2 bargain retail stocks

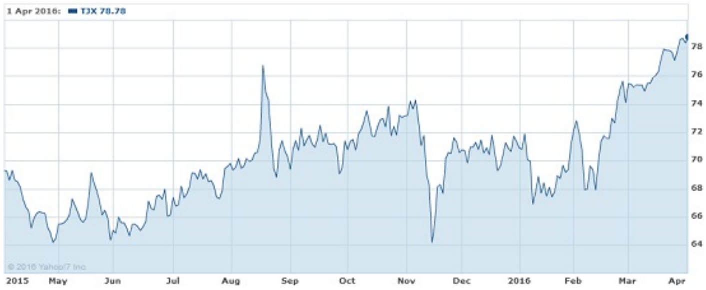
by Christopher Demasi

The life of an American bricks and mortar retailer has been tough going for some time now. But in a niche corner of the market, off-price retailers TJX Companies (NYSE: TJX) and Ross Stores (NASDAQ: ROST) are performing strongly as their unique business model benefits from changes in consumers' habits. And the shares of both companies look very appealing for savvy global investors.

Last year punctuated a challenging environment for traditional retailers in the United States that has persisted for some years now. To begin with, total retail sales for the calendar year 2015 grew just 2.1%, the slowest rate since 2009. At the same time Amazon and other online merchants have relentlessly taken share of the US consumers' wallet by providing a cheaper and more convenient way to shop. Even competition within the space has been white hot. Some of the biggest department store operators – like JC Penney, Sears and Macy's – have permanently shut stores shrinking their networks. Discounting has become mainstream. But something different has been happening at TJX and Ross.

TJX and Ross are the two largest off-price retailers in the US. TJX operates a network of more than 3,600 stores and generated over US$30 billion in sales in the last year. Ross has almost 1,500 stores and turns over about US$12 billion annually. The companies make money from buying out of season and over run stocks from fashion labels and traditional retailers, like the (struggling) department and chain specialty stores, at deeply discounted prices and offering consumers the chance to score great bargains on branded merchandise – the thrill of the bargain hunt if you will. It's a trend that has only been accelerating since the crisis and recession years of 2008 and 2009.

TJX Companies



Source: Yahoo!7 Finance, 4 April 2016

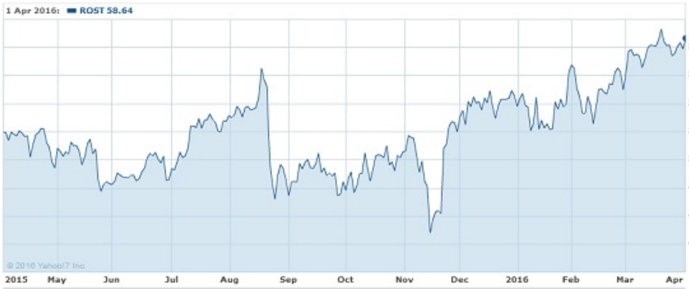
Key to the business model is an organization of savvy merchandisers and low cost structure. Executive buyers at TJX and Ross make opportunistic purchases and make life easy for manufacturers with flexible terms. This enables apparel and products to be sourced at low prices, which can then be passed onto bargain-hungry shoppers. And it's working.

For the past three years, TJX has grown sales at an average rate of 6% each year and Ross has similarly grown at 7% annually.

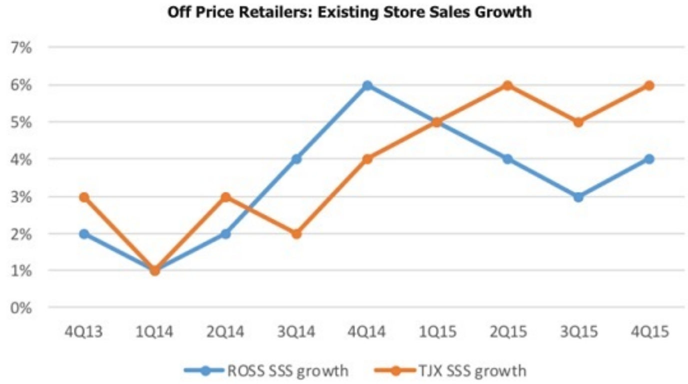
At both companies, the growth has been driven by a strong balance of opening new stores and turning over more merchandise at existing stores.

When bell weather retailers were complaining of the impact of poor weather in the last few months of 2015, TJX and Ross reported year on year growth in sales at existing stores of 6% and 8% respectively. They also increased their collective store base by more than 300 compared to the year prior. And there is still more to come.

Ross Stores



Source: Yahoo!7 Finance, 4 April 2016



TJX and Ross have a wonderful opportunity to continue rolling out new stores in the coming years. While thousands of stores would signal saturation in a small market like Australia – think that David Jones and Myer have around 100 stores combined, and nation-wide retail chains like Harvey Norman and JB Hi-Fi can run 200 to 300 stores – it's just the tip of the iceberg in the United States. Taken together, the off-price giants still represent less than 1% of almost $5 trillion in annual US retail sales.

Importantly, TJX and ROST have demonstrated that they can translate this top line growth into strong profitability for shareholders. Operating margins are currently low teens percentages at both companies. But with limited capital employed, returns on business assets have typically been 60%-plus.

At their current share prices, TJX and Ross trade on trailing PE multiples of around 23x. That may seem expensive at first blush, especially in the context of the broader US equities market, which trades on 19x trailing PE. But after accounting for superior growth prospects and strong returns, these stocks are bargains. Maybe even better than the bargains available to loyal shoppers on the racks and shelves of TJX and Ross across America.

Chris Demasi is a portfolio manager at Montgomery Global Investment Management.

Important: *This content has been prepared without taking account of the objectives, financial situation or needs of any particular individual. It does not constitute formal advice. Consider the appropriateness of the information in regards to your circumstances.*