online rather than in brick-and-mortar stores.

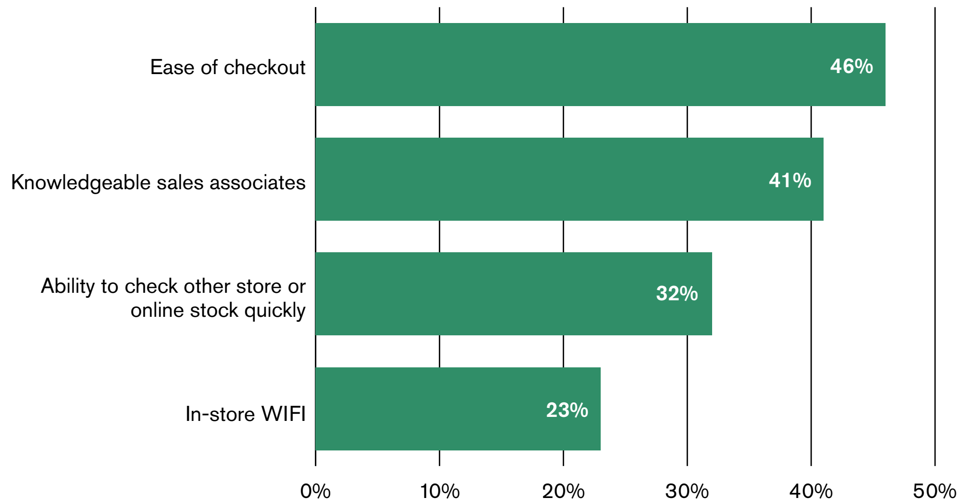
Online Experience Offers Convenience and Price Benefits

According to PwC's *2016 Total Retail Survey*, American shoppers primarily prefer the convenience of online shopping (58%), with low prices coming in second (32%).

To counteract the convenience factor, brick-and-mortar retailers must work that much harder to get shoppers in the door and keep them there. Consumers demand a lifestyle-friendly, in-store experience that makes coming to the store worthwhile. Alternatively, they can simply skip the trip to the store and shop online.

Also ranking high in the PWC survey was human interaction with knowledgeable associates for product queries and checkout. The survey suggests that the big box trend—fewer associates and large inventory for consumers to browse on their own—may be coming full circle to where consumers now seek more information both before and during the purchase journey.

Figure 4: Desirable In-Store Experiences



Data as of 2/01/2016.
Source: PwC, 2016 Total Retail Survey, February 2016

Technology Is Driving the Transformation

Modern retailing draws on numerous technologies, such as mobile commerce, electronic funds transfer, supply chain management, internet marketing, online transaction processing, electronic data interchange (EDI), inventory management systems, and automated data collection systems.

To never lose sales due to empty shelves, retailers such as Walmart, Macy's, Home Depot, Lowe's, Nordstrom and others are investing in technology, hardware, and staff to enable them to sell products held anywhere in their networks to customers visiting a store or shopping online.

Omni-channel shopping is a multichannel approach to sales that seeks to provide the customer with a seamless shopping experience whether the customer is shopping online from a desktop or mobile device, by telephone, or in a brick-and-mortar store. Sophisticated technology drives omni-channel shopping.

Transformation Creates Opportunity for Value Investors

Periods of immense structural transformation in an industry such as retail opens windows of opportunity as well as value traps. The momentous technological and social shifts causing transformation present greater risks than usual. As value investors, we prefer stocks of companies that are temporarily out of favor.

In a transformational situation, we must even more carefully assess the future of a given retailer. Is it adapting to the times? Does it have the financial strength to implement the necessary changes to survive? Will consumers buy into its new way of doing business?

WALMART

Walmart, for example, is an established retailer that is working diligently to adapt to the changing landscape. Better training and compensation for employees, investments in online operations, and updating stores can all potentially drive sales, customer loyalty, and stock appreciation.

The company recently agreed to acquire Jet.com in order to more quickly build out its e-commerce capabilities. Jet markets itself as an online warehouse with “best-in-class” technology and claims to “typically save customers 10-15% from all other available online prices.” Jet gives Walmart improved access to urban and millennial customers. At the time of the acquisition agreement, Jet was adding more than 400,000 users each month.

TARGET

Target’s successful pivot back to its roots as a curator of unique, stylish merchandise that earned it the nickname “Tarjay” will continue to improve the shopping experience at stores that, because of their scale, are already the lowest price providers and therefore better positioned to weather discounting pressure. Additionally, Target is focusing more on existing stores’ productivity, versus adding stores, by investing in its IT and supply chain capabilities, with an emphasis on enhancing its grocery assortment.

LOWE’S

Lowe’s is a specialty retailer that is somewhat insulated from secular trends since consumers generally find it advantageous to physically visit their well-stocked and smartly merchandised stores. Lowe’s also benefits from a cyclical tailwind in which sales are largely driven by consumers’ spending on their homes.

ADVANCE AUTO PARTS

Advance Auto Parts is a company that has struggled to integrate the supply chain of an acquired company that will allow it to better compete in the commercial auto supply space. The integration period has been slower and bumpier than the market would like, and the stock has been penalized as a result. We believe Advance should be able to overcome these challenges, which should lead to improved profit margins and a more consistent performance relative to its peers.

MATTEL

Mattel is a company that is likely to benefit from the disintermediation of retail if the company can selectively leverage new distribution channels to enhance exposure to consumers while being careful not to dilute their brand through over-penetration to discounted channels. As the No. 1 toy and game maker by market share, it should benefit as the internet provides new avenues for reaching customers outside of a traditionally very concentrated retail customer base (Walmart, Target, and Toys “R” Us).

COACH

Coach diluted their brand through over-reliance on the discount outlet/factory channel. However, the company has a very strong brand legacy to fall back on, and new creative designer Stuart Vevers is focused on returning the company’s image to that of a full-price, luxury brand.

We Assess Each Stock on Its Own Merits

Consumers are consistent in that they constantly change their preferences for style and shopping experiences. The process we follow to determine if a stock has unlocked value does not change, regardless of market volatility or macro trends.

Each company is carefully evaluated in a bottom-up approach while also acknowledging long-term, secular trends that may help us determine the winners and the losers. This is especially true in the retail industry.

About American Century Investments

The U.S. Value Equity Team at American Century Investments believes that businesses possessing high-quality attributes whose stock prices are selling at a discount to fair value have the potential to generate superior, risk-adjusted returns. Additionally, we believe that understanding potential risks to these businesses enables us to further mitigate portfolio risk. Portfolio managers utilize a bottom-up approach to identify high-quality companies that may be temporarily undervalued.

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