

# U.S. Hardlines Retail

## 2016 Outlook – Looking Hard and Broad

### Equities

Americas  
Retailers, Broadline

#### How to be positioned in hardlines/broadlines in a potentially challenging 2016

The upcoming year won't be easy for investing in this sector. While these domestically focused co's offer some relative serenity in an otherwise uncertain world, they face their share of adversity. Most notably, the group has typically underperformed as rates have risen. Additionally, real wage growth will be a double-edged sword, likely spurring further gains in spending, but also pressuring expenses for those exposed to low skilled workers. These factors add to the undertone of the shift from shopping at boxes to shopping through devices. Thus, we advocate sticking with the theme of reliability for the next 12 mos. This is what pushed stocks like HD, LOW, & ORLY ahead of others last year. Granted, the spread between those that have produced consistent performances & those that haven't (such as BBBY, SPLS, BBY) widened to an unsustainable level with a 13x PE gap (vs. an average of 5x historically). For those looking to play some reversion to the mean, we suggest DKS & SPLS as the best vehicles in the NT.

#### Our top ideas for this year are DLTR and COST

These retailers offer the most alluring combo of stable business models along w. visible drivers to spur earnings growth. We expect DLTR to make considerable progress w. its FDO integration. We conservatively est. it could see \$500 mm+ in synergies by '18, well in excess of its \$300 mm guidance. COST's switch to Visa could add an incremental 2 mm new members. Further, its shares have historically outperformed leading up to a membership fee hike (expected late CY'16/early CY'17). We like these stocks.



#### RH and FIVE are fallen growth stories that should come back

Both companies saw their forward multiples contract by 30%+ in '15, but we expect them to bounce back as their stories solidify & they outperform EPS expectations. For RH, its real estate transformation will further unfold in '16, contributing to its sales growth w. upside from new concepts like Modern. For FIVE, some of the burden of its investments will lift, enabling its EPS growth to accelerate. Plus, it should show further evidence that it can generate stable SSS & NSP, addressing key points of the debate.

#### We recommend taking a cautious approach with PIR and HGG

Both face pressure from competitive dynamics & awkward competitive positioning. HF promo intensity and the shift to its eComm channel should weigh on PIR. HGG's strategies haven't produced any real progress and we don't expect them to in '16.

Figure 1: Summary of our price target changes, earnings estimates

	Company	Ticker	Price 7-Jan	UBS Rating	New Price Target	Old Price Target	Target Justification	CY'15E Current EPS	CY'16E Current EPS	CY'17E Current EPS
	<b>Hardlines Coverage Universe</b>									
	Dollar Tree	DLTR	\$78.45	Buy	\$92	\$88	19x CY'17 EPS	\$2.42	\$3.85	\$4.90
	Costco	COST	\$154.82	Buy	\$180	\$180	27x CY'17 EPS	\$5.33	\$5.95	\$6.78
	Restoration Hardware	RH	\$72.66	Buy	\$105	\$115	21x CY'17 EPS	\$3.15	\$3.95	\$4.95
	Five Below	FIVE	\$33.72	Buy	\$40	\$39	24x CY'17 EPS	\$1.05	\$1.33	\$1.66
	Lowe's	LOW	\$72.07	Buy	\$84	\$82	18x CY'17 EPS	\$3.29	\$4.00	\$4.75
	Home Depot	HD	\$125.40	Buy	\$145	\$140	21x CY'17 EPS	\$5.37	\$6.20	\$6.95
	Tractor Supply	TSCO	\$82.48	Buy	\$99	\$99	25x CY'17 EPS	\$3.09	\$3.60	\$4.02
	O'Reilly Automotive	ORLY	\$240.17	Buy	\$285	\$300	25x CY'17 EPS	\$9.12	\$10.12	\$11.38
	Advance Auto Parts	AAP	\$148.83	Buy	\$180	\$190	17x CY'17 EPS	\$7.82	\$9.15	\$10.40
	Dollar General	DG	\$71.84	Buy	\$82	\$78	16x CY'17 EPS	\$3.93	\$4.43	\$5.00
	Dick's Sporting Goods	DKS	\$35.83	Buy	\$42	\$43	12x CY'17 EPS	\$2.90	\$3.10	\$3.50
	Staples	SPLS	\$9.83	Buy	\$14	\$14	14x CY'17 EPS	\$0.92	\$0.95	\$0.97
	AutoZone	AZO	\$735.96	Neutral	\$825	\$825	18x CY'17 EPS	\$37.04	\$42.18	\$46.30
	Mattress Firm	MFRM	\$41.81	Neutral	\$46	\$57	13x CY'17 EPS	\$2.01	\$2.85	\$3.50
	Target	TGT	\$73.88	Neutral	\$75	\$75	13x CY'17 EPS	\$4.70	\$5.31	\$5.92
	Best Buy	BBY	\$30.23	Neutral	\$33	\$33	11x CY'17 EPS	\$2.60	\$2.89	\$3.09
	Walmart	WMT	\$65.03	Neutral	\$64	\$64	15x CY'17 EPS	\$4.57	\$4.05	\$4.24
	Williams-Sonoma	WSM	\$56.49	Neutral	\$70	\$70	17x CY'17 EPS	\$3.42	\$3.85	\$4.23
	Office Depot	ODP	\$5.65	Neutral	\$6	\$6	10x CY'17 EPS	\$0.46	\$0.98	\$0.61
	Bed Bath & Beyond	BBBY	\$46.51	Neutral	\$52	\$64	9x CY'17 EPS	\$4.99	\$5.18	\$5.74
	PIR 1 Imports	PIR	\$4.70	Sell	\$4.50	\$5.00	10x CY'17 EPS	\$0.43	\$0.45	\$0.47
	hbgagg	HGG	\$2.50	Sell	\$3.30	\$3.30	4.8x CY'17 EBITDA	-\$1.16	-\$0.80	-\$0.55

Source: FactSet, Company Reports UBS estimates

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# Summary

While generating superior investment returns in the hardline / broadline retail space is never easy, we think it will be particularly challenging in 2016. The perils grow greater moving this far into the economic cycle (not that it was easy in the early stages of the recovery). Many of the themes from prior years have played out like chasing higher beta names, sticking with a barbell approach of owning the low end and the high end, and riding the housing recovery wave. The most recent trend of focusing on the retailers that can produce the most reliable growth still has legs in our view (including LOW, HD, and ORLY). Yet, returns can be enhanced by finding the stocks who are nearing inflection of moving into or out of the reliable growth category (a name like DG fits this bill). Valuation probably starts to matter more this year as it didn't last year for those with big multiples or for those with far less demanding ones. Some reversion to the mean between these buckets could push SPLS and DKS higher. Overall, we think the best way to play the space this year is to be nimble, picking and choosing spots.

**Figure 2: UBS Hardlines Universe**

Company	Ticker	Price 7-Jan	UBS Rating	Price Target	Implied Price Change	Target Justification	Market Cap.	Enterprise Value	Enterprise Value / '15E Revs	EV/ EBITDA			P/E Multiple**			Dividend Yield
UBS Hardlines Coverage Universe																
Home Depot	HD	\$125.40	Buy	\$145	16%	21x CY'17 EPS	\$159,760	\$177,582	2.0x	13.1x	11.7x	11.0x	23.3x	20.2x	18.0x	1.8%
Low e's	LOW	\$72.07	Buy	\$84	17%	18x CY'17 EPS	66,376	77,590	1.3x	11.0x	9.8x	8.9x	21.9x	18.0x	15.2x	1.5%
Bed Bath & Beyond	BBBY	\$46.51	Neutral	\$52	12%	9x CY'17 EPS	7,750	8,483	0.7x	5.1x	5.4x	5.5x	9.3x	9.0x	8.1x	-
Williams-Sonoma	WSM	\$56.49	Neutral	\$70	24%	17x CY'17 EPS	5,186	5,314	1.1x	7.8x	7.2x	6.8x	16.5x	14.7x	13.4x	2.4%
Best Buy	BBY	\$30.23	Neutral	\$33	9%	11x CY'17 EPS	10,550	8,818	0.2x	4.1x	3.9x	3.8x	11.6x	10.5x	9.8x	2.9%
hhgregg	HGG	\$2.50	Sell	\$3.30	32%	4.8x CY'17 EBITDA	69	59	0.0x	21.7x	6.0x	3.5x	-2.2x	-3.1x	-4.6x	-
AutoZone	AZO	\$735.96	Neutral	\$825	12%	18x CY'17 EPS	22,916	27,505	2.7x	12.2x	11.7x	11.3x	19.9x	17.4x	15.9x	-
Advance Auto Parts	AAP	\$148.83	Buy	\$180	21%	17x CY'17 EPS	10,978	12,166	1.2x	9.6x	8.5x	7.9x	19.0x	16.3x	14.3x	0.2%
O'Reilly Automotive	ORLY	\$240.17	Buy	\$285	19%	25x CY'17 EPS	24,202	25,322	3.2x	14.8x	13.2x	12.3x	26.3x	23.7x	21.1x	-
Staples	SPLS	\$9.83	Buy	\$14	42%	14x CY'17 EPS	6,350	6,603	0.3x	4.8x	4.7x	4.6x	10.7x	10.4x	10.1x	4.9%
Office Depot	ODP	\$5.65	Neutral	\$6	6%	10x CY'17 EPS	3,096	2,837	0.2x	3.6x	3.3x	3.1x	12.4x	9.8x	9.3x	-
Dick's Sporting Goods	DKS	\$35.83	Buy	\$42	17%	12x CY'17 EPS	4,174	4,449	0.6x	6.0x	5.8x	5.4x	12.4x	11.6x	10.2x	1.5%
Mattress Firm	MFRM	\$41.81	Neutral	\$46	10%	13x CY'17 EPS	1,486	2,173	0.9x	10.0x	8.0x	7.0x	20.8x	14.7x	11.9x	-
Five Below	FIVE	\$33.72	Buy	\$40	19%	24x CY'17 EPS	1,849	1,831	2.2x	15.9x	12.7x	10.2x	32.0x	25.4x	20.3x	-
Tractor Supply	TSKO	\$82.48	Buy	\$99	20%	25x CY'17 EPS	11,333	11,483	1.8x	14.4x	12.8x	11.8x	26.7x	22.9x	20.5x	0.9%
Dollar General	DG	\$71.84	Buy	\$82	14%	16x CY'17 EPS	21,042	23,981	1.2x	10.5x	9.8x	9.1x	18.3x	16.2x	14.4x	1.2%
Dollar Tree	DLTR	\$78.45	Buy	\$92	17%	19x CY'17 EPS	16,890	23,936	1.5x	15.0x	9.6x	8.2x	32.4x	20.4x	16.0x	-
Costco	COST	\$154.82	Buy	\$180	16%	27x CY'17 EPS	68,335	69,407	0.6x	14.3x	12.9x	11.6x	29.0x	26.0x	22.8x	1.0%
Target	TGT	\$73.88	Neutral	\$75	2%	13x CY'17 EPS	46,456	57,255	0.8x	8.4x	7.8x	7.4x	15.7x	13.9x	12.5x	2.9%
Walmart	WMT	\$65.03	Neutral	\$64	-2%	15x CY'17 EPS	209,332	249,844	0.5x	7.2x	7.8x	7.6x	14.2x	16.0x	15.4x	3.0%
Restoration Hardw are	RH	\$72.66	Buy	\$105	45%	21x CY'17 EPS	3,082	3,207	1.5x	11.4x	9.1x	7.5x	23.0x	18.4x	14.7x	-
Pier 1 Imports	PIR	\$4.70	Sell	\$4.50	-4%	10x CY'17 EPS	396	552	0.3x	4.5x	4.2x	4.2x	10.9x	10.5x	10.0x	6.0%

Source: Company Reports, Factset, UBS Estimates

The hardline retail sector experienced a difficult 2015 with the average stock returning -14%. The second half of 2015 was especially weak as slowing comp growth, unseasonably warm weather, and the generally difficult retail environment took its toll on stock prices and forward multiples. For the year, the average company in this group witnessed a -27.5% decline in its forward EPS multiple, despite a 9.8% gain in the consensus forward EPS estimate. However the decline was not necessarily broad-based as the multiple gap between the higher quality and lower quality names increased materially during 2015. However, this year, we expect the multiples to converge a bit as risk appetites rise and investors look for value on some of the heavily beaten down names.

**Figure 3: The hardline retail sector's forward PE declined by -27% in 2015**

YoY Change	2005		2006		2007		2008		2009		2010		2011		2012		2013		2014		2015	
	NTM PE	NTM EPS	NTM PE	NTM EPS	NTM PE	NTM EPS	NTM PE	NTM EPS	NTM PE	NTM EPS	NTM PE	NTM EPS	NTM PE	NTM EPS	NTM PE	NTM EPS	NTM PE	NTM EPS	NTM PE	NTM EPS	NTM PE	NTM EPS
DG											-4.1%	42.6%	7.5%	24.7%	-12.4%	22.3%	20.4%	13.7%	9.5%	7.1%	-9.4%	12.2%
DLTR	-12.6%	-4.8%	12.3%	11.9%	-26.9%	17.8%	37.8%	16.7%	-16.6%	38.9%	21.3%	43.6%	14.9%	29.0%	-17.9%	18.9%	19.3%	16.6%	15.0%	8.5%	5.0%	4.5%
DKS	-6.0%	0.6%	11.8%	31.9%	-12.4%	29.3%	-28.5%	-28.9%	52.3%	15.7%	4.8%	43.9%	-23.7%	28.9%	-0.4%	23.9%	20.5%	6.0%	-17.1%	3.1%	-30.8%	2.8%
FIVE																	-2.0%	37.6%	-20.0%	18.1%	-31.8%	15.3%
AAP	17.5%	27.0%	-17.5%	-0.8%	-1.9%	8.9%	-13.4%	2.2%	1.2%	18.9%	16.4%	40.4%	-12.9%	20.9%	3.3%	0.5%	23.4%	24.0%	14.6%	25.6%	-11.1%	6.3%
LOW	-2.7%	19.0%	-10.1%	3.9%	-20.2%	-9.0%	29.2%	-26.4%	10.6%	-1.7%	-11.9%	21.7%	-6.6%	8.3%	20.6%	16.1%	9.6%	27.3%	12.5%	23.4%	-9.0%	21.5%
HD	-19.7%	17.9%	1.8%	-2.6%	-18.7%	-17.5%	39.1%	-38.5%	11.0%	13.2%	-8.3%	32.2%	-1.5%	21.8%	15.7%	27.2%	4.5%	27.3%	7.9%	18.2%	6.6%	18.1%
ORLY	14.4%	24.2%	-12.0%	13.8%	-7.5%	9.4%	2.6%	-7.6%	-12.7%	42.1%	19.4%	32.7%	4.7%	26.4%	-10.4%	24.8%	16.2%	23.9%	21.4%	23.3%	5.3%	24.9%
TSCO	15.7%	22.9%	-26.7%	15.3%	-21.9%	2.9%	2.0%	-1.4%	23.3%	18.8%	20.1%	52.4%	7.0%	35.2%	-2.4%	29.0%	43.4%	22.5%	-10.2%	13.1%	-8.5%	18.5%
MFRM																	57.0%	11.8%	6.8%	26.4%	-28.2%	7.0%
COST	-6.2%	8.9%	-5.0%	12.5%	13.7%	16.0%	-24.3%	-0.6%	17.5%	-4.1%	4.7%	16.5%	-0.5%	16.0%	2.5%	15.6%	11.2%	8.4%	12.6%	5.8%	6.0%	7.5%
WMT	-19.4%	9.9%	-7.9%	7.1%	-4.1%	7.3%	8.9%	8.3%	-10.3%	6.3%	-10.2%	12.4%	0.6%	10.2%	4.0%	9.8%	10.0%	4.9%	17.1%	-6.8%	-11.4%	-19.5%
ODP	39.0%	30.1%	-18.3%	48.8%	-39.8%	-39.5%	208.5%	-93.1%	-186.6%	-350.0%	-399.0%	-128.0%	-65.2%	14.3%	22.0%	25.0%	-38.0%	160.0%	-8.4%	76.9%	-45.5%	20.7%
SPLS	-11.5%	14.2%	-1.2%	19.1%	-21.1%	9.6%	-12.0%	-11.7%	41.9%	-3.3%	-17.5%	12.2%	-36.7%	-3.7%	-13.7%	-4.9%	50.5%	-7.4%	54.8%	-26.3%	-45.0%	-4.9%
AZO	-3.0%	3.6%	13.1%	11.3%	-9.6%	14.7%	4.9%	10.9%	-9.8%	25.7%	29.0%	33.7%	-6.7%	27.8%	-8.5%	19.2%	19.0%	13.3%	13.7%	14.0%	5.5%	13.6%
WSM	6.7%	15.4%	-20.3%	-8.6%	-19.1%	1.8%	457.1%	-94.6%	-64.3%	639.7%	-31.1%	149.1%	-13.8%	25.1%	1.9%	11.5%	17.9%	12.9%	14.8%	13.1%	-27.7%	6.7%
TGT	-11.3%	19.3%	-10.8%	16.4%	-18.5%	7.5%	-5.8%	-26.7%	11.4%	25.8%	0.2%	24.1%	-14.2%	-0.7%	3.7%	11.4%	13.9%	-6.1%	43.5%	-16.4%	-29.6%	35.9%
BBY	0.8%	8.9%	-11.6%	28.0%	-7.7%	16.0%	-18.4%	-34.6%	1.1%	38.9%	-21.0%	10.0%	-33.8%	2.9%	-13.6%	-41.3%	160.7%	29.1%	3.6%	-5.7%	-27.1%	7.1%
BBBY	-21.6%	15.8%	-6.7%	12.9%	-22.2%	-0.8%	24.8%	-30.7%	17.4%	29.4%	-11.6%	44.1%	-14.7%	38.3%	-17.0%	16.2%	29.6%	10.8%	-3.0%	-2.2%	-35.1%	-2.4%
RH																	18.7%	68.0%	3.7%	37.6%	-37.3%	32.1%
HGG							-4.6%	-33.9%	66.7%	52.2%	-29.0%	33.9%	-24.5%	-8.6%	-27.6%	-32.9%	112.6%	-6.4%	-166.8%	-181.1%	-57.3%	13.1%
PIR	160.7%	-83.0%	-114.3%	-577.3%	105.1%	-57.1%	-96.5%	103.6%			-87.3%		-5.4%	40.2%	5.4%	36.3%	7.3%	7.5%	-10.5%	-25.4%	-29.2%	-53.3%
Median	-4.5%	15.6%	-9.0%	12.7%	-18.6%	8.2%	2.6%	-26.4%	10.6%	18.9%	-6.2%	33.2%	-9.8%	21.3%	-1.4%	16.1%	19.0%	13.7%	9.5%	13.1%	-27.4%	9.8%
S&P 500	-10.2%	14.7%	-0.2%	13.8%	-4.6%	8.5%	-12.8%	-29.5%	13.1%	9.2%	-7.5%	21.9%	-9.6%	10.6%	7.6%	5.4%	19.5%	8.4%	2.9%	8.2%	-1.6%	0.9%

The hardline sector has seen significantly higher multiple compression than the S&P, despite superior EPS growth

Source: Company Reports, Factset, UBS Estimates

- **As for specific stocks, our top idea for 2016 is Dollar Tree.** We think merger synergies, combined with a favorable macro backdrop should drive 20% EPS growth. DLTR should make process on its integration, closing the productivity gap between Family Dollar and DG. We conservatively think it can generate over \$500 million in synergies over three years, which is considerably higher than the \$300 million company guidance. At the same time, the core business should demonstrate solid, stable growth.
- **Costco is positioned to benefit from several key catalysts.** While Costco has been a consistently high performer for years, we think it is poised to benefit from several factors that many are underestimating. First, we estimate its planned switch to Visa in April can generate \$0.14/share in savings in CY'16. In addition, our Evidence Lab work suggests that by switching to the more popular Visa platform, COST can add an incremental ~2 mm members and ~\$4 bn in annual sales. When also considering the stock's historic outperformance in the year leading up to a membership fee hike (which is likely to occur in late CY'16 or early CY'17), we think now is a very attractive time to buy shares.
- **Restoration Hardware's ambitious transformation is gaining steam.** We believe many investors are underestimating the potential of the company's highly visible store growth prospects, as well as its ability to carve out a niche in the fragmented high-end home furnishings industry. When coupled with strong early results from its RH Modern rollout, we believe the retailer is poised for 25%+ EPS growth for the next few years.
- **We expect Five Below to reaccelerate and continue to mature as a retailer.** FIVE has somewhat fallen into the bucket of a growth story that is currently out of favor. We think it should rebound in '16 with 25%+ EPS growth and a more robust trajectory. The company has faltered in recent fourth quarters when it generates ~80% of its annual EPS. However, its early sales results for the first 9 weeks were encouraging, and we think the company

is poised to break out of this pattern in 4Q'15 as it refines its TV advertising and offers more compelling values. Despite 20% expected square footage growth, new stores should see near 100% productivity. Further, the company will likely grow its operating margin as it laps investments in '15 related to TV advertising and its new distribution center, as well as continues to gain purchasing scale.

- **The Home Improvement vertical including Lowe's and Home Depot should continue to excel in the upcoming year.** Even though the category is especially vulnerable to rising interest rates, we think LOW and HD should grow their earnings enough to offset any multiple contraction. GDP is set to continue to grow, home prices should appreciate, while wages are set to rise. Plus, the retailers should pick up market share with the DIY customer, while accumulating share with the professional segment. LOW has made a number of investments over the last few years related to merchandising, labor, and omni-channel which should bear fruit this year. Further, HD's acquisition of Interline Brand provides a new set of customers to cross-sell its products and services. We think these stocks will perform well despite a potentially tricky environment.
- **We think Tractor Supply should have another strong year.** Its solid comp sales growth should be sustained into the new year, especially if it's able to sidestep weather obstacles. Plus, we think the impact from deflation should lessen over the course of the year or even benefit average ticket. With further margin expansion expected and a generous capital allocation policy, TSCO is well positioned for further earnings growth in '16.
- **Favorable industry tailwinds and best in class execution should again support O'Reilly Automotive.** Though AAP and AZO are both investing heavily in ramping up their store replenishment capabilities, ORLY's superior distribution network should allow it to maintain an edge in product delivery speed in the coming year. With favorable macro tailwinds such as low fuel prices and higher vehicle miles traveled expected to continue, we expect the retailer to enjoy low to mid single digit comp growth on difficult compares and double digit EPS growth in '16. In our view, ORLY's impressive earnings algorithm and strong free cash flow generation continue to warrant a premium valuation for the retailer.
- **Advance Auto Parts should benefit from its unique situation.** Though AAP's merger integration process has been taking a bit longer than anticipated, we still think it has the right assets in place to work. We expect sales growth to be modest (0.5% comp in CY'16), but its long term path to enhanced profitability remains in play and its recent employment initiatives should help the company reach an 11.7% operating margin, which is below its 12.0% goal but 20 bps above the consensus. Having a prominent activist investor on board should help further align the company's incentives with shareholders as it goes about its new CEO search. Finally, media reports suggest AAP has been approached by at least one competitor. This provides another potential path to shareholder gains for AAP.
- **We expect solid performance from Dollar General.** Despite concerns that it may not be able to consistently comp in the MSD range, we believe its earnings algorithm can still work. Instead, it will accelerate store openings and we think this should position it to take advantage of any disruption at Family Dollar. Since its acquisition of Family Dollar fell through, DG has been aggressively

repurchasing shares and we expect it to reduce its share count by -5% in '16. These factors, plus a relatively inexpensive valuation of 14x CY'17 earnings, present a favorable risk/reward.

- **We think Dick's Sporting Goods has an attractive risk/reward setup at current levels.** With the retailer trading at just 10x our CY'17 estimates, we believe the upside opportunity from store growth, private label lines such as CALIA, and its pending Jan 2017 re-launch of its website remain strong. These factors outweigh any lingering concerns about disintermediation or operational risks from operating too many banners at once. Further, DKS is seeing some signs of stability in its golf business and could see a boost in gun sales given the evolving political climate.
- **Staples is well positioned, even if the merger doesn't go through.** With an ODP deal looking less likely, we expect SPLS to accelerate its store closures and ramp up share repurchases. Further, while the company's proposed merger with ODP is looking less likely after the FTC's initial move to block the deal, there is still the chance for further upside should the courts approve the deal.
- **Pier 1 will continue to face margin pressure as its customers shift to its online channel.** PIR remains in a difficult situation. Its market position is being squeezed as emerging competitors offer products that are either less costly or higher quality. Meanwhile, we expect most of its online channel growth to continue to come from existing customers shifting over to the less profitable medium. With these factors unlikely to change any time soon, we remain cautious on the name.
- **Competitive pressures should weigh on hhgregg.** We think HGG will have a tough time to considerably improve on its weak performances. It will probably continue to lose share to online-only players and BBY, which has a larger brick and mortar footprint. Even if it can stabilize its sales, it would probably still see deleverage, which would limit flowthrough. While the company is cutting expenses through reducing advertising spend and reducing payroll, it may impact the customer experience. We recommend a cautious approach with its shares.

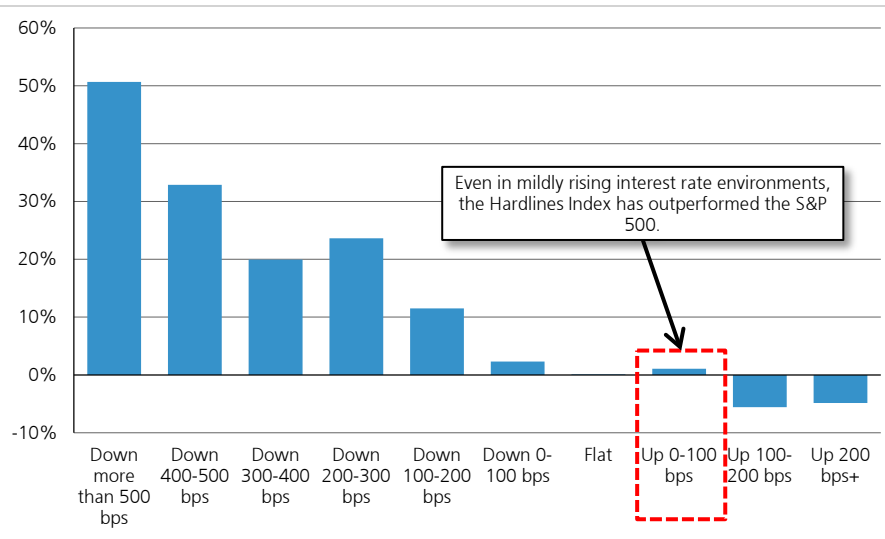
To better gauge the risk/reward for the stocks in the hardline sector, we think it is useful to look at our price targets over a range of assumptions:

Figure 4: Hardline universe price target sensitivity analysis

	Comp			Revenue Growth			Op. Margin Change (YoY bps)			Operating Margin			EPS			EPS Multiple			Projected Share Price			Potential Upside / Downside (Total Return)		
	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E
Home Depot	Recent Price:																		\$125.40					
Base Case	4.9%	4.0%	4.0%	6%	7%	4%	76	47	47	13.3%	13.8%	14.3%	\$5.37	\$6.20	\$6.95	27x	23x	21x	\$145	\$145	\$145	17%	18%	18%
High Case	5.5%	5.5%	5.5%	6%	8%	6%	95	105	105	13.5%	14.6%	15.6%	\$5.49	\$6.70	\$7.93	32x	26x	22x	\$176	\$174	\$174	42%	41%	41%
Low Case	3.8%	1.0%	1.0%	5%	4%	1%	55	30	10	13.1%	13.4%	13.5%	\$5.22	\$5.76	\$6.10	21x	19x	18x	\$110	\$109	\$110	-11%	-11%	-10%
Lowe's	Recent Price:																		\$72.07					
Base Case	4.4%	3.5%	3.5%	5%	4%	4%	80	88	71	9.3%	10.2%	10.9%	\$3.29	\$4.00	\$4.75	26x	21x	18x	\$84	\$84	\$84	18%	18%	18%
High Case	5.0%	5.0%	5.0%	5%	6%	6%	90	115	110	9.4%	10.6%	11.7%	\$3.35	\$4.25	\$5.30	30x	24x	19x	\$101	\$102	\$101	41%	43%	41%
Low Case	4.0%	1.0%	1.0%	4%	2%	2%	70	40	30	9.2%	9.6%	9.9%	\$3.24	\$3.64	\$4.04	20x	18x	16x	\$65	\$65	\$65	-9%	-8%	-9%
Best Buy	Recent Price:																		\$30.23					
Base Case	1.2%	0.6%	0.5%	-2%	1%	1%	8	24	10	3.8%	4.0%	4.1%	\$2.61	\$2.89	\$3.09	13x	11x	11x	\$33	\$33	\$33	12%	12%	12%
High Case	3.0%	2.0%	2.0%	0%	2%	2%	30	75	45	4.0%	4.8%	5.2%	\$2.82	\$3.55	\$4.10	17x	14x	12x	\$48	\$50	\$49	62%	67%	66%
Low Case	-1.0%	-1.5%	-1.5%	-4%	-2%	-1%	(20)	(15)	(10)	3.5%	3.4%	3.3%	\$2.35	\$2.28	\$2.26	7x	7x	7x	\$16	\$16	\$16	-43%	-44%	-45%
Bed Bath & Beyond	Recent Price:																		\$46.51					
Base Case	0.9%	1.5%	2.0%	2%	2%	3%	(166)	(85)	(60)	11.4%	10.6%	10.0%	\$4.99	\$5.18	\$5.74	10x	10x	9x	\$52	\$52	\$52	12%	12%	12%
High Case	1.0%	3.0%	3.5%	2%	4%	5%	(75)	(50)	(30)	12.3%	11.8%	11.5%	\$5.43	\$5.94	\$6.92	13x	12x	10x	\$71	\$71	\$69	52%	53%	49%
Low Case	-1.0%	-1.0%	-1.0%	0%	0%	0%	(150)	(200)	(150)	11.6%	9.6%	8.1%	\$4.97	\$4.45	\$4.22	5x	6x	6x	\$25	\$27	\$25	-47%	-43%	-46%
Williams-Sonoma	Recent Price:																		\$56.49					
Base Case	2.9%	2.0%	1.0%	6%	6%	4%	(46)	47	15	10.1%	10.5%	10.7%	\$3.42	\$3.85	\$4.23	20x	18x	17x	\$70	\$70	\$70	26%	26%	26%
High Case	4.0%	3.5%	2.5%	8%	7%	6%	(30)	75	45	10.2%	11.0%	11.4%	\$3.51	\$4.11	\$4.70	24x	20x	18x	\$84	\$82	\$85	52%	48%	52%
Low Case	0.0%	0.0%	-0.5%	4%	4%	4%	(60)	15	(20)	9.9%	10.1%	10.1%	\$3.28	\$3.51	\$3.67	18x	17x	13x	\$59	\$60	\$48	7%	8%	8%
Dick's Sporting Goods	Recent Price:																		\$35.83					
Base Case	0.1%	1.5%	1.5%	7%	8%	6%	(67)	(39)	10	7.5%	7.2%	7.3%	\$2.90	\$3.10	\$3.50	14x	14x	12x	\$42	\$42	\$42	19%	19%	19%
High Case	1.0%	3.0%	3.0%	8%	9%	8%	(50)	35	40	7.7%	8.1%	8.5%	\$2.99	\$3.57	\$4.22	18x	15x	13x	\$54	\$54	\$55	52%	51%	55%
Low Case	-1.5%	-1.0%	-1.0%	6%	5%	4%	(90)	(100)	(5)	7.3%	6.3%	6.3%	\$2.77	\$2.63	\$2.84	11x	11x	10x	\$30	\$29	\$28	-13%	-18%	-19%
O'Reilly Automotive, Inc.	Recent Price:																		\$240.17					
Base Case	6.6%	3.5%	3.0%	9%	6%	5%	147	50	50	19.1%	19.6%	20.1%	\$9.13	\$10.12	\$11.38	31x	28x	25x	\$285	\$285	\$285	19%	19%	19%
High Case	7.5%	5.0%	4.5%	10%	7%	7%	175	80	80	19.4%	20.2%	21.0%	\$9.34	\$10.67	\$12.34	39x	34x	30x	\$364	\$363	\$370	52%	51%	54%
Low Case	4.0%	1.0%	0.5%	7%	3%	3%	80	30	30	18.4%	18.7%	19.0%	\$8.58	\$9.18	\$9.98	28x	26x	24x	\$240	\$239	\$240	0%	-1%	0%
AutoZone	Recent Price:																		\$735.96					
Base Case	3.5%	2.9%	2.5%	7%	5%	4%	(2)	(20)	(8)	19.2%	19.0%	19.0%	\$37.04	\$42.18	\$46.30	22x	20x	18x	\$825	\$825	\$825	12%	12%	12%
High Case	4.0%	4.0%	4.0%	7%	6%	6%	10	(10)	0	19.2%	19.1%	19.1%	\$37.20	\$43.08	\$48.23	23x	20x	18x	\$856	\$862	\$868	16%	17%	18%
Low Case	0.5%	0.0%	0.0%	4%	2%	2%	(25)	(25)	(25)	16.6%	16.3%	16.1%	\$39.74	\$43.69	\$46.14	18x	16x	15x	\$695	\$699	\$692	-6%	-5%	-6%
Advance Auto Parts	Recent Price:																		\$148.83					
Base Case	0.5%	0.5%	1.3%	-1%	0%	2%	28	152	65	10.2%	11.7%	12.4%	\$7.82	\$9.15	\$10.40	23x	20x	17x	\$180	\$180	\$180	21%	21%	21%
High Case	1.0%	4.0%	3.5%	0%	3%	4%	50	175	80	10.4%	12.2%	13.0%	\$8.05	\$9.93	\$11.64	26x	21x	18x	\$209	\$209	\$210	41%	40%	41%
Low Case	-1.0%	-2.0%	-1.0%	-2%	-3%	0%	10	80	40	10.0%	10.8%	11.2%	\$7.55	\$8.07	\$8.80	20x	18x	16x	\$151	\$145	\$141	2%	-2%	-5%
Five Below	Recent Price:																		\$33.72					
Base Case	3.6%	3.0%	3.0%	22%	21%	21%	(17)	47	45	11.3%	11.8%	12.2%	\$1.05	\$1.33	\$1.66	38x	30x	24x	\$40	\$40	\$40	19%	19%	19%
High Case	4.0%	5.5%	5.5%	22%	24%	23%	0	75	75	11.4%	12.2%	12.9%	\$1.07	\$1.41	\$1.84	44x	33x	26x	\$47	\$47	\$48	40%	38%	42%
Low Case	1.5%	1.5%	1.5%	20%	20%	19%	(35)	25	20	11.1%	11.3%	11.5%	\$1.02	\$1.24	\$1.51	25x	20x	17x	\$25	\$25	\$26	-25%	-26%	-24%
Tractor Supply	Recent Price:																		\$82.48					
Base Case	4.3%	3.5%	3.5%	10%	11%	6%	37	26	33	10.7%	10.9%	11.3%	\$3.09	\$3.60	\$4.02	32x	27x	25x	\$99	\$99	\$99	21%	21%	21%
High Case	5.0%	6.5%	6.5%	11%	14%	9%	50	75	80	10.8%	11.6%	12.4%	\$3.15	\$3.94	\$4.69	39x	31x	26x	\$123	\$122	\$122	50%	49%	49%
Low Case	2.0%	1.5%	1.5%	8%	9%	4%	20	30	35	10.5%	10.8%	11.2%	\$2.98	\$3.42	\$3.76	24x	21x	19x	\$72	\$72	\$71	-12%	-12%	-13%
Dollar General	Recent Price:																		\$71.84					
Base Case	2.8%	2.5%	2.5%	8%	8%	8%	4	(10)	(5)	9.5%	9.4%	9.3%	\$3.93	\$4.43	\$5.00	21x	19x	16x	\$82	\$82	\$82	14%	15%	15%
High Case	3.0%	4.0%	4.0%	8%	9%	9%	15	40	40	9.6%	10.0%	10.4%	\$3.99	\$4.81	\$5.77	24x	20x	17x	\$96	\$96	\$98	33%	35%	38%
Low Case	2.5%	2.0%	1.0%	7%	7%	6%	(5)	0	(20)	9.4%	9.4%	9.2%	\$3.88	\$4.40	\$4.81	15x	13x	12x	\$58	\$57	\$58	-19%	-19%	-18%
Dollar Tree	Recent Price:																		\$78.45					
Base Case	2.6%	2.5%	3.5%	81%	34%	7%	(521)	160	115	7.2%	8.8%	10.0%	\$2.42	\$3.85	\$4.90	38x	24x	19x	\$92	\$92	\$92	17%	17%	17%
High Case	3.0%	4.0%	5.0%	81%	35%	8%	(450)	250	150	8.6%	11.1%	12.6%	\$3.02	\$5.19	\$6.65	44x	26x	20x	\$133	\$135	\$133	69%	72%	70%
Low Case	2.0%	1.0%	1.5%	80%	33%	5%	(550)	100	75	6.9%	7.9%	8.7%	\$2.33	\$3.37	\$4.07	26x	18x	15x	\$61	\$61	\$61	-23%	-23%	-22%
Costco	Recent Price:																		\$154.82					
Base Case	-0.3%	3.3%	5.4%	2%	8%	9%	12	11	12	3.1%	3.2%	3.4%	\$5.33	\$5.95	\$6.78	34x	30x	27x	\$180	\$180	\$180	20%	17%	18%
High Case	0.0%	6.0%	7.0%	2%	10%	10%	20	30	20	3.2%	3.5%	3.7%	\$5.42	\$6.66	\$7.82	40x	33x	28x	\$217	\$220	\$219	44%	43%	43%
Low Case	-0.5%	1.0%	1.0%	2%	5%	4%	0	(5)	(5)	3.0%	3.0%	2.9%	\$5.05	\$5.31	\$5.47	26x	25x	25x	\$131	\$133	\$137	-11%	-13%	-10%
Target	Recent Price:																		\$73.88					
Base Case	2.0%	1.5%	1.5%	2%	2%	2%	52	63	7	7.0%	7.6%	7.7%	\$4.70	\$5.31	\$5.92	16x	14x	13x	\$75	\$75	\$75	4%	5%	5%
High Case	2.5%	3.0%	3.0%	3%	4%	4%	65	80	30	7.2%	8.0%	8.3%	\$4.65	\$5.82	\$6.78	20x	16x	14x	\$93	\$93	\$95	29%	29%	32%
Low Case	1.0%	0.0%	0.0%	1%	1%	1%	40	20	(15)	6.9%	6.9%	6.9%	\$4.63	\$4.97	\$5.39	14x	13x	12x	\$65	\$65	\$65	-9%	-9%	-9%
Wal-Mart Stores	Recent Price:																		\$65.03					
Base Case	1.3%	1.5%	2.0%	0%	3%	3%	(44)	(69)	(4)	5.2%	4.5%	4.4%	\$4.57	\$4.05	\$4.24	14x	16x	15x	\$64	\$64	\$64	1%	1%	2%
High Case	1.8%	3.0%	3.0%	0%	4%	4%	(35)	(60)	5	5.2%	4.6%	4.7%	\$4.69	\$4.33	\$4.68	18x	19x	18x	\$84	\$82	\$84	33%	30%	33%
Low Case	0.8%	0.0%	1.0%	-1%	1%	2%	(60)	(90)	(10)	5.0%	4.1%	4.0%	\$4.38	\$3.58	\$3.62	11x	13x	13x	\$48	\$46	\$47	-23%	-25%	-24%
Restoration Hardware	Recent Price:																		\$72.66					
Base Case	14.9%	8.0%	6.5%	17%	20%	18%	141	55	48	10.7%	11.2%	11.7%	\$3.15	\$3.95	\$4.95	33x	27x	21x	\$105	\$105	\$105	45%	45%	45%
High Case	16.0%	12.0%	8.0%	18%	24%	20%	180	115	100	11.1%	12.2%	13.2%	\$3.31	\$4.51	\$5.95	40x	29x	22x	\$132	\$131	\$131	82%	80%	80%
Low Case	12.0%	5.0%	3.0%	14%	17%	15%	110	10	25	10.4%	10.5%	10.7%	\$2.97	\$3.47	\$4.14	21x	18x	15x	\$62	\$62	\$62	-14%	-14%	-14%
Pier 1 Imports	Recent Price:																		\$4.70					
Base Case	-0.1%	2.0%	2.0%	0%	2%	2%	(302)	(18)	(10)	3.8%	3.6%	3.5%	\$0.43	\$0.45	\$0.47	10x	10x	10x	\$5	\$5	\$5	2%	2%	2%
High Case	0.5%	2.5%	2.5%	0%	3%	3%	(250)	50	50	4.3%	4.8%	5.3%	\$0.50	\$0.63	\$0.77	11x	11x	11x	\$6	\$7	\$8	24%	54%	87%
Low Case	0.0%	1.5%	1.5%	0%	2%	2%	(350)	(75)	(75)	3.3%	2.6%	1.8%	\$0.37	\$0.29	0.19	6x	8x	11x	\$2	\$2	\$2	-47%	-45%	-49%

Hardlines categories have seen year-over-year [forward multiple contractions](#) when rates have risen. Though, some verticals within the universe have stood up better than others. Overall, the UBS Hardlines Index tends to underperform the S&P 500 when interest rates are increasing. But, when rates are not rising rapidly, the Hardlines stocks can still outperform the market. Specifically, when the Fed Funds rate increased 0-100 bps year-over-year, the Hardlines Index outperformed the S&P 500 by 110 bps.

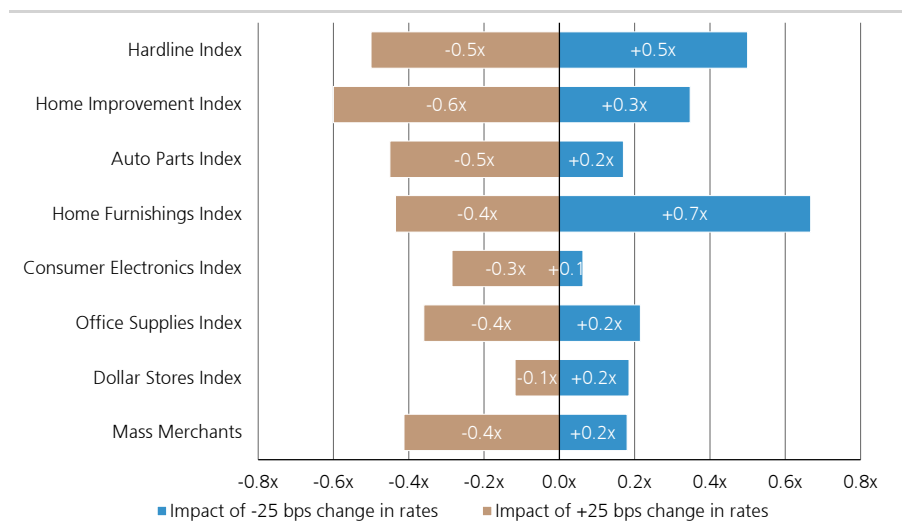
**Figure 5: Hardline Index relative performance (vs. S&P 500) by year-over-year change in Fed Funds rate**



Source: Factset, Federal Reserve Board, UBS

Historically, in rising rate environments, the Auto Parts, Mass Merchants, Home Improvement, and Home Furnishings retailers are most likely to be impacted. On the flipside, the Consumer Electronics, Sporting Goods, and Office Supplies retailers have seen their performance less impacted from rising interest rates. For every 25 bps of interest rate increase, the Hardline Index could see -0.5x forward multiple contraction. From a sector perspective, Home Improvement (HD and LOW) has seen the most contraction when rates rose in the past, while the Dollar Stores (DLTR and DG) forward multiple has remained relatively constant.

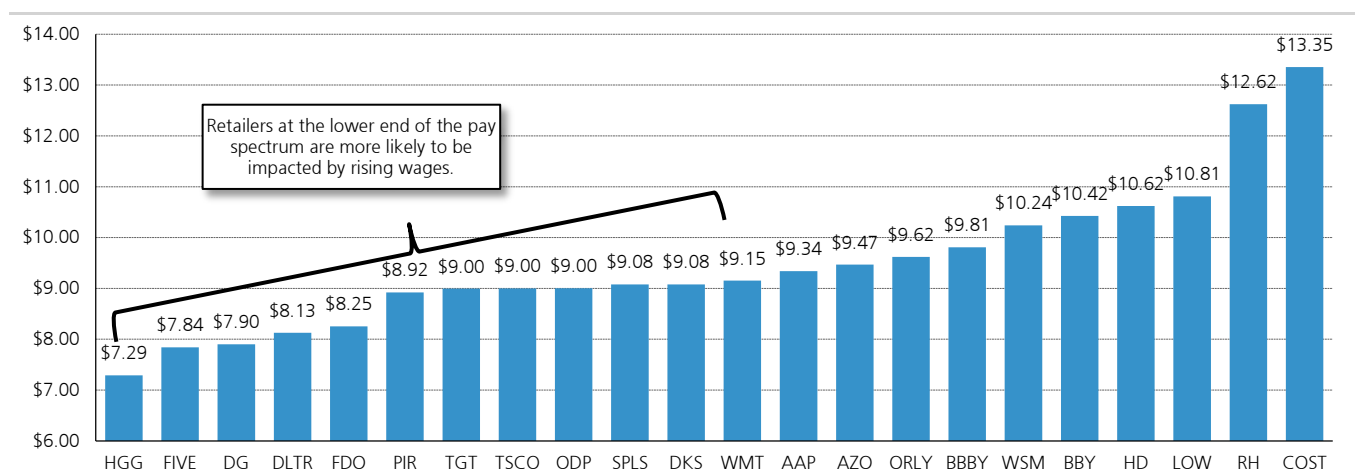
**Figure 6: NTM P/E sensitivity to 25 bps Fed Funds changes**



Source: Factset, Federal Reserve Board, UBS

- How will rising wages impact the sector?** Although increased pay should lead to increased spending at Hardlines and Broadlines retailers, the increase in pay will likely weigh on their margins. There are a number of factors that could push pay higher in 2016. First, low unemployment should drive more competition for employees. Second, although the federal minimum wage of \$7.25 an hour has remained steady for more than six years, 14 states raised their minimum wages effective January 1, 2016. Third, companies like Walmart are investing in their employees and wages, which could have a ripple effect on other retailers in the sector. Previously, we estimated that rising wages could [suppress earnings by 2%-4%](#). Though, should consumers see a rise in real income, it would likely trigger increased spending, returning in some of the wages being paid spent at retailers. We think retailers at the lower end of the pay spectrum are probably most vulnerable as they have the greatest exposure to rising minimum wages. This would probably impact the Discounters (DG, DLTR, FIVE), Mass Merchants (TGT, WMT), Office Supplies (ODP, SPLS) as well as HGG, PIR, TSCO, and DKS the most.

**Figure 7: Hardline retail sales associate and cashier average hourly compensation**

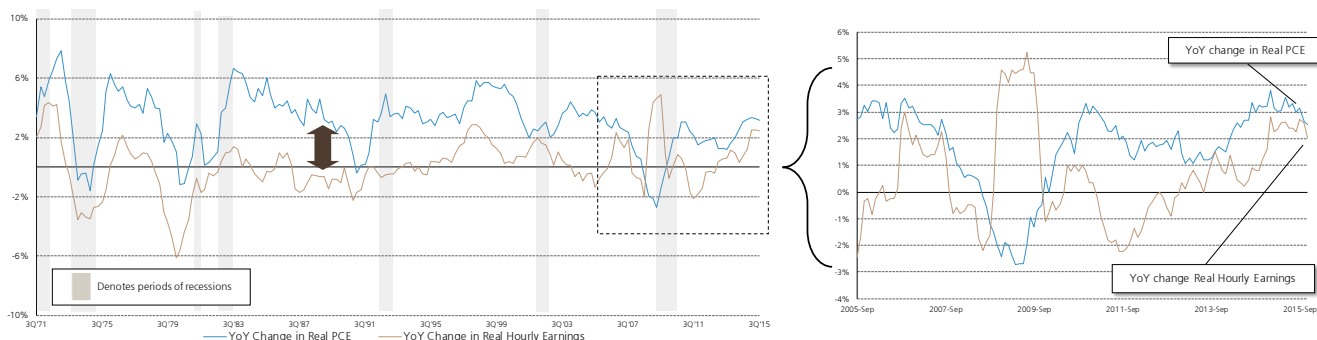


Source: GlassDoor, UBS



Real wages are starting to move higher on an uneven path. Historically, the growth in real Personal Consumption Expenditure (PCE) has tracked the pattern of real hourly wage growth. In 2015, PCE continued to exhibit steady growth. Real wages also grew steadily, in-line with the trends witnessed in 2014. Accelerating earnings growth should support PCE growth heading into 2016.

**Figure 8: Year-over-year change in real PCE versus change in real hourly earnings**

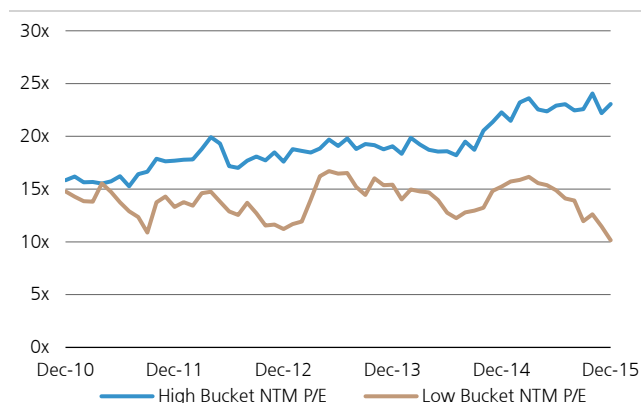


Source: Bureau of Economic Analysis

**Will investors continue to reward quality companies with stronger balance sheets?** While Hardline and Broadline retail multiples in aggregate contracted by -18.8% in 2015 on a median basis, the impact has been greater to lower multiple retailers, as investors have increasingly been allocating capital to higher quality names. Lower multiple stocks (PIR, ODP, SPLS, DKS, BBY, BBBY, HGG) saw their NTM P/E's fall by -33.4% in FY'15, while higher multiple stocks (LOW, HD, FIVE, COST, ORLY, DLTR) saw their forward multiples expand by 3.6%.

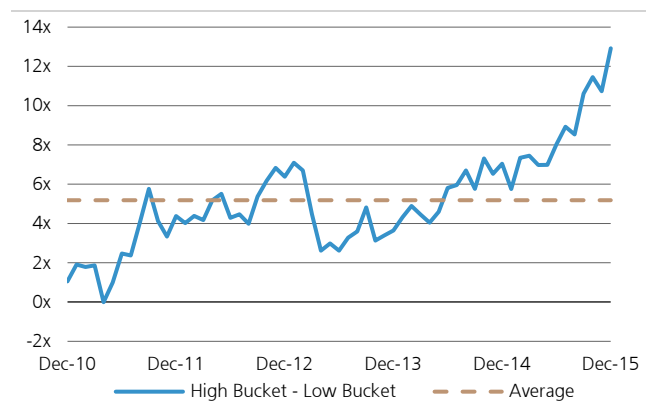
We suspect the multiple gap has extended a bit beyond what is sustainable in the sector. Over the past 5 years, the P/E gap has averaged ~5x, but in the past year, it has climbed to ~13x. We expect to see some mean reversion in the early part of the year toward the ~10x-11x range, which favors stocks such as DKS and SPLS. Ultimately, though, with fewer macro tailwinds supporting the sector in 2016, we expect investors to look for quality as the year progresses.

**Figure 9: High Bucket (LOW, HD, FIVE, COST, ORLY, DLTR) NTM P/E vs Low Bucket (PIR, ODP, SPLS, DKS, BBY, BBBY, HGG)**



Source: FactSet, UBS

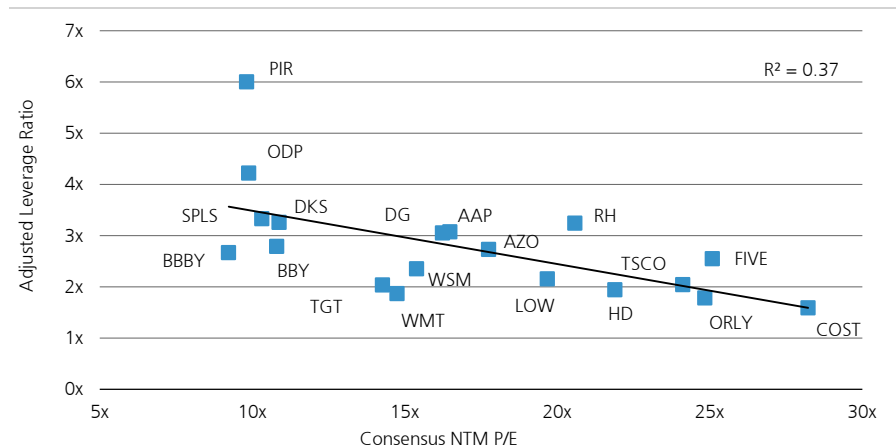
**Figure 10: High Bucket NTM P/E - Low Bucket**



Source: FactSet, UBS

The higher quality names tend to share a common trait – they have strong balance sheets and lower adjusted net debt to EBITDAR ratios. There is a -0.61 correlation (0.37 R squared) between a hardline retailer's adjusted net debt to EBITDAR ratio and its NTM P/E (excluding DLTR and MFRM, which have both either announced or completed acquisitions in 2015). We believe names such as COST, ORLY, HD, and TSCO should ultimately benefit in 2016. All four of these companies have adjusted leverage ratios of 2.0x or lower.

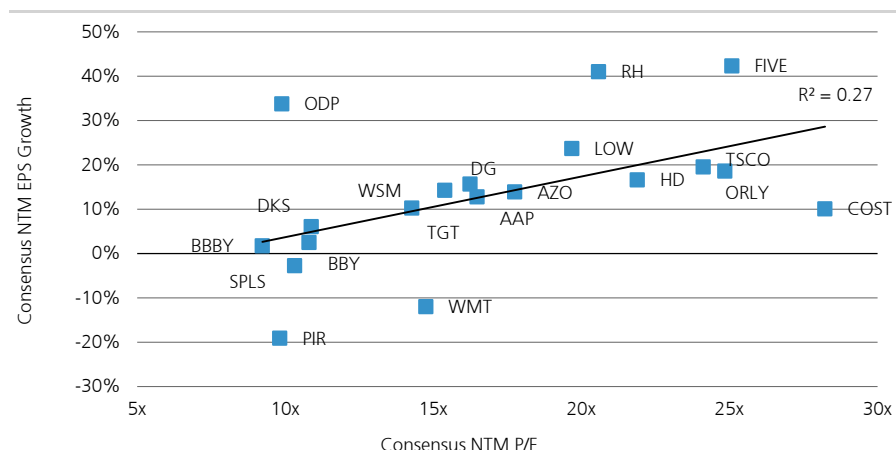
**Figure 11: Hardline Retail Adjusted Leverage Ratios vs NTM P/Es**



Source: FactSet, Company reports, UBS estimates

As expected, hardline and broadline retailers with high EPS growth expectations are typically rewarded with higher multiples. However, the correlation (at 50%) for the same set of retailers isn't as strong as what we see with adjusted debt ratios and multiples, further underscoring the importance investors are placing on companies with strong balance sheets. We expect this theme to continue in 2016.

**Figure 12: Hardline Retail NTM EPS Growth vs NTM P/Es**



Source: FactSet, UBS

- **How will weather patterns impact the auto parts retailers?** Recently, El Niño has received much attention in the auto parts sector, with retailers such as AutoZone suggesting that it could considerably impact maintenance failure related sales if there are fewer severe cold snaps. After an unseasonably warm December in the Eastern half of the country, we think these fears are coming to fruition in the near term. That said, any negative impact would most likely be more than offset by higher vehicle miles travelled. Outside of the auto parts

retailers, other companies that could be considerably impacted by a milder winter include DKS (apparel sales), TSCO (apparel and wood pellet sales), and the home improvement retailers (lower snowblower and shovel sales).

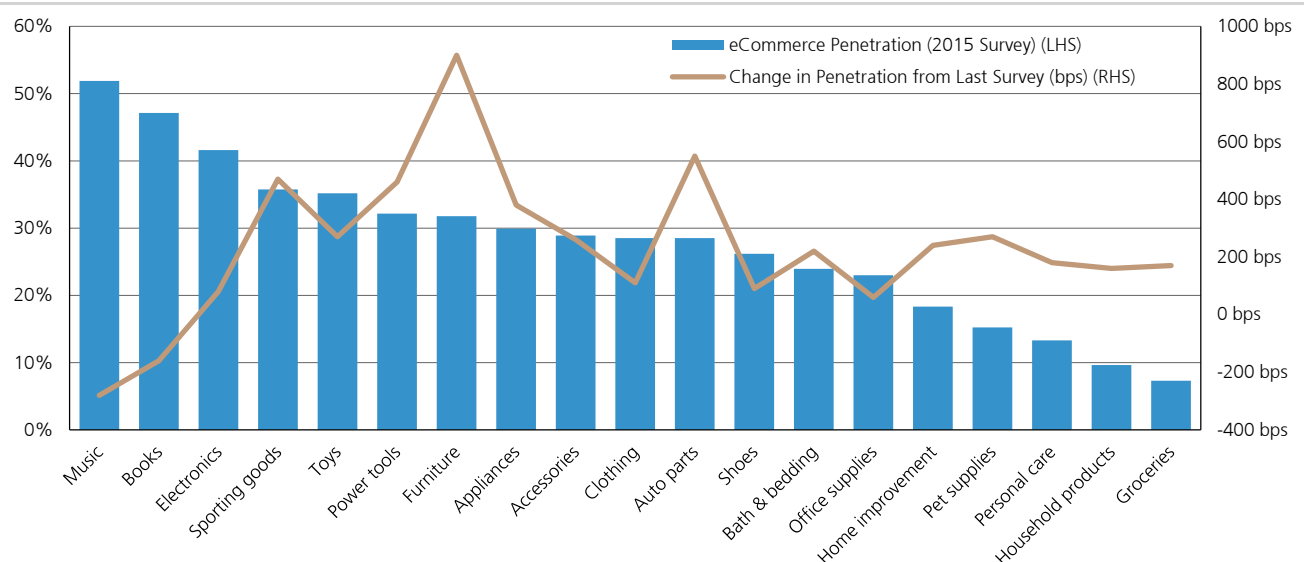
While El Niño is expected to subside in the spring, La Niña events have followed it in 11 of the past 15 cycles, according to the Japan Meteorological Agency and the WSJ. Should a La Niña event occur, drier US weather could lead to higher commodity prices in categories such as corn, soybeans, wheat, and sugar. This in turn could lead to higher sales (and gross margin pressure) at retailers such as WMT and COST, which derive over half of their US revenue from food.

#### ▪ **How will the migration from brick and mortar to online evolve in 2016?**

We expect the movement to the digital channel to continue next year for most of the hardlines categories. In our latest [eCommerce survey](#), Music, Books, and Consumer Electronics continued to have the highest levels of digital penetration ranging between 40% and 50%. Outside of Consumer Electronics (42% penetration), other hardline categories spanned between 18% and 36% penetration. We think many of these verticals could continue to see further online share in 2016.

Most categories saw their online penetration increase over the last year. Specifically, categories such as Furniture, Auto Parts, Sporting Goods Equipment, Power Tools, and Appliances saw between 350 and 900 bps of added online share in our 2015 survey when compared to the prior year. In our view, it's interesting that Furniture and Appliances have seen such a sudden shift to the online channel. This probably means that consumers are becoming less averse to buying big-ticket items online. This should support further growth of companies selling these categories (RH, WSM, AAP, ORLY, DKS), as well as Home Improvement retailers (HD and LOW) online.

**Figure 13: Online penetration by category and the change since our last survey**

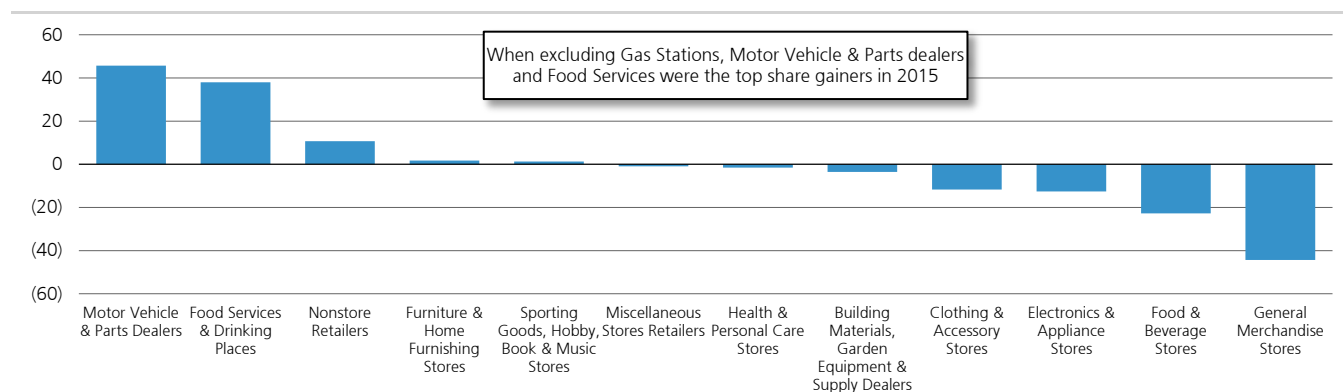


Source: UBS Evidence Lab

- **Which categories are poised to gain wallet share in 2016?** In 2015, the Retail and Food Services categories that saw the largest gains in wallet share were Motor Vehicle & Parts Dealers, Food Services & Drinking Places, and Nonstore Retailers. On the other hand, the biggest share donors (ex Gas

Stations) were General Merchandise Stores, Food & Beverage Stores, and Electronics & Appliance Stores. In 2016, we expect Autos to maintain their recent momentum, as the category benefits from lower fuel prices and higher miles driven, both of which will likely lead to elevated spending in the sub sector. Nonstore retailers will also likely continue to gain share, as more customers continue to shop online. While General Merchandise stores will likely still lose share overall, higher comp growth at Walmart US in 2016 (UBSe 1.3% in CY'16 vs 0.5% in CY'15) should help the category reduce its overall rate of loss.

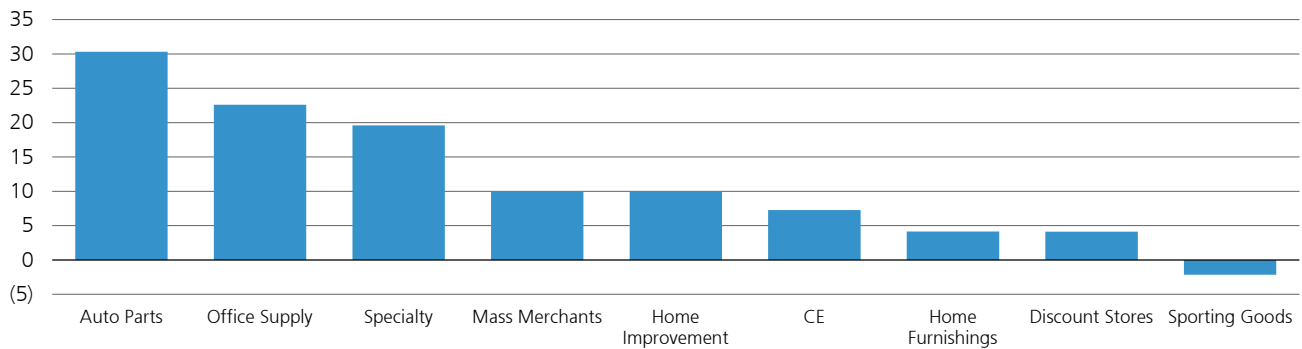
**Figure 14: 2015 Wallet share shift**



Source: US Census Retail, Haver, UBS estimates

- What's the gross margin outlook for Hardline / Broadline retailers?** In 2015, most hardline and broadline subsectors saw gross margin expansion. While the office supply subsector faced some challenges on the sales growth side, ODP's synergies from the OMX merger helped lead the subsector to the best hardline / broadline performance in 2015. Heading into 2016, we again expect modest gross margin expansion to be a common theme across the larger sector. Auto parts in particular are poised to benefit from a favorable industry backdrop, higher private label penetration, and AAP's merger synergies. We model 30 bps of expansion for the subsector as a whole. However, while 2016 should be another strong year for the sector overall, retailers with rapidly growing eCommerce businesses such as Bed Bath (-40 bps YoY) and Walmart (UBSe -20 bps YoY) are likely to face continued pressure in the coming year. Further, elevated promotional activity will likely moderate any margin gains for the home furnishings sector as a whole.

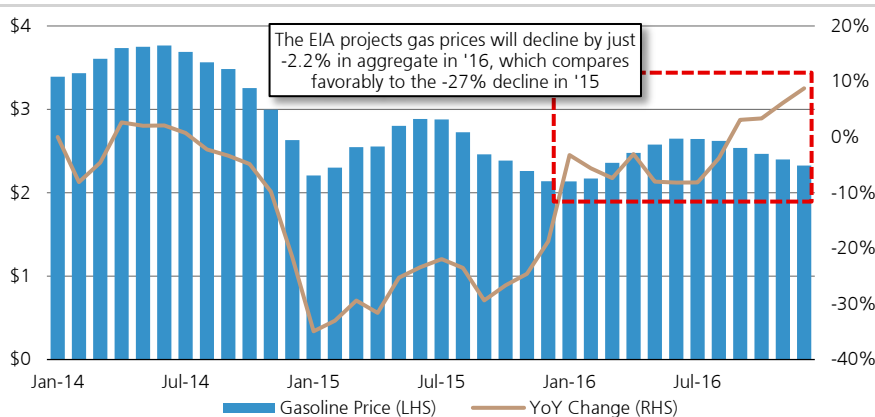
**Figure 15: Expected bps change in gross margin, 2016**



Source: UBS estimates

- **Gasoline prices are expected to be more stable in 2016.** In 2015, gas prices declined by an average of -27% across the US. This led to more cash in consumers' pockets, which in turn benefitted Hardline subsectors such as Auto Parts. We expect fuel costs to be less of an issue in 2016, as the EIA projects gasoline prices will decline by just ~2% for the year. However, should geopolitical turmoil increase, there is a chance that fuel prices could rise, which in turn could lead to a sector headwind.

**Figure 16: US gasoline prices including taxes, 2014-2016E**



Source: EIA, UBS

- **Who is poised to sustain earnings momentum in 2016?** Broadly speaking, FY'15 was a good year for hardlines in terms of growing EPS, with a median YoY improvement of about 12% YoY, compared to a median of 8% in 2014. Looking at the year ahead, we think stand-out EPS growers will include: DLTR, TSCO, FIVE, RH, ORLY, AAP, LOW, and HD.

**Figure 17: Many of the hardlines retailers will see respectable EPS growth in 2015**

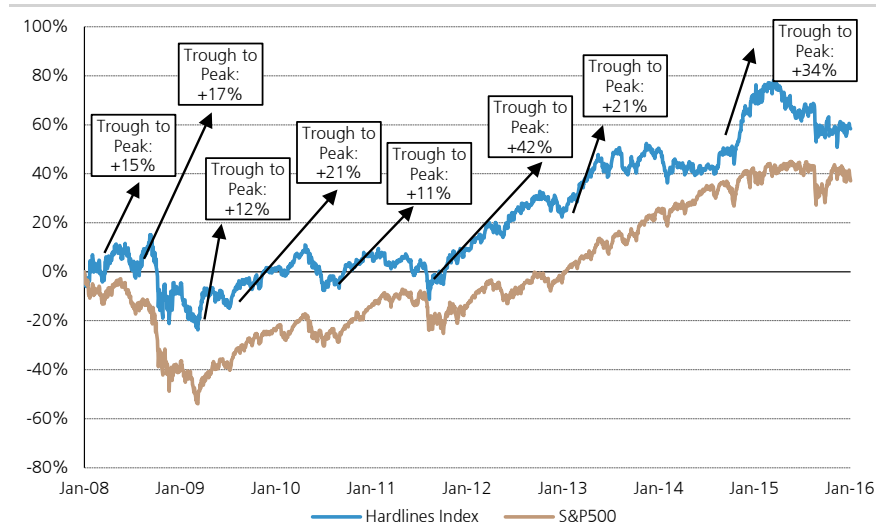
Company	'10/'09 Growth			'11/'10 Growth			'12/'11 Growth			'13/'12 Growth			'14/'13 Growth			'15E/'14A Growth			'16E/'15E Growth		
	Sales	EBIT	EPS	Sales	EBIT	EPS	Sales	EBIT	EPS	Sales	EBIT	EPS	Sales	EBIT	EPS	Sales	EBIT	EPS	Sales	EBIT	EPS
Home Depot	3.1%	18.0%	24.9%	3.5%	14.1%	21.5%	6.2%	18.6%	24.2%	5.4%	16.0%	22.3%	5.5%	14.2%	23.0%	5.7%	12.1%	16.2%	5.7%	10.4%	15.3%
Lowe's	3.4%	11.2%	15.0%	2.9%	3.4%	15.0%	0.6%	-1.9%	5.0%	5.7%	13.7%	23.2%	5.3%	14.8%	23.8%	4.7%	14.5%	22.3%	4.7%	13.9%	21.6%
Bed Bath & Beyond	11.9%	31.4%	33.1%	8.5%	21.7%	32.3%	14.9%	4.5%	12.3%	5.4%	-1.4%	5.2%	3.3%	-3.7%	5.8%	2.6%	-5.5%	2.2%	2.6%	-3.7%	5.6%
Williams-Sonoma	12.9%	113.9%	106.7%	6.2%	11.0%	14.5%	8.7%	8.4%	15.6%	8.5%	9.3%	10.7%	7.1%	8.8%	12.2%	6.5%	2.4%	7.3%	6.5%	10.9%	12.8%
Mattress Firm	14.3%	53.4%	-107.4%	42.5%	87.7%	8894.1%	43.1%	25.2%	-15.7%	20.8%	27.8%	31.7%	48.4%	0.8%	-17.9%	41.0%	59.2%	57.7%	41.0%	27.0%	41.8%
Best Buy	0.4%	10.1%	-2.1%	-10.2%	-14.0%	-9.3%	-1.7%	-31.8%	-10.5%	-7.8%	-21.2%	2.3%	-0.7%	28.7%	1.8%	-1.5%	0.6%	-0.8%	-1.5%	7.1%	-3.0%
hbgregg	35.4%	25.4%	-8.4%	20.0%	-17.5%	3.4%	-0.7%	-37.8%	-24.3%	-5.5%	-84.9%	-34.4%	-8.9%	-764.5%	-284.8%	-3.8%	-47.2%	5.6%	-3.8%	-31.4%	-32.6%
Restoration Hardware	23.5%	-87.6%		24.0%	-1630.4%		24.5%	39.5%	41.6%	30.0%	76.1%	68.7%	20.4%	43.4%	38.3%	16.6%	34.3%	33.4%	16.6%	26.0%	25.2%
Pier1 Imports	8.2%	-3289.3%	-1.2%	9.8%	49.2%	10.2%	11.2%	28.6%	27.3%	3.9%	-11.8%	-15.4%	5.3%	-27.5%	-19.4%	-0.4%	-44.6%	-47.2%	-0.4%	-2.8%	3.8%
AutoZone	8.0%	11.8%	27.5%	9.6%	13.3%	29.1%	6.6%	9.0%	21.4%	6.3%	8.9%	18.1%	3.6%	3.2%	16.6%	7.5%	6.7%	15.2%	7.5%	4.6%	11.1%
Advance Auto Parts	9.5%	21.9%	32.5%	4.1%	13.6%	29.0%	0.6%	-1.1%	1.8%	4.7%	3.9%	7.1%	51.6%	42.9%	38.9%	-0.9%	1.9%	0.6%	-0.9%	17.4%	20.2%
O'Reilly Automotive	11.4%	35.2%	35.7%	7.2%	17.8%	24.6%	6.8%	13.1%	24.5%	7.6%	12.9%	27.2%	8.5%	15.1%	21.6%	9.5%	18.6%	24.3%	9.5%	8.5%	10.9%
Staples	1.1%	8.1%	11.4%	1.9%	-0.2%	8.0%	-2.0%	-4.2%	3.1%	-5.8%	-20.4%	-18.1%	-2.7%	-22.8%	-16.5%	-5.6%	-1.7%	-4.7%	-5.6%	1.8%	3.2%
Office Depot	-4.2%	-521.4%	-80.6%	-1.2%	84.5%	-39.7%	-6.9%	5.7%	-206.0%	5.1%	-31.4%	-458.3%	41.8%	340.4%	-290.9%	-8.4%	67.8%	107.7%	-8.4%	23.9%	25.9%
Tractor Supply	13.5%	39.0%	37.7%	16.3%	32.5%	34.0%	10.2%	23.8%	26.1%	10.7%	17.8%	21.9%	10.6%	14.5%	14.8%	10.3%	14.2%	16.2%	10.3%	13.4%	16.5%
Dick's Sporting Goods	10.4%	42.8%	35.9%	7.0%	27.8%	24.0%	12.0%	21.8%	25.0%	6.5%	4.0%	6.5%	9.7%	2.8%	6.6%	7.4%	0.3%	3.0%	7.4%	2.0%	6.5%
Five Below	57.6%	161.8%	-45.7%	50.7%	83.6%	-72.9%	41.0%	50.7%	545.5%	27.8%	22.1%	31.4%	27.0%	28.1%	31.5%	21.5%	19.2%	17.3%	21.5%	26.3%	26.2%
Walmart	3.3%	3.7%	11.4%	6.0%	4.0%	9.8%	5.0%	4.7%	12.2%	1.5%	-3.3%	2.1%	1.9%	2.3%	-1.1%	3.5%	5.4%	-9.8%	3.5%	5.4%	-11.3%
Target	3.1%	12.4%	17.6%	1.6%	3.6%	14.7%	5.1%	2.7%	9.2%	-0.9%	-11.3%	-9.8%	1.9%	-5.0%	-3.6%	1.6%	9.8%	11.6%	1.6%	5.4%	13.0%
Costco	9.1%	16.9%	18.8%	14.2%	17.4%	12.9%	11.5%	13.8%	20.2%	6.0%	10.0%	16.6%	7.1%	5.5%	0.5%	3.1%	12.5%	13.4%	3.1%	7.7%	6.6%
Dollar General	10.5%	26.7%	44.1%	13.6%	17.1%	25.8%	8.2%	9.4%	22.4%	9.2%	5.3%	10.3%	8.0%	2.2%	9.2%	7.8%	8.2%	12.4%	7.8%	6.4%	12.7%
Dollar Tree	12.4%	28.0%	36.1%	12.7%	19.2%	24.9%	11.5%	17.6%	32.8%	6.0%	5.5%	1.6%	9.7%	10.1%	14.7%	80.7%	4.9%	-22.5%	80.7%	63.6%	58.9%

Source: FactSet, company reports, UBS estimates

## Looking back before we look forward...

For 2016, the UBS Hardlines Index decreased -7.4% (vs. a -0.7% decline for the S&P 500).

**Figure 18: Share price performance for hardline retail stocks versus S&P 500, Jan-08 – Dec-16**



Source: FactSet, UBS estimates

In the following figure, we rank the hardlines stocks by calendar year performance going back to 2000.

[illegible]

During 2015, the best performing Hardlines / Broadlines sub-industry was Auto Parts at 17%. The Home Improvement retailers came in second with an average price return of 20% (HD 27%, LOW 12%). However, Office Supplies (-41%), Consumer Electronics (-34%), and Home Furnishings (-32%) delivered negative returns. Additionally, DKS declined -28% in 2015.

U.S. Hardlines Retail 8 January 2016

**Figure 20: Hardline Index absolute and relative quarterly returns**

Year	Hardline Index Quarterly Returns				Hardline Index Relative Returns (vs. S&P 500)			
	1Q	2Q	3Q	4Q	1Q	2Q	3Q	4Q
1980	-14%	20%	9%	-5%	-9%	7%	0%	-13%
1981	17%	5%	-12%	3%	17%	8%	-1%	-2%
1982	4%	2%	21%	36%	12%	3%	13%	19%
1983	23%	16%	-2%	-5%	14%	6%	-1%	-4%
1984	-14%	8%	5%	-3%	-11%	11%	-3%	-4%
1985	11%	13%	-13%	21%	3%	7%	-8%	5%
1986	23%	19%	-20%	6%	10%	14%	-12%	1%
1987	26%	7%	6%	-32%	5%	3%	0%	-9%
1988	15%	8%	4%	-2%	11%	3%	5%	-4%
1989	9%	9%	9%	2%	2%	1%	-1%	1%
1990	4%	20%	-21%	14%	8%	15%	-6%	6%
1991	33%	11%	11%	18%	19%	12%	6%	11%
1992	-3%	-3%	11%	11%	0%	-5%	8%	7%
1993	-2%	-12%	-1%	2%	-5%	-11%	-2%	1%
1994	1%	-5%	3%	-6%	5%	-4%	-1%	-6%
1995	9%	3%	-1%	-8%	0%	-6%	-8%	-14%
1996	7%	10%	2%	-9%	2%	6%	0%	-17%
1997	13%	20%	12%	9%	10%	3%	5%	6%
1998	27%	17%	-13%	49%	13%	14%	-3%	28%
1999	12%	4%	-4%	36%	7%	-3%	3%	22%
2000	-9%	-12%	-6%	0%	-11%	-9%	-5%	8%
2001	-1%	4%	-8%	26%	11%	-1%	7%	15%
2002	2%	-11%	-17%	0%	2%	3%	1%	-8%
2003	2%	13%	4%	1%	6%	-2%	2%	-10%
2004	8%	-9%	2%	5%	7%	-10%	4%	-3%
2005	-6%	0%	-4%	6%	-3%	-1%	-7%	4%
2006	3%	-5%	2%	0%	0%	-3%	-4%	-6%
2007	0%	2%	-12%	-4%	0%	-4%	-13%	0%
2008	2%	-1%	4%	-12%	12%	2%	13%	11%
2009	-4%	-2%	7%	7%	8%	-17%	-8%	1%
2010	5%	-12%	11%	4%	0%	-1%	0%	-6%
2011	-5%	0%	-5%	13%	-10%	0%	9%	2%
2012	9%	5%	5%	-4%	-3%	8%	-1%	-3%
2013	10%	3%	1%	5%	0%	1%	-4%	-5%
2014	-5%	-1%	5%	16%	-6%	-6%	4%	11%
2015	2%	-8%	-2%	1%	2%	-8%	5%	-6%
Mean	6%	4%	0%	6%	4%	1%	0%	1%
Median	4%	4%	2%	3%	3%	1%	0%	0%
High	33%	30%	21%	49%	19%	15%	13%	28%
Low	-14%	-12%	-21%	-32%	-11%	-17%	-13%	-17%

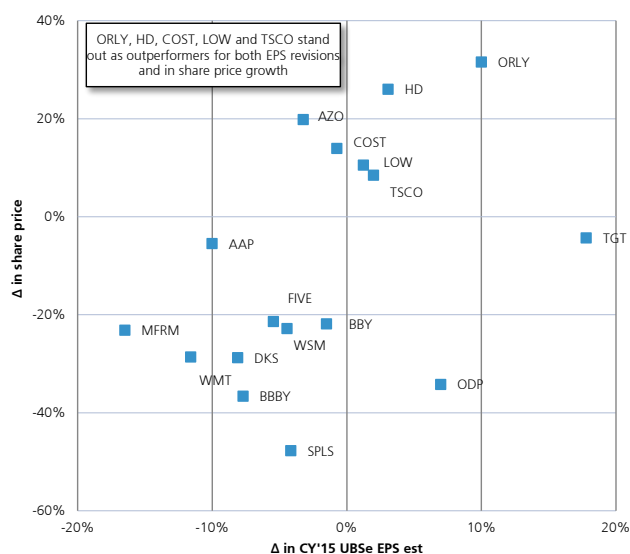
The first and fourth quarters have typically been the best periods for hardline stocks

Source: UBS, Factset

Not surprisingly, the majority of the best performing hardlines stocks were from those companies that had the largest upwards EPS estimate revisions in 2015. Both ORLY and HD in particular stand out, with 10% and 3% increases in EPS estimates correlating with 32% and 26% increases in share price. TGT and ODP were clear outliers, as TGT divested its Canadian segment which was weighing on earnings, while ODP has been impacted by long-term secular concerns within the sector.



**Figure 21: Change in share price over the past year vs changes to our estimates**



Source: FactSet, UBS estimates

**Figure 22: Change in share price over the past year vs changes to our estimates**

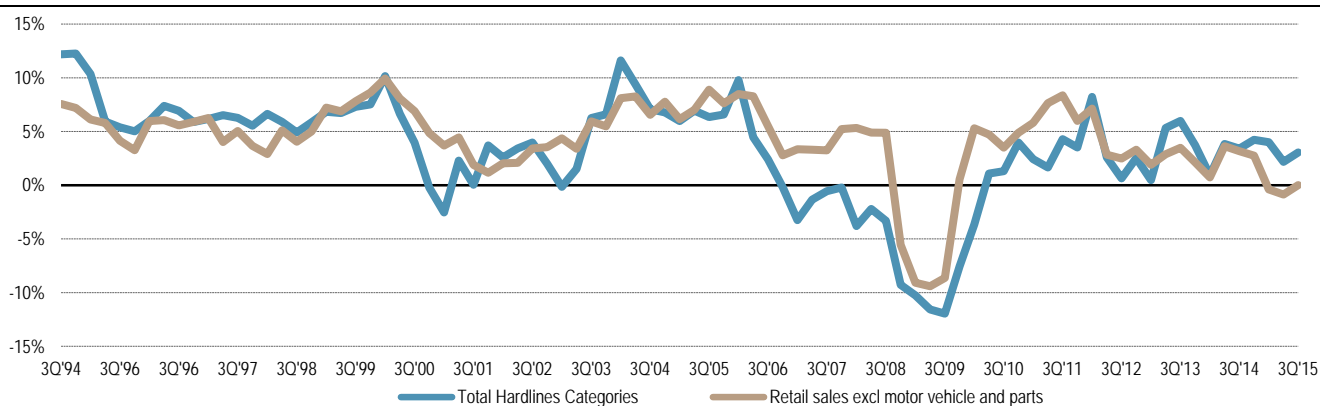
	2015 EPS			Share Price		
	Jan-15	Jan-16	% Change	Jan-15	Jan-16	% Change
AAP	8.70	7.83	-10.0%	159.28	150.51	-5.5%
AZO	38.28	37.04	-3.2%	619.11	741.91	19.8%
BBBY	5.45	5.03	-7.7%	76.17	48.25	-36.7%
BBY	2.65	2.61	-1.5%	38.98	30.45	-21.9%
COST	5.38	5.34	-0.7%	141.75	161.50	13.9%
DKS	3.21	2.95	-8.1%	49.65	35.35	-28.8%
FIVE	1.10	1.04	-5.5%	40.83	32.10	-21.4%
HD	5.21	5.37	3.1%	104.97	132.25	26.0%
LOW	3.25	3.29	1.2%	68.80	76.04	10.5%
MFRM	2.85	2.38	-16.5%	58.08	44.63	-23.2%
ORLY	8.30	9.13	10.0%	192.62	253.42	31.6%
ODP	0.43	0.46	7.0%	8.58	5.64	-34.2%
SPLS	0.96	0.92	-4.2%	18.12	9.47	-47.7%
TGT	3.99	4.70	17.8%	75.91	72.61	-4.3%
TSCO	3.02	3.08	2.0%	78.82	85.50	8.5%
WMT	5.17	4.57	-11.6%	85.88	61.30	-28.6%
WSM	3.60	3.44	-4.4%	75.68	58.41	-22.8%
HGG	1.00	-0.98	-198.0%	7.57	3.66	-51.7%

Source: FactSet, UBS estimates

## Watching the Macro in 2016

The overall macro environment looks to be set up favorably for 2016 after a somewhat sluggish 2015. During the last four quarters, retail sales growth (ex. auto) has averaged about 0.4%, a deceleration from the 2.4% growth rate for the trailing four quarters (4Q'13 – 3Q'14). We think that recent pace will accelerate in the year ahead, due in part to the following factors:

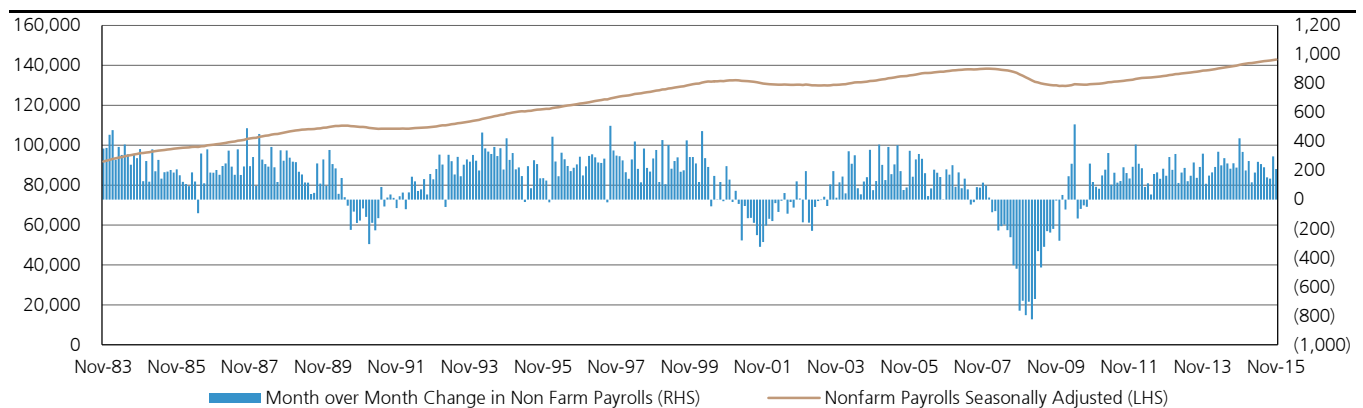
**Figure 23: We think hardlines can produce low to mid-single digit year-over-year sales growth in 2015**



Source: U.S. Census Bureau, UBS estimates

- **Payroll numbers continue to show steady gains:** Since October 2010, nonfarm payrolls have been showing steady sequential improvement every month. The total seasonally adjusted nonfarm payroll level in November 2015 exceeded its previous peak in January 2008 by 3.3%. Any further momentum into 2016 would represent new highs.

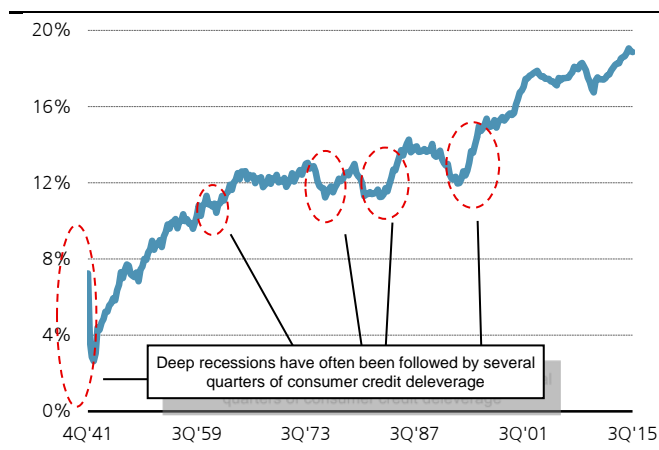
**Figure 24: Nonfarm payroll growth has been steady**



Source: U.S. Department of Labor – Bureau of Labor Statistics

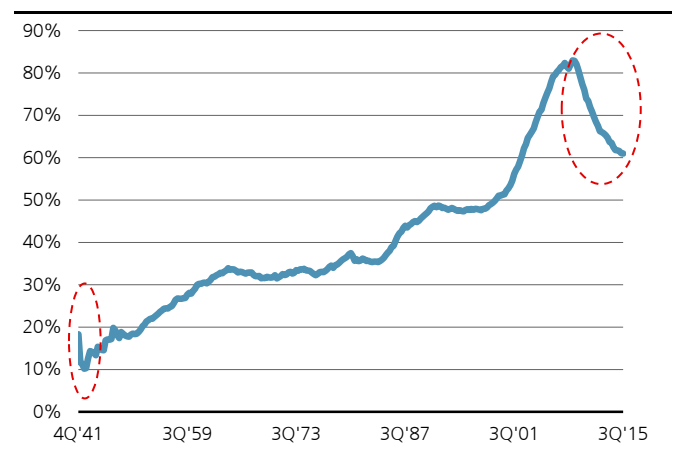
- **Households continue to deleverage:** Consumer credit continues to reach new highs while mortgage debt as a percentage of GDP is declining. The increase in outstanding credit has been in-line with GDP gains, as consumer credit as a percentage of GDP has remained relatively stable between 17% and 19% over the past decade. (However, 11 consecutive quarters of growth may indicate further acceleration in 2015.) Meanwhile, the value of household mortgage debt outstanding as a percentage of GDP continues to fall from the highs experienced in 2008. This has been driven from steady reductions in mortgage debt outstanding, combined with GDP growth. The Mortgage Bankers' Association forecasts that rates will rise to 4.8% by the end of 2016, while Freddie Mac's chief economist expects that the rate will average 4.7% in 4Q'16.

**Figure 25: Revolving consumer credit as % of GDP**



Source: Federal Reserve Board, Bureau of Economic Analysis

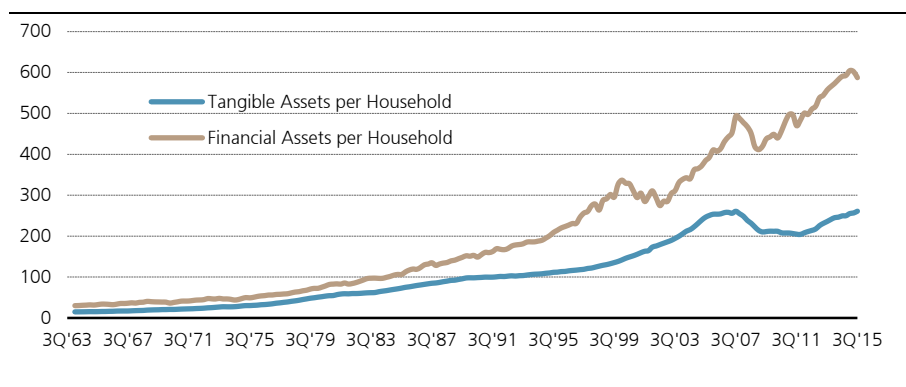
**Figure 26: Mortgage debt outstanding as a % of GDP**



Source: Federal Reserve Board, Bureau of Economic Analysis

- **Wealth effect might provide a boost:** A key driver of consumer spending throughout the recovery has been the strong performance of the capital markets. Since the market trough in 1Q'09, financial assets per household have risen from \$355k to \$587k as of 3Q'15. This has coincided with a brisk improvement of tangible assets per household (mostly the value of the home itself), which has risen from \$208k to \$261k. If these improvements in asset values continue, consumers may spend more as a result of feeling more financially secure.

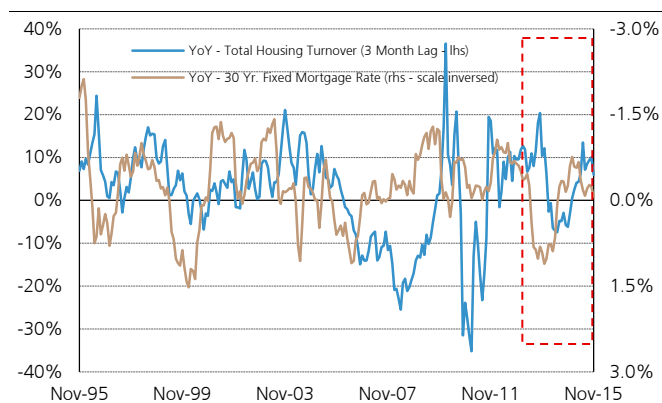
**Figure 27: Tangible and financial assets per household (\$ 000s)**



Source: Federal Reserve Board, U.S. Census Bureau

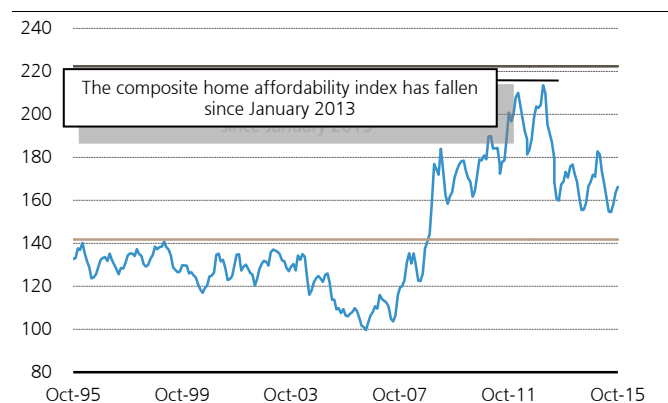
- **We expect housing to continue to improve in 2016:** There are a number of encouraging signs that point to a continuing recovery in the housing market. The National Association of Realtor's Housing Affordability Index is still comfortably above the long term mean as it grew slightly year-over-year over the last twelve months. Also, housing inventory for existing homes continue to remain low and are now -29% below the average level over the last ten years.

**Figure 28: Housing transactions have been volatile**



Source: National Association of Realtors, U.S. Census Bureau, Freddie Mac

**Figure 29: Housing affordability is well above the LT mean**

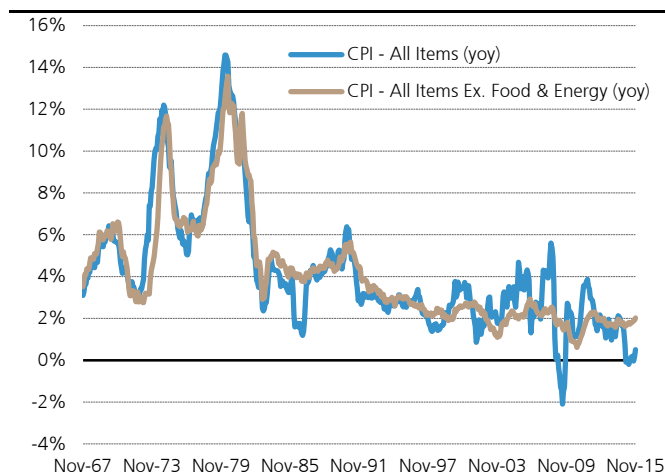


Source: National Association of Realtors

- **CPI data shows a stable rate of inflation:** Over the course of 2015, the CPI indicated a stable inflation rate. In line with CPI, core inflation also remained stable. Most categories retained their spending rank and stayed relatively stable in percentage terms. Overall, CPI was hovering around flat for most of the year before accelerating to 0.5% in November. Core CPI is a bit higher at around 2%.

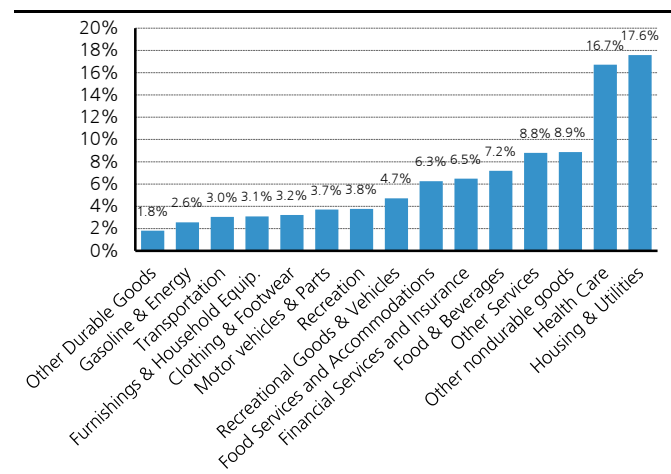
Throughout 2015, fuel prices fell about -27% after only falling around -4% in 2014. Though, consumers probably won't see much further relief in 2016, as the EIA estimates that gas prices will decline about -2%. Gasoline & Energy as a percentage of PCE remained stable year-over-year at about 2.5%. Food & Beverages, however, fell to 7.2% of PCE in 3Q'15 vs. 7.5% in 3Q'14.

**Figure 30: CPI – All Items ex. food & energy (YoY)**



Source: U.S. Bureau of Labor Statistics

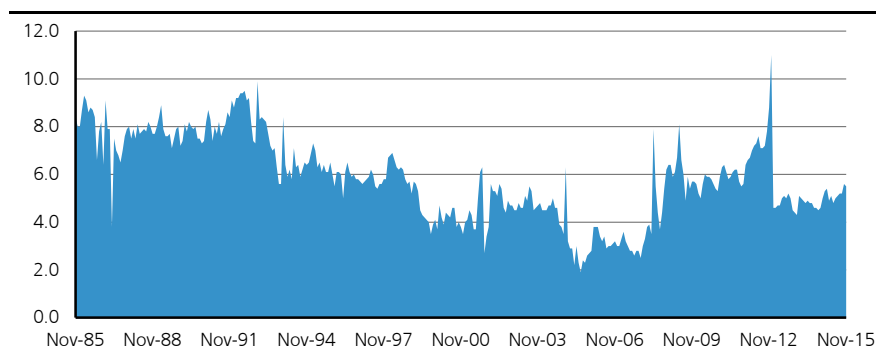
**Figure 31: Major spending categories as a percentage of PCE (as on 3Q'15)**



Source: U.S. Bureau of Economic Analysis

- **The personal savings rate has trended downward:** The November 2015 personal savings rate (personal savings as percentage of disposable personal income) was 5.5%, up from November 2014's 4.6% and November 2013's 4.4%. We think the savings rate will stabilize around current levels but a shift in the rate in either direction could impact consumer spending.

**Figure 32: The personal savings rate has fallen slightly since the end of 2012**



Source: U.S. Bureau of Economic Analysis

## What does this mean for the outlook for hardline retail sales?

Putting these pieces together, we can develop a picture for how sales trends might look for the hardline retail categories over the next twelve months. In the following figure, we forecast potential growth rates for each hardline category using the U.S. Census Bureau's retail sales data.

**Figure 33: Overall retail sales will likely grow in the low to mid-single digits with variability by hardline sectors**

Unadjusted	2007	2008	2009	2010	2011	2012	2013	2014	2015E	2016E	2016E	2016E
										Low Case	Base Case	High Case
Total Retail / food sales	\$4,439,733	\$4,392,750	\$4,066,822	\$4,288,339	\$4,601,788	\$4,831,131	\$5,011,740	\$5,208,443	\$5,314,381	\$5,340,953	\$5,447,241	\$5,553,529
Yr./Yr. Change	3.4%	-1.1%	-7.4%	5.4%	7.3%	5.0%	3.7%	3.9%	2.0%	0.5%	2.5%	4.5%
2-Yr Stacked	8.5%	2.3%	-8.5%	-2.0%	12.8%	12.3%	8.7%	7.7%	6.0%	2.5%	4.5%	6.5%
Retail sales ex. I motor vehicle and parts	\$3,529,594	\$3,606,797	\$3,394,907	\$3,545,172	\$3,787,200	\$3,943,141	\$4,049,759	\$4,174,533	\$4,208,264	\$4,280,160	\$4,292,429	\$4,448,490
Yr./Yr. Change	4.0%	2.2%	-5.9%	4.4%	6.8%	4.1%	2.7%	3.1%	0.8%	1.7%	2.0%	5.7%
2-Yr Stacked	10.1%	6.2%	-3.7%	-1.4%	11.3%	10.9%	6.8%	5.8%	3.9%	2.5%	2.8%	6.5%
Furniture and home furnishings stores	\$111,144	\$98,799	\$84,894	\$85,408	\$87,652	\$91,552	\$94,879	\$98,232	\$103,735	\$98,912	\$106,328	\$113,956
Yr./Yr. Change	-1.5%	-11.1%	-14.1%	0.6%	2.6%	4.4%	3.6%	3.5%	5.6%	-4.6%	2.5%	9.9%
2-Yr Stacked	1.9%	-12.6%	-25.2%	-13.5%	3.2%	7.1%	8.1%	7.2%	9.1%	1.0%	8.1%	15.5%
% Total Retail Sales	2.5%	2.2%	2.1%	2.0%	1.9%	1.9%	1.9%	1.9%	2.0%	1.9%	2.0%	2.1%
YoY bps change	(12)	(25)	(16)	(10)	(9)	(1)	(0)	(1)	7	(10)	0	10
% Total Retail Sales, ex. MV and parts	3.1%	2.7%	2.5%	2.4%	2.3%	2.3%	2.3%	2.4%	2.5%	2.3%	2.5%	2.6%
YoY bps change	(17)	(41)	(24)	(9)	(9)	1	2	1	11	(15)	1	10
Electronics and appliance stores	\$106,599	\$105,402	\$95,533	\$97,642	\$100,287	\$102,644	\$103,744	\$106,081	\$104,138	\$99,318	\$106,741	\$114,378
Yr./Yr. Change	1.1%	-1.1%	-9.4%	2.2%	2.7%	2.4%	1.1%	2.3%	-1.8%	-4.6%	2.5%	9.8%
2-Yr Stacked	6.1%	-0.1%	-10.5%	-7.2%	4.9%	5.1%	3.4%	3.3%	0.4%	-6.5%	0.7%	8.0%
% Total Retail Sales	2.4%	2.4%	2.3%	2.3%	2.2%	2.1%	2.1%	2.0%	2.0%	1.9%	2.0%	2.1%
YoY bps change	(6)	(0)	(5)	(7)	(10)	(5)	(5)	(3)	(8)	(10)	0	10
% Total Retail Sales, ex. MV and parts	3.0%	2.9%	2.8%	2.8%	2.6%	2.6%	2.6%	2.5%	2.5%	2.3%	2.5%	2.6%
YoY bps change	(9)	(10)	(11)	(6)	(11)	(4)	(4)	(2)	(7)	(15)	1	10
Building material (NAICS 444)	\$320,854	\$301,911	\$261,772	\$260,737	\$269,711	\$281,869	\$302,150	\$318,690	\$331,233	\$327,548	\$339,514	\$351,692
Yr./Yr. Change	-4.0%	-5.9%	-13.3%	-0.4%	3.4%	4.5%	7.2%	5.5%	3.9%	-1.1%	2.5%	6.2%
2-Yr Stacked	0.2%	-9.9%	-19.2%	-13.7%	3.0%	7.9%	11.7%	12.7%	9.4%	2.8%	6.4%	10.1%
% Total Retail Sales	7.2%	6.9%	6.4%	6.1%	5.9%	5.8%	6.0%	6.1%	6.2%	6.1%	6.2%	6.3%
YoY bps change	(55)	(35)	(44)	(36)	(22)	(3)	19	9	11	(10)	0	10
% Total Retail Sales, ex. MV and parts	9.1%	8.4%	7.7%	7.4%	7.1%	7.1%	7.5%	7.6%	7.9%	7.7%	7.9%	7.9%
YoY bps change	(75)	(72)	(66)	(36)	(23)	3	31	17	24	(22)	4	3
Sporting goods, hobby, book, and music stores	\$84,651	\$83,546	\$80,069	\$80,208	\$80,540	\$82,771	\$84,393	\$83,875	\$88,672	\$83,774	\$90,888	\$98,215
Yr./Yr. Change	1.8%	-1.3%	-4.2%	0.2%	0.4%	2.8%	2.0%	-0.6%	5.7%	-5.5%	2.5%	10.8%
2-Yr Stacked	4.6%	0.5%	-5.5%	-4.0%	0.6%	3.2%	4.7%	1.3%	5.1%	0.2%	8.2%	16.5%
% Total Retail Sales	1.9%	1.9%	2.0%	1.9%	1.8%	1.7%	1.7%	1.6%	1.7%	1.6%	1.7%	1.8%
YoY bps change	(3)	(0)	7	(10)	(12)	(4)	(3)	(7)	6	(10)	0	10
% Total Retail Sales, ex. MV and parts	2.4%	2.3%	2.4%	2.3%	2.1%	2.1%	2.1%	2.0%	2.1%	2.0%	2.1%	2.2%
YoY bps change	(5)	(8)	4	(10)	(14)	(3)	(2)	(7)	10	(15)	1	10
General Merchandise	\$578,582	\$595,202	\$589,228	\$604,210	\$625,371	\$643,039	\$653,093	\$667,475	\$598,348	\$595,999	\$613,307	\$630,827
Yr./Yr. Change	4.4%	2.9%	-1.0%	2.5%	3.5%	2.8%	1.6%	2.2%	1.1%	-0.4%	2.5%	5.4%
2-Yr Stacked	9.3%	7.3%	1.9%	1.5%	6.0%	6.3%	4.4%	3.8%	3.3%	0.7%	3.6%	6.5%
% Total Retail Sales	13.0%	13.5%	14.5%	14.1%	13.6%	13.3%	13.0%	12.8%	11.3%	11.2%	11.3%	11.4%
YoY bps change	13	52	94	(40)	(50)	(28)	(28)	(22)	(156)	(10)	0	10
% Total Retail Sales, ex. MV and parts	16.4%	16.5%	17.4%	17.0%	16.5%	16.3%	16.1%	16.0%	14.2%	13.9%	14.3%	14.2%
YoY bps change	6	11	85	(31)	(53)	(20)	(18)	(14)	(177)	(29)	7	(4)
Automotive parts, acc., and tire stores	\$74,735	\$76,407	\$74,409	\$78,218	\$83,183	\$84,349	\$85,094	\$86,162	\$86,824	\$81,917	\$88,994	\$96,284
Yr./Yr. Change	3.4%	2.2%	-2.6%	5.1%	6.3%	1.4%	0.9%	1.3%	0.8%	-5.7%	2.5%	10.9%
2-Yr Stacked	6.6%	5.6%	-0.4%	2.5%	11.5%	7.7%	2.3%	2.1%	2.0%	-4.9%	3.3%	11.7%
% Total Retail Sales	1.7%	1.7%	1.8%	1.8%	1.8%	1.7%	1.7%	1.7%	1.6%	1.5%	1.6%	1.7%
YoY bps change	0	6	9	(1)	(2)	(6)	(5)	(4)	(2)	(10)	0	10

Source: U.S. Census Bureau, UBS estimates

# What do we expect for the companies?

In this section, we highlight key topics to watch and outline our recommendations for each stock.

## Home Depot (HD) - Buy

Topics to Watch: For 2016, we believe the following factors will be the critical drivers for how the shares perform.

- Are HD's new long-term financial targets achievable?** HD set forth FY'18 guidance at its [December Analyst Meeting](#) that is conservative and attainable, in our view. In particular, its expected 4.5% annual sales growth over the next three years only reflects the growth rates of the overall economy, supported by its modest housing outlook. As such, it excludes the effects from initiatives that have helped drive HD's sales in the past, such as building out its interconnected retail presence, increasing its relevance with the pro customer, and merchandising stores to local preferences. We believe these initiatives will continue to be tailwinds over the next few years. Further, HD established an operating margin target of 14.5% for FY'18, which implies only ~40 bps of expansion per year despite having averaged 100 bps of expansion per year over the last 6 years. It will probably manage its gross margin to be relatively flat, so any margin improvement should come from expense leverage. It is implementing its Sync supply chain strategy to manage distribution flow evenly. Further, it continues to find ways to better manage payroll hours and improve its yield from its employees. For these reasons, we think HD could exceed these new targets, as it has surpassed its guidance in the past. Market expectations are typically tied to its long-term targets so beating these numbers should send shares higher.

**Figure 34: HD has exceeded its recent long-term targets and we think its new guidance is likely achievable**

As of:	6/6/2012		12/11/2013		12/8/2015	
Metric Targets	LT Target	2013-2015	LT Target	2014	2015	LT Target
Sales		3.5% CAGR		5.0%	4.0%	4.7%
Gross Margin		~35% (+40 bps from 2012F)		~34.8% (+~20 bps from 2012A)	~Flat	~Flat
OPEX		+150 bps leverage from 2012F Expenses grow at ~38% of sales growth		>~150 bps leverage from 2012A	~100 bps from 2014T	~+150 bps leverage from 2014F Expenses grow at ~50% of sales growth
Operating Margin	12%	12% by 2015 (+190 bps from 2012F)	13%	~+70 bps to >12%	+~100 bps to ~13%	14.5% 14.5% by 2018 (+120 bps from 2015E)
ROIC	24%	24% by 2015	27%	24%	~27%	35% 35% by 2018
Adjusted debt to EBITDAR		2.0x				
New Stores		36 stores over the next 3-yrs (contrib. 50 bps to sales growth/yr)		8 (1 US, 1 Canada, 6 Mexico)		
CAPEX		\$1.3 - \$1.4B / yr		\$1.5B	\$1.5B	
Dividend Payout Ratio		50% of earnings		50% of earnings	50% of earnings	50% of earnings

Source: Company reports, UBS

- Can mid-single digit comp growth continue?** We think there are plenty of opportunities for the company to drive its comp sales upwards, including by making more inroads with professional customers, improving its omni-channel positioning, and making more progress in categories such as appliances. We model 4.0% comp growth in FY'16, which would mark the third consecutive year of slowing same store sales. The pro customer reflects only 3% of its current shoppers, but accounts for 40% of its sales. We think improvement in its interconnected offerings, including buy online, deliver from store, should resonate with professionals. The [Appliances](#) category is experiencing strong organic growth through increased demand and higher ASPs. Further, HD is well positioned to take share from Sears, which is losing share in this product

group, and other categories including outdoor power equipment, hand tools, and power tools. In addition, HD could see further gains in the flooring category from any spillover demand from Lumber Liquidator's recent issues. In addition, it will benefit as it constantly refines its product offering. Also, in 2016 Home Depot will be lapping the residual fallout from its data breach, which will make comparisons slightly easier. These factors, in total, support a strong revenue growth story. Further, the acquisition of Interline Brands increases the company's total addressable market by at least \$50 billion, improving its long-term sales prospects. This should provide a multi-year tailwind to sales growth as it cross-sells its products.

**Figure 35: HD has only 15% market share in the segments where it competes**

Market Segment		Sales \$B
Market Opportunity	Products - Home Improvement Retail - Pro	\$120
	Products - Home Improvement Retail - Consumer	\$180
	Products - MRO	\$50
	Services - Services - Product Pull Through	\$60
	Services - Services - Labor	\$140
	<b>Total</b>	<b>\$550</b>
HD	<b>Home Depot</b>	<b>\$80</b>
	Home Depot as % of Total Market	15%

Source: Company reports, UBS

**Figure 36: In our base case, we expect HD appliances sales to increase \$650 mm in FY'16, adding 70 bps of comp**

Home Depot - Base Case	2014	2015E	2016E	2017E
<b>Total Sales</b>	<b>\$83,176</b>	<b>\$87,947</b>	<b>\$93,779</b>	<b>\$97,653</b>
Yr/Yr Change	5.5%	5.7%	6.6%	4.1%
Comp Store Sales Change	5.3%	4.9%	4.0%	4.0%
<b>Appliance Sales</b>	<b>\$4,828</b>	<b>\$5,547</b>	<b>\$6,195</b>	<b>\$6,829</b>
Yr/Yr Change	12.4%	14.9%	11.7%	10.2%
As a % of Total Sales	5.8%	6.3%	6.6%	7.0%
Major Appliance Market Share	13.8%	14.2%	14.6%	15.1%
Yr/Yr Change (bps)	70	40	40	50
Sales Benefit from Appliances (\$mm)	\$533	\$719	\$648	\$634
Comp Benefit from Appliances (bps)	70	90	70	70

Source: TWICE, BEA, Company reports, UBS estimates

- **How much operating margin expansion can HD generate?** We model 50 bps of operating margin growth in FY'16. This would be about -30 bps less than we are expecting in '15 and -50 bps less than the growth it saw in '14. Still it would be 10 bps higher than its guidance suggests. Our '16 forecast reflects some of the increased costs of doing business in retail, including rising healthcare costs and wages. However, there are ways that HD can exceed our margin forecast. Higher than expected sales growth should generate more leverage on fixed expenses. Should the home improvement cycle accelerate, HD could see further reduction in its expense rate. In addition, there are some nice synergies that could come out of the Interline Brands acquisition, which could help support higher margins.

## What to do with the stock?

Home Depot should continue to be able to drive efficiencies throughout the organization. While its top line growth should remain in the mid-single digits, opportunities remain with the pro customer and through interconnected retail. Further, HD will likely continue to see improvements from its supply chain and distribution to limit expense growth. All the while, it should be able to repurchase a healthy amount of shares. Our new \$145 price target (\$140 previously) equates to 21x our CY'17 EPS estimate of \$6.95 and is based on a DCF/multiple blend analysis.

We think it is useful to examine how our price target would respond to various changes in our assumptions for HD's earning outlook over the next few years and the valuation multiple that would be associated with those scenarios. The following figure highlights our base case, a high case, and a low case.

Figure 37: HD price target sensitivity analysis

	Base Case (Published estimates)					High Case			Low Case		
	2013A	2014A	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E
Comparable Store Sales Growth	6.8%	5.3%	4.9%	4.0%	4.0%	5.5%	5.5%	5.5%	3.8%	1.0%	1.0%
Growth Contribution from New Stores	-1.4%	0.2%	0.8%	2.6%	0.1%	0.8%	2.6%	0.1%	0.8%	2.6%	0.1%
Total Sales Growth	5.4%	5.5%	5.7%	6.6%	4.1%	6.3%	8.1%	5.6%	4.6%	3.6%	1.1%
<b>Total Sales</b>	<b>78,812</b>	<b>83,176</b>	<b>87,947</b>	<b>93,779</b>	<b>97,653</b>	<b>88,410</b>	<b>95,599</b>	<b>100,981</b>	<b>86,996</b>	<b>90,155</b>	<b>91,174</b>
<b>Operating Income</b>	<b>9,166</b>	<b>10,469</b>	<b>11,738</b>	<b>12,960</b>	<b>13,955</b>	<b>11,968</b>	<b>13,945</b>	<b>15,790</b>	<b>11,428</b>	<b>12,114</b>	<b>12,342</b>
Operating Income Margin	11.6%	12.6%	13.3%	13.8%	14.3%	13.5%	14.6%	15.6%	13.1%	13.4%	13.5%
Operating Income Yr. / Yr. Change	106	96	76	47	47	95	105	105	55	30	10
Interest Income (Expense)	(699)	(660)	(896)	(908)	(868)	(896)	(908)	(868)	(896)	(908)	(868)
Provision for Income Taxes	3,082	3,595	3,955	4,432	4,822	4,039	4,794	5,499	3,842	4,120	4,228
Income Taxes Rate	36.4%	36.6%	36.5%	36.8%	36.9%	36.5%	36.8%	36.9%	36.5%	36.8%	36.9%
<b>Diluted Net Income</b>	<b>5,385</b>	<b>6,214</b>	<b>6,887</b>	<b>7,621</b>	<b>8,264</b>	<b>7,033</b>	<b>8,243</b>	<b>9,423</b>	<b>6,690</b>	<b>7,085</b>	<b>7,246</b>
<b>Diluted EPS - reported</b>	<b>\$3.76</b>	<b>\$4.62</b>	<b>\$5.37</b>	<b>\$6.20</b>	<b>\$6.95</b>	<b>\$5.49</b>	<b>\$6.70</b>	<b>\$7.93</b>	<b>\$5.22</b>	<b>\$5.76</b>	<b>\$6.10</b>
Shares outstanding - diluted	1,432.3	1,344.3	1,281.6	1,230.1	1,188.7	1,281.6	1,230.1	1,188.7	1,281.6	1,230.1	1,188.7
NTM PE Multiple:			27x	23x	21x	32x	26x	22x	21x	19x	18x
Estimated Value:			\$145	\$145	\$145	\$176	\$174	\$174	\$110	\$109	\$110
Dividend:			\$2.24	\$2.69	\$2.69	\$2.24	\$2.69	\$2.69	\$2.24	\$2.69	\$2.69
<b>Upside / Downside Potential (vs. \$125.40):</b>			<b>17%</b>	<b>18%</b>	<b>18%</b>	<b>42%</b>	<b>41%</b>	<b>41%</b>	<b>-11%</b>	<b>-11%</b>	<b>-10%</b>

Source: Company reports, UBS estimates



Figure 38: HD financial model summary (\$ millions except per share amounts)

	1Q14	2Q14	3Q14	4Q14	2014	1Q15	2Q15	3Q15	4Q15E	2015E	1Q16E	2Q16E	3Q16E	4Q16E	2016E	1Q17E	2Q17E	3Q17E	4Q17E	2017E
<b>Income Statement</b>																				
<b>Total Sales</b>	<b>\$19,687</b>	<b>\$23,811</b>	<b>\$20,516</b>	<b>\$19,162</b>	<b>\$83,176</b>	<b>\$20,891</b>	<b>\$24,829</b>	<b>\$21,819</b>	<b>\$20,408</b>	<b>\$87,947</b>	<b>\$22,969</b>	<b>\$26,845</b>	<b>\$22,722</b>	<b>\$21,244</b>	<b>\$93,779</b>	<b>\$23,913</b>	<b>\$27,952</b>	<b>\$23,662</b>	<b>\$22,126</b>	<b>\$97,653</b>
Yr./Yr. Change	2.9%	5.7%	5.4%	8.3%	5.5%	6.1%	4.3%	6.4%	6.5%	5.7%	9.9%	8.1%	4.1%	4.1%	6.6%	4.1%	4.1%	4.1%	4.2%	4.1%
Comp Store Sales	2.6%	5.8%	5.2%	7.9%	5.3%	6.1%	4.2%	5.1%	4.5%	4.9%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
Gross Profit	6,757	8,007	7,043	6,582	28,389	7,179	8,365	7,565	6,990	30,099	7,905	9,058	7,889	7,286	32,138	8,241	9,445	8,228	7,600	33,514
% of Sales	34.3%	33.6%	34.3%	34.3%	34.1%	34.4%	33.7%	34.7%	34.2%	34.2%	34.4%	33.7%	34.7%	34.3%	34.3%	34.5%	33.8%	34.8%	34.3%	34.3%
Yr./Yr. Change (bps)	(60)	(65)	(59)	(64)	(62)	4	6	34	(10)	9	5	5	5	5	5	5	5	5	5	5
SG&A Expense	4,066	4,144	4,075	3,984	16,269	4,163	4,207	4,141	4,162	16,673	4,508	4,468	4,221	4,247	17,445	4,610	4,554	4,313	4,346	17,823
% of Sales	20.7%	17.4%	19.9%	20.8%	19.6%	19.9%	16.9%	19.0%	20.4%	19.0%	19.6%	16.6%	18.6%	20.0%	18.6%	19.3%	16.3%	18.2%	19.6%	18.3%
Yr./Yr. Change (bps)	(122)	(166)	(117)	(195)	(150)	(73)	(46)	(88)	(40)	(60)	(30)	(30)	(40)	(40)	(36)	(35)	(35)	(35)	(35)	(35)
<b>Operating Income</b>	<b>\$2,277</b>	<b>\$3,448</b>	<b>\$2,553</b>	<b>\$2,191</b>	<b>\$10,469</b>	<b>\$2,597</b>	<b>\$3,739</b>	<b>\$3,001</b>	<b>\$2,401</b>	<b>\$11,738</b>	<b>\$2,961</b>	<b>\$4,155</b>	<b>\$3,239</b>	<b>\$2,605</b>	<b>\$12,960</b>	<b>\$3,195</b>	<b>\$4,458</b>	<b>\$3,484</b>	<b>\$2,818</b>	<b>\$13,955</b>
% of Sales	11.6%	14.5%	12.4%	11.4%	12.6%	12.4%	15.1%	13.8%	11.8%	13.3%	12.9%	15.5%	14.3%	12.3%	13.8%	13.4%	15.9%	14.7%	12.7%	14.3%
Yr./Yr. Change (bps)	62	108	67	148	96	87	58	131	33	76	46	42	50	50	47	47	47	47	47	47
Interest, Net	(188)	(191)	(113)	(168)	(660)	(193)	(228)	(240)	(235)	(896)	(227)	(227)	(227)	(227)	(908)	(217)	(217)	(217)	(217)	(868)
Pretax Income	2,089	3,257	2,440	2,023	9,809	2,404	3,511	2,761	2,166	10,842	2,734	3,928	3,012	2,378	12,052	2,978	4,241	3,267	2,601	13,087
Income Taxes	771	1,207	903	714	3,595	825	1,310	1,023	797	3,955	1,005	1,444	1,107	875	4,432	1,097	1,563	1,204	958	4,822
Tax Rate	36.9%	37.1%	37.0%	35.3%	36.6%	34.3%	37.3%	37.1%	36.8%	36.5%	36.8%	36.8%	36.8%	36.8%	36.8%	36.9%	36.9%	36.9%	36.9%	36.9%
Net Income	1,318	2,050	1,537	1,309	6,214	1,579	2,201	1,738	1,369	6,887	1,729	2,484	1,904	1,504	7,621	1,881	2,678	2,063	1,642	8,264
<b>EPS</b>	<b>\$0.96</b>	<b>\$1.52</b>	<b>\$1.15</b>	<b>\$1.00</b>	<b>\$4.62</b>	<b>\$1.21</b>	<b>\$1.71</b>	<b>\$1.36</b>	<b>\$1.09</b>	<b>\$5.37</b>	<b>\$1.39</b>	<b>\$2.01</b>	<b>\$1.56</b>	<b>\$1.24</b>	<b>\$6.20</b>	<b>\$1.56</b>	<b>\$2.24</b>	<b>\$1.74</b>	<b>\$1.40</b>	<b>\$6.95</b>
Yr./Yr. Change	15.5%	21.8%	20.8%	36.8%	23.0%	26.3%	12.7%	18.4%	9.2%	16.2%	14.6%	17.7%	14.0%	13.9%	15.3%	11.6%	12.7%	12.1%	12.9%	12.2%
Avg Shares Outstanding	1,376	1,353	1,334	1,314	1,344	1,305	1,289	1,274	1,258	1,282	1,247	1,235	1,224	1,214	1,230	1,203	1,193	1,184	1,174	1,189
Total Stores, end of period	2,263	2,264	2,266	2,269	2,269	2,270	2,270	2,273	2,274	2,274	2,275	2,276	2,276	2,277	2,277	2,279	2,280	2,281	2,282	2,282
Yr./Yr. Change	6	6	6	6	6	7	6	7	5	5	5	6	3	3	3	4	4	5	5	5
Square Footage, end of period	236	236	236	236	236	236	236	236	236	236	237	237	237	237	237	237	237	237	237	237
Yr./Yr. Change	0.4%	0.4%	0.0%	0.0%	0.0%	0.0%	0.0%	0.1%	0.2%	0.2%	0.2%	0.3%	0.1%	0.1%	0.1%	0.2%	0.2%	0.2%	0.2%	0.2%
<b>Cash Flow Statement</b>																				
<b>FFO</b>	<b>2,568</b>	<b>2,829</b>	<b>850</b>	<b>1,995</b>	<b>8,242</b>	<b>3,404</b>	<b>2,530</b>	<b>1,432</b>	<b>2,173</b>	<b>9,539</b>	<b>3,398</b>	<b>1,032</b>	<b>1,620</b>	<b>4,163</b>	<b>10,213</b>	<b>3,464</b>	<b>1,168</b>	<b>1,767</b>	<b>4,570</b>	<b>10,968</b>
Yr./Yr. Change	-5%	40%	-33%	21%	8%	33%	-11%	68%	9%	16%	0%	-59%	13%	92%	7%	2%	13%	9%	10%	7%
<b>FCF</b>	<b>2,281</b>	<b>2,485</b>	<b>482</b>	<b>1,552</b>	<b>6,800</b>	<b>3,082</b>	<b>2,147</b>	<b>1,054</b>	<b>1,795</b>	<b>8,078</b>	<b>2,985</b>	<b>548</b>	<b>1,211</b>	<b>3,781</b>	<b>8,525</b>	<b>3,034</b>	<b>664</b>	<b>1,341</b>	<b>4,171</b>	<b>9,211</b>
Yr./Yr. Change	-6%	46%	-46%	27%	9%	35%	-14%	119%	16%	19%	-3%	-74%	15%	111%	6%	2%	21%	11%	10%	8%
<b>EBITDA</b>	<b>\$2,724</b>	<b>\$3,897</b>	<b>\$3,002</b>	<b>\$2,632</b>	<b>\$12,255</b>	<b>\$3,051</b>	<b>\$4,200</b>	<b>\$3,470</b>	<b>\$2,870</b>	<b>\$13,591</b>	<b>\$3,489</b>	<b>\$4,773</b>	<b>\$3,761</b>	<b>\$3,094</b>	<b>\$15,117</b>	<b>\$3,745</b>	<b>\$5,101</b>	<b>\$4,028</b>	<b>\$3,326</b>	<b>\$16,201</b>
Yr./Yr. Change	8%	13%	10%	20%	12%	12%	8%	16%	9%	11%	14%	14%	8%	8%	11%	7%	7%	7%	8%	7%
<b>Balance Sheet</b>																				
<b>Cash &amp; S/T Investments</b>	<b>\$2,511</b>	<b>\$4,216</b>	<b>\$2,181</b>	<b>\$1,723</b>	<b>\$1,723</b>	<b>\$2,827</b>	<b>\$4,936</b>	<b>\$3,040</b>	<b>\$2,143</b>	<b>\$2,143</b>	<b>\$3,190</b>	<b>\$1,809</b>	<b>\$1,098</b>	<b>\$2,563</b>	<b>\$2,563</b>	<b>\$3,565</b>	<b>\$2,205</b>	<b>\$1,529</b>	<b>\$3,291</b>	<b>\$3,291</b>
Cash per Share	\$1.82	\$3.12	\$1.63	\$1.31	\$1.54	\$2.17	\$3.83	\$2.39	\$1.70	\$1.67	\$2.56	\$1.46	\$0.90	\$2.11	\$2.08	\$2.96	\$1.85	\$1.29	\$2.80	\$2.77
Inventory, end of period	12,343	11,665	12,008	11,079	11,079	12,306	11,859	12,495	11,818	11,818	13,520	14,973	14,670	12,138	12,138	14,064	15,578	15,265	12,473	12,473
Yr./Yr. Change	4%	5%	6%	0%	0%	0%	4%	7%	3%	7%	4%	26%	17%	3%	3%	4%	4%	4%	3%	3%
Ending Inventory per Sq Ft	52	49	51	47	47	52	50	53	50	50	57	63	62	51	51	59	66	64	53	53
Yr./Yr. Change	4%	5%	6%	0%	0%	0%	2%	4%	6%	6%	10%	26%	17%	3%	3%	4%	4%	4%	3%	3%
Total Assets	42,629	43,479	41,512	39,946	39,946	42,510	43,798	44,152	41,629	41,629	45,196	44,945	44,057	41,991	41,991	45,771	45,589	44,732	42,662	42,662
Total Liabilities	30,483	32,022	31,402	30,624	30,624	33,306	35,161	36,533	35,252	35,252	39,336	38,823	38,262	36,923	36,923	41,159	40,611	40,013	38,622	38,622
Total shareholders' equity	12,146	11,457	10,110	9,322	9,322	9,204	8,637	7,619	6,377	6,377	5,860	6,122	5,794	5,068	5,068	4,612	4,978	4,719	4,041	4,041
Book Value per Share	\$8.83	\$8.47	\$7.58	\$7.09	\$8.34	\$7.05	\$6.70	\$5.98	\$5.07	\$4.98	\$4.70	\$4.95	\$4.73	\$4.18	\$4.12	\$3.83	\$4.17	\$3.99	\$3.44	\$3.40
Total Debt	14,741	16,736	16,727	17,197	17,197	16,872	19,375	20,862	20,862	20,862	21,262	21,662	22,062	22,062	22,062	22,462	22,862	23,262	23,262	23,262
Total Debt / EBITDA	1.3x	1.4x	0.8x	1.4x	1.4x	1.3x	1.5x	1.6x	1.5x	1.5x	1.5x	1.5x	1.5x	1.5x	1.5x	1.5x	1.5x	1.5x	1.4x	1.4x
Total Adjusted Debt / EBITDAR	-	-	-	-	1.9x	-	-	-	-	1.9x	-	-	-	-	1.8x	-	-	-	-	1.8x

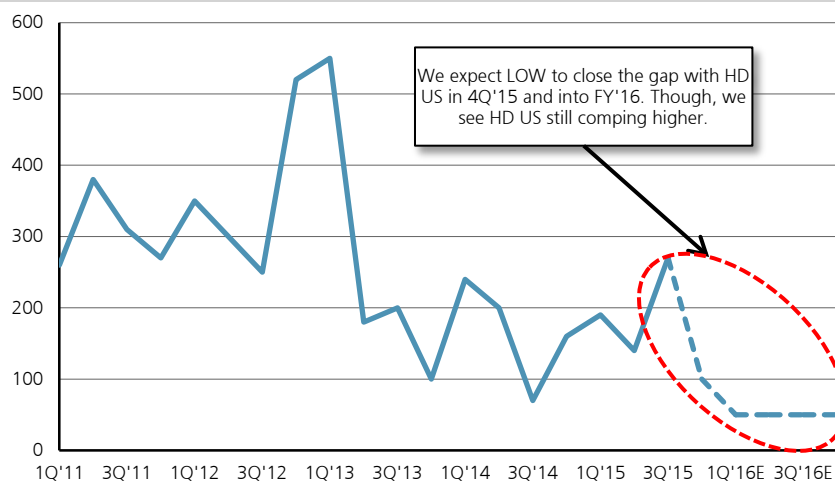
Source: Company Reports, UBS

## Lowe's (LOW) - Buy

Topics to Watch: For 2016, we believe the following factors will be the critical drivers for how the shares perform.

- **Can LOW close the comp gap with HD?** For the past several years, LOW's comp sales growth has trailed that of HD. Over the last 8 quarters, the comp gap has been ~170 bps. Though, the difference has been a little volatile lately. We expect LOW to make progress closing the gap in 4Q'15 and into FY'16. Specifically, we expect the gap to narrow to 100 bps in 4Q'15 and reduce the difference to 50 bps through '16. The company should benefit from improving its standing with the pro customer, better its positioning with the Appliances category, and through showing its products in its Outdoor Living Experience. Closing the comp gap with HD would demonstrate a more competitive stance from LOW.

**Figure 39: Comp gap between HD US and LOW, 1Q'11-4Q'16E**



Source: Company reports, UBS estimates

- **Will LOW continue to accelerate its operating margin expansion?** We expect LOW to expand its operating margin by 90 bps in FY'16. This would be 10 bps higher than our '15 forecast, 20 bps higher than its gains in '14, and 35 bps higher than its expansion in '13. The company noted that its margin gains may be lumpy quarter to quarter, which appears reasonable due to variability in the comparisons and factors related to performance relative to plan and the associated accruals. We believe much of the benefit next year will come from leveraging payroll and advertising expenses. This would result in a FY'16 operating margin of 10.2%, which would be ~350 bps below HD. Rather than emphasize the difference with its peer, we think this highlights the margin upside potential that LOW could generate over time.
- **Can LOW maintain its 20% EPS growth rate?** We think the company can do so in '16. This is based on an earnings algorithm of 3.5% comp sales, 90 bps of operating margin expansion and repurchasing about 5% of its stock. This formula may become a little more difficult to generate 20% earnings growth in '17 however. With its repurchases becoming a little less powerful, and lapping a couple of difficult margin comparisons, we model LOW generating high-teens EPS growth, but falling short of 20%. That being said,

there are scenarios (stronger comp growth, continued margin expansion, more aggressive repurchases), that could push it over the 20% hurdle in '17 as well.

## What to do with the stock?

LOW is well positioned to continue to benefit from the positive home improvement and housing cycle. While it is probably unfairly compared to HD, its results stand on its own. Its earnings algorithm remains in full bloom, which should drive at least high-teens EPS growth over the next several years. Our new \$84 price target (\$82 previously) equates to 18x our CY'17 EPS estimate of \$4.75 and is based on a DCF/multiple blend analysis.

We think it is useful to examine how our price target would respond to various changes in our assumptions for LOW's earnings outlook over the next few years and the valuation multiple that would be associated with those scenarios. The following figure highlights our base case, a high case, and a low case.

**Figure 40: LOW price target sensitivity analysis**

	Base Case (Published estimates)					High Case			Low Case		
	2013A	2014A	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E
Comparable Store Sales Growth	5.0%	4.3%	4.4%	3.5%	3.5%	5.0%	5.0%	5.0%	4.0%	1.0%	1.0%
Growth Contribution from New Stores	0.7%	1.0%	0.3%	0.6%	0.8%	0.3%	0.6%	0.8%	0.3%	0.6%	0.8%
Total Sales Growth	5.7%	5.3%	4.7%	4.1%	4.3%	5.3%	5.6%	5.8%	4.3%	1.6%	1.8%
<b>Total Sales</b>	<b>53,416</b>	<b>56,223</b>	<b>58,857</b>	<b>61,283</b>	<b>63,897</b>	<b>59,188</b>	<b>62,514</b>	<b>66,119</b>	<b>58,625</b>	<b>59,576</b>	<b>60,628</b>
<b>Operating Income</b>	<b>4,180</b>	<b>4,798</b>	<b>5,493</b>	<b>6,256</b>	<b>6,977</b>	<b>5,584</b>	<b>6,617</b>	<b>7,726</b>	<b>5,414</b>	<b>5,740</b>	<b>6,023</b>
Operating Income Margin	7.8%	8.5%	9.3%	10.2%	10.9%	9.4%	10.6%	11.7%	9.2%	9.6%	9.9%
Operating Income Yr. / Yr. Change	55	71	80	88	71	90	115	110	70	40	30
Interest Income (Expense)	(476)	(516)	(549)	(557)	(536)	(549)	(557)	(536)	(549)	(557)	(536)
Provision for Income Taxes	1,398	1,619	1,884	2,160	2,441	1,919	2,297	2,725	1,854	1,964	2,080
Income Taxes Rate	37.8%	37.8%	38.1%	37.9%	37.9%	38.1%	37.9%	37.9%	38.1%	37.9%	37.9%
<b>Diluted Net Income</b>	<b>2,306</b>	<b>2,664</b>	<b>3,060</b>	<b>3,539</b>	<b>4,000</b>	<b>3,116</b>	<b>3,763</b>	<b>4,465</b>	<b>3,011</b>	<b>3,219</b>	<b>3,407</b>
<b>Diluted EPS - reported</b>	<b>\$2.17</b>	<b>\$2.69</b>	<b>\$3.29</b>	<b>\$4.00</b>	<b>\$4.75</b>	<b>\$3.35</b>	<b>\$4.25</b>	<b>\$5.30</b>	<b>\$3.24</b>	<b>\$3.64</b>	<b>\$4.04</b>
Shares outstanding - diluted	1,061.0	990.0	929.7	884.6	842.8	929.7	884.6	842.8	929.7	884.6	842.8
NTM PE Multiple:			26x	21x	18x	30x	24x	19x	20x	18x	16x
Estimated Value:			\$84	\$84	\$84	\$101	\$102	\$101	\$65	\$65	\$65
Dividend:			\$1.07	\$1.12	\$1.12	\$1.07	\$1.12	\$1.12	\$1.07	\$1.12	\$1.12
<b>Upside / Downside Potential (vs. \$72.07):</b>			<b>18%</b>	<b>18%</b>	<b>18%</b>	<b>41%</b>	<b>43%</b>	<b>41%</b>	<b>-9%</b>	<b>-8%</b>	<b>-9%</b>

Source: Company reports, UBS estimates

Figure 41: LOW financial model summary (\$ millions except per share amounts)

	CY	1Q14	2Q14	3Q14	4Q14	2014	1Q15	2Q15	3Q15	4Q15E	2015E	1Q16E	2Q16E	3Q16E	4Q16E	2016E	1Q17E	2Q17E	3Q17E	4Q17E	2017E
<b>Income Statement</b>																					
<b>Total Sales</b>		<b>\$13,403</b>	<b>\$16,599</b>	<b>\$13,681</b>	<b>\$12,540</b>	<b>\$56,223</b>	<b>\$14,129</b>	<b>\$17,348</b>	<b>\$14,360</b>	<b>\$13,020</b>	<b>\$58,857</b>	<b>\$14,685</b>	<b>\$18,058</b>	<b>\$14,960</b>	<b>\$13,579</b>	<b>\$61,283</b>	<b>\$15,312</b>	<b>\$18,829</b>	<b>\$15,598</b>	<b>\$14,158</b>	<b>\$63,897</b>
Yr./Yr. Change		2.4%	5.7%	5.6%	7.5%	5.3%	5.4%	4.5%	5.0%	3.8%	4.7%	3.9%	4.1%	4.2%	4.3%	4.1%	4.3%	4.3%	4.3%	4.3%	4.3%
Comp Store Sales		0.9%	4.4%	5.1%	7.3%	4.3%	5.2%	4.3%	4.6%	3.5%	4.4%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%
Gross Profit		4,758	5,735	4,718	4,346	19,557	5,012	5,981	4,990	4,525	20,508	5,239	6,262	5,213	4,733	21,447	5,478	6,548	5,451	4,949	22,426
% of Sales		35.5%	34.6%	34.5%	34.7%	34.8%	35.5%	34.5%	34.7%	34.8%	34.8%	35.7%	34.7%	34.8%	34.9%	35.0%	35.8%	34.8%	34.9%	35.0%	35.1%
Yr./Yr. Change (bps)		70	20	(10)	(1)	20	(3)	(7)	26	10	6	20	20	10	10	15	10	10	10	10	10
SG&A Expense		3,313	3,541	3,255	3,165	13,274	3,415	3,634	3,287	3,202	13,538	3,454	3,665	3,342	3,264	13,726	3,525	3,728	3,407	3,333	13,992
% of Sales		24.7%	21.3%	23.8%	25.2%	23.6%	24.2%	20.9%	22.9%	24.6%	23.0%	23.5%	20.3%	22.3%	24.0%	22.4%	23.0%	19.8%	21.8%	23.5%	21.9%
Yr./Yr. Change (bps)		10	(40)	(78)	(60)	(42)	(55)	(38)	(90)	(65)	(61)	(65)	(65)	(55)	(55)	(60)	(50)	(50)	(50)	(50)	(50)
<b>Operating Income</b>		<b>\$1,072</b>	<b>\$1,819</b>	<b>\$1,088</b>	<b>\$819</b>	<b>\$4,798</b>	<b>\$1,232</b>	<b>\$1,972</b>	<b>\$1,328</b>	<b>\$961</b>	<b>\$5,493</b>	<b>\$1,423</b>	<b>\$2,228</b>	<b>\$1,499</b>	<b>\$1,107</b>	<b>\$6,256</b>	<b>\$1,592</b>	<b>\$2,457</b>	<b>\$1,673</b>	<b>\$1,255</b>	<b>\$6,977</b>
% of Sales		8.0%	11.0%	8.0%	6.5%	8.5%	8.7%	11.4%	9.2%	7.4%	9.3%	9.7%	12.3%	10.0%	8.2%	10.2%	10.4%	13.0%	10.7%	8.9%	10.9%
Yr./Yr. Change (bps)		51	67	82	88	71	72	41	130	85	80	97	97	77	77	88	71	71	71	71	71
Interest, Net		124	126	134	132	516	134	133	141	141	549	136	135	143	143	557	134	134	134	134	536
Pretax Income		948	1,693	954	687	4,282	1,098	1,839	1,187	820	4,944	1,287	2,093	1,356	964	5,699	1,458	2,323	1,539	1,121	6,441
Income Taxes		359	654	369	237	1,619	425	713	451	295	1,884	488	793	514	365	2,160	553	880	583	425	2,441
Tax Rate		37.8%	38.6%	38.7%	34.5%	37.8%	38.7%	38.8%	38.0%	36.0%	38.1%	37.9%	37.9%	37.9%	37.9%	37.9%	37.9%	37.9%	37.9%	37.9%	37.9%
Net Income		590	1,039	585	450	2,664	670	1,121	736	525	3,060	799	1,300	842	599	3,539	906	1,442	956	696	4,000
<b>EPS</b>		<b>\$0.58</b>	<b>\$1.04</b>	<b>\$0.60</b>	<b>\$0.47</b>	<b>\$2.69</b>	<b>\$0.70</b>	<b>\$1.20</b>	<b>\$0.80</b>	<b>\$0.58</b>	<b>\$3.29</b>	<b>\$0.89</b>	<b>\$1.46</b>	<b>\$0.96</b>	<b>\$0.69</b>	<b>\$4.00</b>	<b>\$1.06</b>	<b>\$1.70</b>	<b>\$1.14</b>	<b>\$0.84</b>	<b>\$4.75</b>
Yr./Yr. Change		17.1%	18.4%	25.5%	48.2%	23.8%	21.4%	15.2%	33.9%	23.6%	22.3%	26.0%	21.6%	19.9%	19.9%	21.6%	19.0%	16.5%	19.1%	21.9%	18.6%
Avg Shares Outstanding		1,017	996	980	967	990	952	933	921	913	930	901	890	879	868	885	858	848	838	828	843
Total Stores, end of period		1,836	1,837	1,836	1,840	1,768	1,843	1,846	1,851	1,855	1,783	1,860	1,865	1,871	1,877	1,805	1,882	1,887	1,893	1,899	1,827
Yr./Yr. Change		81	79	5	8	8	7	9	15	15	15	17	19	20	22	22	22	22	22	22	22
Square Footage, end of period		201	201	201	201	201	201	201	202	202	203	203	203	204	204	205	205	206	206	207	208
Yr./Yr. Change		1.6%	1.6%	0.3%	0.4%	0.4%	0.2%	0.3%	0.4%	0.6%	0.8%	0.7%	0.9%	1.1%	1.2%	1.2%	1.2%	1.2%	1.2%	1.2%	1.2%
<b>Cash Flow Statement</b>																					
FFO		1,994	1,929	761	245	4,929	2,478	1,686	382	567	5,113	2,528	2,082	426	971	6,008	2,378	2,338	453	1,458	6,628
Yr./Yr. Change		0%	41%	51%	-3%	20%	24%	-13%	-50%	131%	4%	2%	23%	12%	71%	18%	-6%	12%	6%	50%	10%
FCF		<b>1,800</b>	<b>1,739</b>	<b>558</b>	<b>(48)</b>	<b>4,049</b>	<b>2,246</b>	<b>1,348</b>	<b>108</b>	<b>318</b>	<b>4,020</b>	<b>2,147</b>	<b>1,612</b>	<b>37</b>	<b>618</b>	<b>4,415</b>	<b>1,957</b>	<b>1,820</b>	<b>24</b>	<b>1,069</b>	<b>4,871</b>
Yr./Yr. Change		0%	47%	107%	-38%	28%	25%	-22%	-81%	-763%	-1%	-4%	20%	-65%	94%	10%	-9%	13%	-35%	73%	10%
EBITDA		\$1,470	\$2,219	\$1,489	\$1,206	\$6,384	\$1,623	\$2,372	\$1,729	\$1,325	\$7,049	\$1,829	\$2,728	\$1,913	\$1,483	\$7,952	\$2,016	\$2,978	\$2,105	\$1,646	\$8,745
Yr./Yr. Change		8%	11%	12%	14%	11%	10%	7%	16%	10%	10%	13%	15%	11%	12%	13%	10%	9%	10%	11%	10%
<b>Balance Sheet</b>																					
Cash & S/T Investments		\$768	\$1,129	\$1,773	\$591	\$591	\$1,529	\$1,089	\$1,385	\$843	\$843	\$1,887	\$2,400	\$2,841	\$2,367	\$2,367	\$3,233	\$3,967	\$4,406	\$4,393	\$4,393
Cash per Share		\$0.65	\$1.04	\$1.59	\$0.48	\$0.47	\$1.51	\$0.97	\$1.33	\$0.75	\$0.74	\$1.92	\$2.52	\$3.05	\$2.54	\$2.50	\$3.59	\$4.49	\$5.07	\$5.12	\$5.03
Inventory, end of period		10,515	9,315	9,762	8,911	8,911	10,614	9,704	10,434	8,958	8,958	10,686	9,681	10,532	9,037	9,037	10,801	9,674	10,630	9,104	9,104
Yr./Yr. Change		2%	2%	2%	-2%	1%	1%	4%	7%	1%	1%	1%	0%	1%	1%	1%	0%	0%	1%	1%	1%
Ending Inventory per Sq Ft		52	46	49	44	44	53	48	52	44	44	53	48	52	44	44	53	47	52	44	44
Yr./Yr. Change		1%	1%	1%	-3%	-3%	1%	4%	6%	0%	0%	0%	-1%	0%	0%	0%	0%	-1%	0%	0%	0%
Total Assets		34,229	33,137	34,032	31,827	31,827	34,422	32,745	33,655	31,558	31,558	34,367	33,768	35,038	33,111	33,111	35,776	35,299	36,695	35,222	35,222
Total Liabilities		22,747	21,897	23,302	21,859	21,859	24,945	24,058	25,277	23,479	23,479	26,562	25,733	27,229	25,758	25,758	28,577	27,714	29,210	28,083	28,083
Total shareholders' equity		11,482	11,240	10,730	9,968	9,968	9,477	8,687	8,378	8,079	8,079	7,806	8,035	7,809	7,353	7,353	7,199	7,585	7,486	7,139	7,139
Book Value per Share		\$11.29	\$11.29	\$10.95	\$10.31	\$10.07	\$9.95	\$9.31	\$9.10	\$8.85	\$8.69	\$8.66	\$9.03	\$8.88	\$8.47	\$8.31	\$8.39	\$8.95	\$8.94	\$8.62	\$8.47
Total Debt		10,127	10,117	11,357	11,367	11,367	11,360	11,359	12,599	12,599	12,599	12,599	12,599	14,099	14,099	14,099	14,099	14,099	15,599	15,599	15,599
Total Debt / EBITDA		6.9x	4.6x	7.6x	9.4x	1.8x	7.0x	4.8x	7.3x	9.5x	1.8x	6.9x	4.6x	7.4x	9.5x	1.8x	7.0x	4.7x	7.4x	9.5x	1.8x
Total Adjusted Debt / EBITDAR		-	-	-	-	2.2x	-	-	-	-	2.2x	-	-	-	-	2.1x	-	-	-	-	2.1x

Source: Company reports, UBS estimates

## Tractor Supply (TSCO) - Buy

Topics to Watch: For 2016, we believe the following factors will be the critical drivers for how the shares perform.

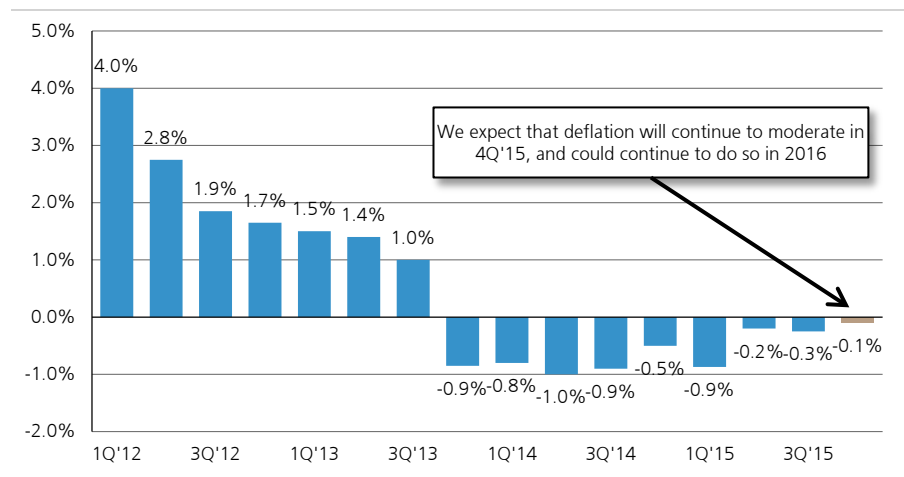
- **Will TSCO's exposure to Texas and oil markets impact its sales growth?**

We believe the impact will be minimal. In 3Q'15, TSCO noted that its stores in Texas, accounting for 10% of its footprint, performed in-line with the company average. While its stores in locations levered to the energy industry did perform lower than the company average, they were still positive. If the company sees a decline in sales, it likely would be in bigger ticket items such as truck boxes, fuel tanks, and compressors. It should continue to do well in some of its core categories, such as consumables. As the performance in these regions in 3Q has been consistent with what the company has seen over the last several months, and the overall impact appears to be rather nominal, it provides us confidence that TSCO can continue to put together strong sales performances going forward. Plus, it should have other ways to offset any losses, such as the rollout of its customer loyalty program.

- **How much of a benefit will TSCO see if commodity deflation moderates?**

We expect commodity prices to moderate in the upcoming year. This is consistent with TSCO's view of slight deflation in the first half of '16 before flattening out or even turning inflationary in the second half of next year. As a result, it should see less of a headwind to average ticket, or even provide a tailwind. Over the last seven quarters, TSCO's comp sales were held back by 70 bps on average due to commodity deflation. However, there has been a gross margin benefit from the deflation as retail prices take a longer time to adjust than wholesale prices. That being said, the benefits of commodity inflation can probably be more clearly tied to the financials, so as the deflationary environment dissipates, we think it will be well received by the market.

**Figure 42: TSCO comp inflation/deflation impact (bps)**



Source: Company reports, UBS estimates

- **How much margin expansion can TSCO generate in the upcoming year?**

Even though TSCO remains in investment mode, it has been able to push its operating margin higher. We expect the company to generate 25 bps of operating margin growth in '16 to 10.9%. It should see continued gross margin growth albeit at a slower rate due to lapping lower fuel prices and

commodity deflation. Further, there is upside to our estimate on the SG&A line as TSCO laps expenses related to the startup of its Southwest distribution center. Taken together, TSCO should continue to march its operating margin higher towards its 11.5% goal.

**Figure 43: TSCO has a history of increasing its long-term margin guidance**

Date	Event	Long-Term Margin Guidance	Comments
Feb-15	Analyst Day	11.5%	Achieved 10.3% EBIT Margin in 2014
Mar-13	Analyst Day	10.8%	Guidance for 2015, achieved 10.0% in 2013
Feb-12	Analyst Day	9.5%	Achieved a 9.4% EBIT Margin in 2012
Jan-11	4Q'10 Conference Call	8.5%	Achieved an 8.3% EBIT Margin in 2011
Sep-09	Sellside Conference	7%	Achieved a 7.3% EBIT Margin in 2010
Jun-05	Sellside Conference	6.3% in 2005; 7% in 2006	Achieved a 6.6% margin in 2005 and 6.2% in 2006

Source: Company reports, UBS

## What to do with the stock?

TSCO belongs in a bucket with the top retailers in the hardlines space. It's growing its square footage at a HSD rate with strong productivity with continued strong comp growth. Simultaneously, it's been growing its margins despite investing in the future. Plus, it has a nice capital allocation program. This unique blend sets it up well for success in 2016 and beyond. Our \$99 price targets equates to 25x our CY'17 EPS estimate of \$4.02 and is based on a DCF/multiple blend analysis.

We think it is useful to examine how our price target would respond to various changes in our assumptions for TSCO's earnings outlook over the next few years and the valuation multiple that would be associated with those scenarios. The following figure highlights our base case, a high case, and a low case.

**Figure 44: TSCO price target sensitivity analysis**

	Base Case (Published estimates)					High Case			Low Case		
	2013A	2014A	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E
Comparable Store Sales Growth	4.8%	3.8%	4.3%	3.5%	3.5%	5.0%	6.5%	6.5%	2.0%	1.5%	1.5%
Growth Contribution from New Stores	5.9%	6.8%	6.0%	7.2%	2.4%	6.0%	7.2%	2.4%	6.0%	7.2%	2.4%
Total Sales Growth	10.7%	10.6%	10.3%	10.7%	5.9%	11.0%	13.7%	8.9%	8.0%	8.7%	3.9%
<b>Total Sales</b>	<b>5,165</b>	<b>5,712</b>	<b>6,299</b>	<b>6,973</b>	<b>7,385</b>	<b>6,340</b>	<b>7,208</b>	<b>7,850</b>	<b>6,169</b>	<b>6,705</b>	<b>6,967</b>
<b>Operating Income</b>	<b>515</b>	<b>589</b>	<b>673</b>	<b>763</b>	<b>833</b>	<b>686</b>	<b>834</b>	<b>971</b>	<b>649</b>	<b>726</b>	<b>778</b>
Operating Income Margin	10.0%	10.3%	10.7%	10.9%	11.3%	10.8%	11.6%	12.4%	10.5%	10.8%	11.2%
Operating Income Yr. / Yr. Change	60	36	37	26	33	50	75	80	20	30	35
Interest Income (Expense)	(1)	(2)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)	(3)
Provision for Income Taxes	186	217	249	281	307	253	307	358	240	267	287
Income Taxes Rate	36.2%	36.9%	37.1%	37.0%	37.0%	37.1%	37.0%	37.0%	37.1%	37.0%	37.0%
<b>Diluted Net Income</b>	<b>328</b>	<b>371</b>	<b>421</b>	<b>479</b>	<b>523</b>	<b>429</b>	<b>523</b>	<b>610</b>	<b>406</b>	<b>455</b>	<b>488</b>
<b>Diluted EPS - reported</b>	<b>\$2.32</b>	<b>\$2.66</b>	<b>\$3.09</b>	<b>\$3.60</b>	<b>\$4.02</b>	<b>\$3.15</b>	<b>\$3.94</b>	<b>\$4.69</b>	<b>\$2.98</b>	<b>\$3.42</b>	<b>\$3.76</b>
Shares outstanding - diluted	141.7	139.4	136.2	132.9	130.0	136.2	132.9	130.0	136.2	132.9	130.0
NTMPE Multiple:			32x	27x	25x	39x	31x	26x	24x	21x	19x
Estimated Value:			\$99	\$99	\$99	\$123	\$122	\$122	\$72	\$72	\$71
Dividend:			\$0.76	\$0.80	\$0.80	\$0.76	\$0.80	\$0.80	\$0.76	\$0.80	\$0.80
<b>Upside / Downside Potential (vs. \$82.48):</b>			<b>21%</b>	<b>21%</b>	<b>21%</b>	<b>50%</b>	<b>49%</b>	<b>49%</b>	<b>-12%</b>	<b>-12%</b>	<b>-13%</b>

Source: Company reports, UBS estimates

Figure 45: TSCO financial model summary (\$ millions except per share)

	1Q14	2Q14	3Q14	4Q14	2014	1Q15	2Q15	3Q15	4Q15E	2015E	1Q16E	2Q16E	3Q16E	4Q16E	2016E	1Q17E	2Q17E	3Q17E	4Q17E	2017E
<b>Income Statement</b>																				
<b>Total Sales</b>	<b>\$1,184</b>	<b>\$1,584</b>	<b>\$1,360</b>	<b>\$1,584</b>	<b>\$5,712</b>	<b>\$1,331</b>	<b>\$1,773</b>	<b>\$1,476</b>	<b>\$1,719</b>	<b>\$6,299</b>	<b>\$1,447</b>	<b>\$1,922</b>	<b>\$1,601</b>	<b>\$2,003</b>	<b>\$6,973</b>	<b>\$1,568</b>	<b>\$2,074</b>	<b>\$1,728</b>	<b>\$2,014</b>	<b>\$7,385</b>
Yr./Yr. Change	9.0%	8.8%	12.6%	12.0%	10.6%	12.5%	11.9%	8.5%	8.5%	10.3%	8.7%	8.4%	8.5%	16.5%	10.7%	8.4%	7.9%	7.9%	0.6%	5.9%
Comp Store Sales	2.2%	1.9%	5.6%	5.3%	3.8%	5.7%	5.6%	2.9%	3.0%	4.3%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%
Gross Profit	<b>\$396</b>	<b>\$551</b>	<b>\$464</b>	<b>\$540</b>	<b>\$1,950</b>	<b>\$445</b>	<b>\$625</b>	<b>\$512</b>	<b>\$590</b>	<b>\$2,172</b>	<b>\$486</b>	<b>\$682</b>	<b>\$559</b>	<b>\$691</b>	<b>\$2,418</b>	<b>\$531</b>	<b>\$741</b>	<b>\$608</b>	<b>\$700</b>	<b>\$2,579</b>
% of Sales	33.5%	34.8%	34.1%	34.1%	34.1%	33.4%	35.3%	34.7%	34.3%	34.5%	33.6%	35.5%	34.9%	34.5%	34.7%	33.8%	35.7%	35.2%	34.8%	34.9%
Yr./Yr. Change (bps)	105	(1)	(28)	16	19	(8)	51	59	25	33	20	20	20	20	20	25	25	25	25	25
SG&A Expense	290	312	313	332	1,246	321	350	343	362	1,376	349	378	371	420	1,519	376	406	399	421	1,602
% of Sales	24.5%	19.7%	23.0%	20.9%	21.8%	24.1%	19.7%	23.2%	21.0%	21.8%	24.1%	19.7%	23.2%	21.0%	21.8%	24.0%	19.6%	23.1%	20.9%	21.7%
Yr./Yr. Change (bps)	44	17	(84)	(66)	(23)	(38)	6	25	10	2	(5)	(5)	(5)	(5)	(6)	(10)	(10)	(10)	(10)	(8)
<b>Operating Income</b>	<b>79</b>	<b>211</b>	<b>122</b>	<b>178</b>	<b>589</b>	<b>93</b>	<b>245</b>	<b>139</b>	<b>196</b>	<b>673</b>	<b>105</b>	<b>271</b>	<b>155</b>	<b>233</b>	<b>763</b>	<b>119</b>	<b>299</b>	<b>173</b>	<b>242</b>	<b>833</b>
% of Sales	6.7%	13.3%	9.0%	11.2%	10.3%	7.0%	13.8%	9.4%	11.4%	10.7%	7.2%	14.1%	9.7%	11.6%	10.9%	7.6%	14.4%	10.0%	12.0%	11.3%
Yr./Yr. Change (bps)	40	(28)	56	82	36	32	50	46	18	37	25	25	25	25	26	35	35	35	35	33
Interest, Net	0	0	1	1	2	1	1	1	1	3	1	1	1	1	3	1	1	1	1	3
Pretax Income	78	211	122	177	588	92	244	138	195	670	104	270	154	232	760	118	298	173	241	830
Income Taxes	29	77	45	65	217	34	91	51	73	249	38	100	57	86	281	44	110	64	89	307
Tax Rate	37.6%	36.7%	37.0%	36.7%	36.9%	36.9%	37.2%	36.9%	37.2%	37.1%	37.0%	37.0%	37.0%	37.0%	37.0%	37.0%	37.0%	37.0%	37.0%	37.0%
Net Income	49	133	77	112	371	58	153	87	123	421	65	170	97	146	479	74	188	109	152	523
<b>EPS</b>	<b>\$0.35</b>	<b>\$0.95</b>	<b>\$0.55</b>	<b>\$0.81</b>	<b>\$2.66</b>	<b>\$0.42</b>	<b>\$1.12</b>	<b>\$0.64</b>	<b>\$0.91</b>	<b>\$3.08</b>	<b>\$0.49</b>	<b>\$1.27</b>	<b>\$0.73</b>	<b>\$1.11</b>	<b>\$3.60</b>	<b>\$0.57</b>	<b>\$1.44</b>	<b>\$0.84</b>	<b>\$1.18</b>	<b>\$4.02</b>
Yr./Yr. Change	10.9%	8.0%	18.3%	16.9%	13.0%	18.9%	14.9%	14.0%	9.3%	13.6%	12.6%	10.8%	11.3%	19.5%	13.7%	13.7%	10.7%	11.9%	3.6%	9.2%
Avg Shares Outstanding	141	140	139	138	139	138	137	137	135	137	134	133	133	132	133	131	130	130	129	130
Total Stores, end of period	1,308	1,331	1,361	1,382	1,382	1,422	1,438	1,465	1,489	1,489	1,517	1,544	1,571	1,584	1,584	1,613	1,642	1,671	1,700	1,700
Yr./Yr. Change	7%	7%	7%	8%	8%	7%	6%	6%	8%	8%	5%	5%	6%	6%	4%	4%	5%	5%	7%	5%
Square Footage, end of period	21	21	22	22	23	23	23	24	24	25	24	25	25	25	27	26	26	27	27	29
Yr./Yr. Change	9.2%	8.9%	9.2%	8.3%	13.1%	8.7%	8.2%	7.9%	7.9%	8.1%	6.7%	7.3%	7.0%	6.4%	7.5%	6.3%	6.3%	6.4%	7.3%	7.3%
<b>Cash Flow Statement</b>																				
<b>CFFO</b>	<b>-38</b>	<b>205</b>	<b>1</b>	<b>242</b>	<b>409</b>	<b>36</b>	<b>197</b>	<b>10</b>	<b>244</b>	<b>488</b>	<b>40</b>	<b>233</b>	<b>21</b>	<b>215</b>	<b>509</b>	<b>110</b>	<b>259</b>	<b>27</b>	<b>292</b>	<b>688</b>
Yr./Yr. Change	-60%	29%	-97%	3%	23%	-195%	-4%	847%	1%	19%	11%	18%	113%	-12%	4%	172%	11%	25%	36%	35%
<b>FCF</b>	<b>(80)</b>	<b>164</b>	<b>(42)</b>	<b>206</b>	<b>249</b>	<b>(12)</b>	<b>149</b>	<b>(56)</b>	<b>176</b>	<b>256</b>	<b>(15)</b>	<b>160</b>	<b>(39)</b>	<b>139</b>	<b>244</b>	<b>50</b>	<b>180</b>	<b>(39)</b>	<b>216</b>	<b>407</b>
Yr./Yr. Change	-45%	51%	89%	19%	115%	-84%	-9%	34%	-15%	3%	18%	8%	-30%	-21%	-5%	-439%	13%	-1%	56%	67%
EBITDA	106	239	151	208	704	123	275	169	228	796	137	303	188	271	899	154	335	209	279	977
Yr./Yr. Change	17%	8%	18%	19%	15%	16%	15%	12%	10%	13%	12%	10%	11%	19%	13%	12%	10%	11%	3%	9%
<b>Balance Sheet</b>																				
Cash & S/T Investments	48	56	48	51	51	57	56	51	151	151	184	242	101	138	138	162	241	101	216	216
Cash per Share	0	0	0	0	0	0	0	0	1	1	1	2	1	1	1	1	2	1	2	2
Inventory, end of period	1,225	1,155	1,296	1,115	1,115	1,371	1,293	1,415	1,206	1,206	1,486	1,397	1,530	1,401	1,401	1,604	1,502	1,645	1,403	1,403
Yr./Yr. Change	7%	7%	13%	14%	14%	12%	9%	8%	8%	8%	8%	8%	8%	16%	16%	8%	8%	0%	0%	0%
Ending Inventory per Sq Ft	58	54	59	50	48	60	56	60	50	48	61	56	61	55	52	62	57	61	51	49
Yr./Yr. Change	-2%	-2%	4%	5%	1%	3%	4%	1%	0%	0%	2%	1%	1%	9%	8%	2%	1%	1%	-7%	-7%
Total Assets	2,056	2,026	2,189	2,035	2,035	2,322	2,271	2,441	2,345	2,345	2,672	2,683	2,711	2,675	2,675	2,908	2,930	2,972	2,892	2,892
Total Liabilities	852	760	958	741	741	1,007	888	1,103	990	990	1,078	958	1,045	958	958	1,146	1,014	1,107	976	976
Total shareholders' equity	1,205	1,266	1,230	1,294	1,294	1,315	1,383	1,337	1,355	1,355	1,594	1,725	1,666	1,717	1,717	1,762	1,916	1,864	1,917	1,917
Book Value per Share	\$8.54	\$9.04	\$8.86	\$9.39	\$9.28	\$9.55	\$10.07	\$9.73	\$10.04	\$9.94	\$11.89	\$12.94	\$12.57	\$13.03	\$12.92	\$13.44	\$14.70	\$14.38	\$14.86	\$14.74
Total Debt	81	3	153	5	5	69	9	201	201	201	71	71	71	71	71	71	71	71	71	71
Total Debt / EBITDA	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x
Total Adjusted Debt / EBITDAR					9.3x					9.9x					12.9x					14.7x

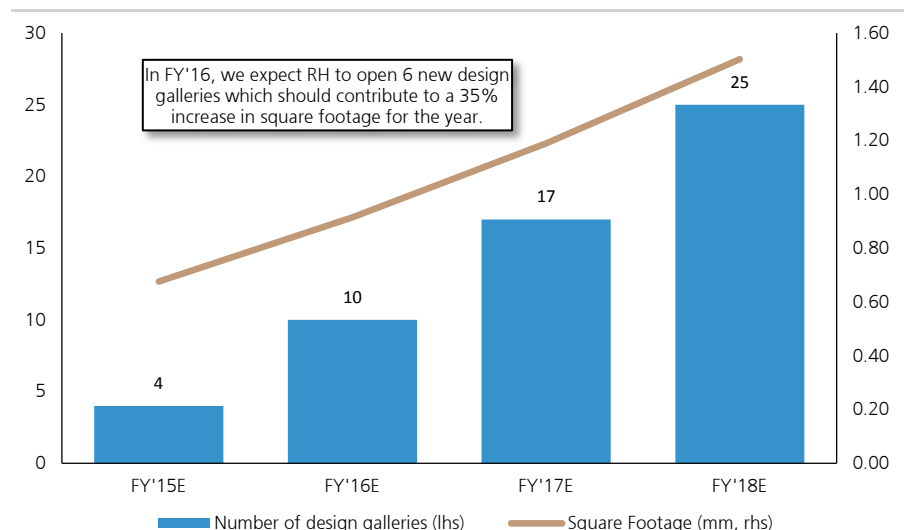
Source: Company reports, UBS estimates

## Restoration Hardware (RH) – Buy

Topics to Watch: For 2016, we believe the following factors will be the critical drivers for how the shares perform.

- **How will its real estate transformation progress?** The bull thesis on RH is primarily based on the successful execution of its North American real estate transformation. In FY'16, the market will likely focus closely on the company's commitment to this strategy in the face of a tough home furnishing environment. We believe the pace of new Design Gallery openings is set accelerate in FY'16. Specifically, we estimate 6 new openings in FY'16, which is above our estimate of 4 new design galleries in FY'15. This will bring the total number of design galleries to 10 and should lead to a 35% increase in square footage for FY'16. How these Design Galleries perform in '16 will be a good indicator of the future trajectory of the transformation.

**Figure 46: RH's Design Galleries and Square footage (mm)**



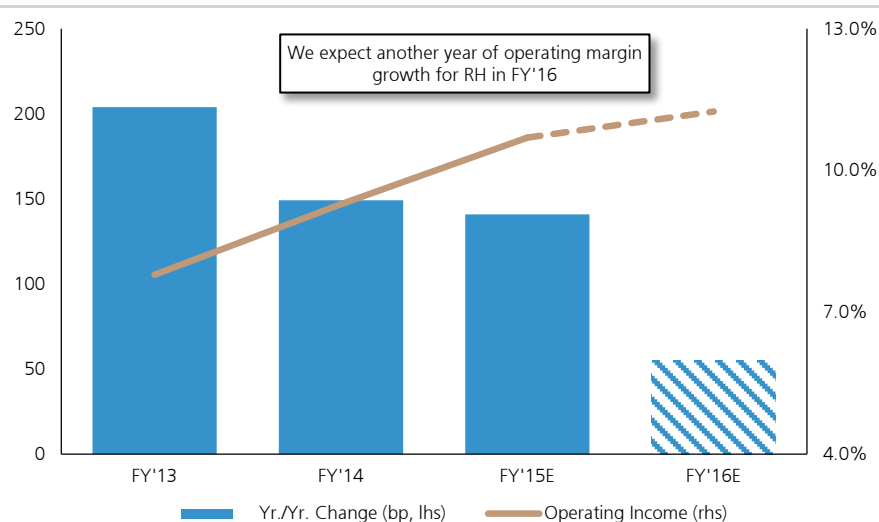
Source: Company Reports, UBS Estimates

- **Will RH continue to grow sales at its current run-rate?** For FY'16, we forecast 20% sales growth, which is above the 17% rate that we forecast for FY'15. We think there are a number of catalysts that should aid RH's top line growth. First, the company will likely have 50-60 design gallery months in FY'16 compared to only 20 in FY'15. This should provide a nice sales lift. Second, its Modern business should ramp up nicely as the company opens more standalone modern stores and displays this line in its new and existing design galleries. Third, other new business lines such as Teen will also aid sales growth. All in, we think RH should exit 2016 with strong sales momentum.
- **Could Modern make a significant impact on RH's financials in 2016?** With Modern, we believe RH has a great opportunity to penetrate into a relatively fragmented market. We estimate that Modern is a \$12 bn market in the US. Presently, a majority of Modern furniture is being sold through interior designers as very few retailers have a meaningful collection on display. Herein lies RH's opportunity. The company noted that its first Modern freestanding store in LA is already on track to generate \$25 mm in sales in its first year. In addition, Modern furniture will get a floor of display space in all its Design Galleries, which should help generate further customer awareness.



- **Will RH continue to see strong operating margin growth?** The company should see further operating margin growth in FY'16, though not likely at the pace seen in the last few years. Specifically, we forecast its FY'16 operating margin will expand by 55 bps to 11.2%, which is below our FY'15 forecast of 140 bps of expansion. Our 20% sales growth estimate and 6 new Design Galleries should translate to nice leverage on occupancy and other fixed costs. That said, if the promotional environment remains elevated in FY'16, it could pressure its gross margin.

**Figure 47: RH operating margin profile**



Source: Company Reports, UBS Estimates

## What to do with the stock?

We think that the company has a unique but sound strategy that positions it well for long-term success. In 2016, its top-line should continue to gain traction as its Modern business ramps up and the company opens new Design Galleries. Further, the company should also take strides towards achieving its long term mid-teens operating margin goal as it leverages occupancy and advertising costs over a larger sales base. All this while, it should continue to innovate to come up with new business lines. Our new \$105 price target (\$115 previously) equates to 21x our CY'17 EPS estimate of \$4.95 and is based on a DCF/multiple blend analysis

We think it is useful to examine how our price target would respond to various changes in our assumptions for RH's earning outlook over the next few years and the valuation multiple that would be associated with those scenarios. The following figure highlights our base case, a high case, and a low case.

Figure 48: RH price target sensitivity analysis

	Base Case (Published estimates)					Upside Case			Downside Case		
	2013A	2014A	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E
Comparable Store Sales Growth	29.1%	19.7%	14.9%	8.0%	6.5%	16.0%	12.0%	8.0%	12.0%	5.0%	3.0%
Growth Contribution from New Stores	0.9%	0.7%	1.7%	11.8%	11.7%	1.7%	11.8%	11.7%	1.7%	11.8%	11.7%
Total Sales Growth	30.0%	20.4%	16.6%	19.8%	18.2%	17.7%	23.8%	19.7%	13.7%	16.8%	14.7%
<b>Total Sales</b>	<b>1,551</b>	<b>1,867</b>	<b>2,177</b>	<b>2,608</b>	<b>3,083</b>	<b>2,197</b>	<b>2,720</b>	<b>3,256</b>	<b>2,123</b>	<b>2,479</b>	<b>2,843</b>
<b>Operating Income</b>	<b>121</b>	<b>173</b>	<b>233</b>	<b>293</b>	<b>361</b>	<b>244</b>	<b>333</b>	<b>431</b>	<b>220</b>	<b>260</b>	<b>305</b>
Operating Income Margin	7.8%	9.3%	10.7%	11.2%	11.7%	11.1%	12.2%	13.2%	10.4%	10.5%	10.7%
Operating Income Yr. / Yr. Change	204	149	141	55	48	180	115	100	110	10	25
Interest Expense	(6)	(11)	(15)	(18)	(17)	(15)	(18)	(17)	(15)	(18)	(17)
Other Income, Net	0	0	0	0	0	0	0	0	0	0	0
Provision for Income Taxes	46	65	85	107	135	89	123	162	80	94	113
Income Taxes Rate	40.0%	40.0%	38.8%	39.0%	39.0%	38.8%	39.0%	39.0%	38.8%	39.0%	39.0%
<b>Diluted Net Income</b>	<b>69</b>	<b>98</b>	<b>133</b>	<b>168</b>	<b>210</b>	<b>140</b>	<b>192</b>	<b>253</b>	<b>126</b>	<b>147</b>	<b>176</b>
<b>Diluted EPS - reported</b>	<b>\$1.71</b>	<b>\$2.36</b>	<b>\$3.15</b>	<b>\$3.95</b>	<b>\$4.95</b>	<b>\$3.31</b>	<b>\$4.51</b>	<b>\$5.95</b>	<b>\$2.97</b>	<b>\$3.47</b>	<b>\$4.14</b>
Shares outstanding - diluted	40.4	41.3	42.3	42.5	42.5	42.3	42.5	42.5	42.3	42.5	42.5
NTM PE Multiple:			33x	27x	21x	40x	29x	22x	21x	18x	15x
Estimated Value:			\$105	\$105	\$105	\$132	\$131	\$131	\$62	\$62	\$62
Dividend:			\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
<b>Upside / Downside (vs. \$72.66):</b>			<b>45%</b>	<b>45%</b>	<b>45%</b>	<b>82%</b>	<b>80%</b>	<b>80%</b>	<b>-14%</b>	<b>-14%</b>	<b>-14%</b>

Source: Company reports, UBS estimates

Figure 49: RH financial model summary (\$ millions except per share)

	1Q14	2Q14	3Q14	4Q14	2014	1Q15	2Q15	3Q15	4Q15E	2015E	1Q16E	2Q16E	3Q16E	4Q16E	2016E	1Q17E	2Q17E	3Q17E	4Q17E	2017E
<b>Income Statement</b>																				
<b>Total Sales</b>	<b>\$366</b>	<b>\$434</b>	<b>\$485</b>	<b>\$583</b>	<b>\$1,867</b>	<b>\$422</b>	<b>\$507</b>	<b>\$532</b>	<b>\$715</b>	<b>\$2,177</b>	<b>\$484</b>	<b>\$602</b>	<b>\$657</b>	<b>\$864</b>	<b>\$2,608</b>	<b>\$578</b>	<b>\$719</b>	<b>\$777</b>	<b>\$1,009</b>	<b>\$3,083</b>
Yr./Yr. Change	21.5%	13.5%	22.4%	23.5%	20.4%	15.3%	16.9%	9.8%	22.8%	16.6%	14.6%	18.8%	23.4%	20.8%	19.8%	19.4%	19.3%	18.2%	16.7%	18.2%
Comp Store Sales	18.0%	13.0%	22.0%	24.0%	19.7%	15.0%	16.0%	7.0%	20.0%	14.9%	8.0%	8.0%	8.0%	8.0%	8.0%	6.5%	6.5%	6.5%	6.5%	6.5%
Gross Profit	124	168	180	218	\$691	145	199	196	261	\$800	167	238	243	317	\$965	201	286	289	373	\$1,149
% of Sales	34.0%	38.7%	37.2%	37.4%	37.0%	34.3%	39.3%	36.7%	36.4%	36.7%	34.5%	39.5%	37.0%	36.7%	37.0%	34.8%	39.8%	37.2%	36.9%	37.3%
Yr./Yr. Change (bps)	14	227	164	34	109	32	57	(49)	(100)	(24)	25	25	25	25	27	25	25	25	25	25
SG&A Expense	110	119	144	144	517	126	137	146	158	567	143	162	178	189	672	170	191	208	218	787
% of Sales	30.1%	27.4%	29.6%	24.8%	27.7%	29.9%	27.1%	27.3%	22.1%	26.1%	29.6%	26.8%	27.1%	21.9%	25.8%	29.4%	26.6%	26.8%	21.6%	25.5%
Yr./Yr. Change (bps)	(215)	(6)	10	2	(41)	(26)	(36)	(230)	(265)	(165)	(25)	(25)	(25)	(25)	(29)	(25)	(25)	(25)	(25)	(22)
<b>Operating Income</b>	<b>14</b>	<b>49</b>	<b>37</b>	<b>74</b>	<b>173</b>	<b>19</b>	<b>62</b>	<b>50</b>	<b>102</b>	<b>233</b>	<b>24</b>	<b>77</b>	<b>65</b>	<b>128</b>	<b>293</b>	<b>31</b>	<b>95</b>	<b>81</b>	<b>155</b>	<b>361</b>
% of Sales	3.8%	11.3%	7.6%	12.7%	9.3%	4.4%	12.2%	9.4%	14.3%	10.7%	4.9%	12.7%	9.9%	14.8%	11.2%	5.4%	13.2%	10.4%	15.3%	11.7%
Yr./Yr. Change (bps)	229	234	154	32	149	59	93	181	165	141	50	50	50	50	55	50	50	50	50	48
Interest, Net	(2)	(3)	(3)	(3)	(11)	(3)	(3)	(5)	(5)	(15)	(5)	(5)	(5)	(5)	(18)	(5)	(4)	(4)	(4)	(17)
Pretax Income	12	46	34	71	163	16	59	45	98	218	19	72	60	123	275	27	91	77	151	345
Income Taxes	5	18	14	28	65	6	23	18	38	85	7	28	24	48	107	10	35	30	59	135
Tax Rate	40.0%	40.0%	40.0%	40.0%	40.0%	37.1%	38.9%	38.9%	39.0%	38.8%	39.0%	39.0%	39.0%	39.0%	39.0%	39.0%	39.0%	39.0%	39.0%	39.0%
Net Income	7	28	20	42	98	10	36	28	60	133	12	44	37	75	168	16	55	47	92	210
<b>EPS</b>	<b>\$0.18</b>	<b>\$0.67</b>	<b>\$0.49</b>	<b>\$1.02</b>	<b>\$2.36</b>	<b>\$0.23</b>	<b>\$0.85</b>	<b>\$0.65</b>	<b>\$1.40</b>	<b>\$3.15</b>	<b>\$0.27</b>	<b>\$1.03</b>	<b>\$0.87</b>	<b>\$1.77</b>	<b>\$3.95</b>	<b>\$0.38</b>	<b>\$1.31</b>	<b>\$1.10</b>	<b>\$2.16</b>	<b>\$4.95</b>
Yr./Yr. Change	200.5%	38.0%	54.6%	22.9%	38.0%	33.7%	27.0%	33.4%	38.1%	33.6%	17.1%	21.2%	32.4%	26.2%	25.2%	39.7%	26.4%	27.0%	21.9%	25.4%
Avg Shares Outstanding	41	41	41	42	41	42	42	42	43	42	43	43	43	43	43	43	43	43	43	43
Total Stores, end of period	61	59	59	57	57	57	57	54	53	53	52	50	48	47	47	45	43	41	40	40
Yr./Yr. Change	-1.6%	-4.8%	-4.8%	-8.1%	-8.1%	-6.6%	-3.4%	-8.5%	-7.0%	-7.0%	-8.8%	-12.3%	-11.1%	-11.3%	-11.3%	-10.0%	-10.4%	-12.8%	-14.9%	#REF!
Square Footage, end of period	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1	1
Yr./Yr. Change	5.2%	5.2%	8.3%	9.6%	9.6%	10.4%	10.4%	10.6%	11.4%	11.4%	17.9%	30.2%	38.2%	35.2%	35.2%	38.6%	35.0%	31.9%	30.1%	30.1%
<b>Cash Flow Statement</b>																				
<b>CFFO</b>	<b>-57</b>	<b>27</b>	<b>7</b>	<b>105</b>	<b>82</b>	<b>-14</b>	<b>28</b>	<b>-31</b>	<b>-44</b>	<b>-62</b>	<b>98</b>	<b>97</b>	<b>183</b>	<b>-74</b>	<b>303</b>	<b>119</b>	<b>120</b>	<b>209</b>	<b>-63</b>	<b>385</b>
Yr./Yr. Change	192%	-46%	-815%	84%	-6%	-75%	2%	-549%	-142%	-175%	-779%	245%	-685%	67%	-591%	22%	24%	14%	-15%	27%
<b>FCF</b>	<b>(74)</b>	<b>5</b>	<b>(24)</b>	<b>65</b>	<b>(28)</b>	<b>(44)</b>	<b>11</b>	<b>(62)</b>	<b>(101)</b>	<b>(196)</b>	<b>65</b>	<b>56</b>	<b>139</b>	<b>(132)</b>	<b>128</b>	<b>81</b>	<b>73</b>	<b>158</b>	<b>(128)</b>	<b>184</b>
Yr./Yr. Change	151%	-83%	-14%	210%	339%	-41%	111%	158%	-257%	602%	-249%	412%	-325%	30%	-166%	24%	30%	14%	-3%	44%
<b>EBITDA</b>	<b>22</b>	<b>57</b>	<b>46</b>	<b>83</b>	<b>208</b>	<b>29</b>	<b>73</b>	<b>61</b>	<b>118</b>	<b>281</b>	<b>35</b>	<b>90</b>	<b>79</b>	<b>147</b>	<b>351</b>	<b>45</b>	<b>110</b>	<b>97</b>	<b>177</b>	<b>429</b>
Yr./Yr. Change	92%	40%	49%	26%	40%	32%	27%	34%	42%	35%	23%	23%	29%	24%	25%	28%	23%	23%	20%	22%
<b>Balance Sheet</b>																				
<b>Cash &amp; S/T Investments</b>	<b>11</b>	<b>181</b>	<b>157</b>	<b>211</b>	<b>211</b>	<b>179</b>	<b>455</b>	<b>388</b>	<b>126</b>	<b>126</b>	<b>191</b>	<b>247</b>	<b>386</b>	<b>254</b>	<b>254</b>	<b>335</b>	<b>408</b>	<b>567</b>	<b>438</b>	<b>438</b>
Cash per Share	0	4	4	4	4	2	7	5	3	3	4	6	9	6	6	8	10	13	10	10
<b>Inventory, end of period</b>	<b>484</b>	<b>547</b>	<b>610</b>	<b>559</b>	<b>559</b>	<b>602</b>	<b>708</b>	<b>761</b>	<b>683</b>	<b>683</b>	<b>676</b>	<b>825</b>	<b>922</b>	<b>803</b>	<b>803</b>	<b>792</b>	<b>967</b>	<b>1,069</b>	<b>927</b>	<b>927</b>
Yr./Yr. Change	32%	35%	36%	23%	23%	24%	29%	25%	22%	22%	12%	17%	21%	18%	18%	17%	17%	16%	15%	15%
Ending Inventory per Sq Ft	882	998	1,082	921	921	995	1,169	1,219	1,009	1,009	948	1,048	1,069	879	879	801	909	940	779	779
Yr./Yr. Change	26%	28%	26%	12%	12%	13%	17%	13%	10%	10%	-5%	-10%	-12%	-13%	-13%	-15%	-13%	-12%	-11%	-11%
<b>Total Assets</b>	<b>1,100</b>	<b>1,367</b>	<b>1,452</b>	<b>1,526</b>	<b>1,526</b>	<b>1,602</b>	<b>1,997</b>	<b>2,059</b>	<b>1,753</b>	<b>1,753</b>	<b>1,838</b>	<b>2,054</b>	<b>2,373</b>	<b>2,150</b>	<b>2,150</b>	<b>2,247</b>	<b>2,506</b>	<b>2,863</b>	<b>2,619</b>	<b>2,619</b>
<b>Total Liabilities</b>	<b>558</b>	<b>752</b>	<b>814</b>	<b>823</b>	<b>823</b>	<b>884</b>	<b>1,195</b>	<b>1,220</b>	<b>1,254</b>	<b>1,254</b>	<b>900</b>	<b>993</b>	<b>1,011</b>	<b>1,048</b>	<b>1,048</b>	<b>952</b>	<b>1,058</b>	<b>1,076</b>	<b>1,094</b>	<b>1,094</b>
<b>Total shareholders' equity</b>	<b>542</b>	<b>614</b>	<b>638</b>	<b>703</b>	<b>703</b>	<b>719</b>	<b>802</b>	<b>839</b>	<b>499</b>	<b>499</b>	<b>938</b>	<b>1,061</b>	<b>1,362</b>	<b>1,101</b>	<b>1,101</b>	<b>1,295</b>	<b>1,448</b>	<b>1,787</b>	<b>1,525</b>	<b>1,525</b>
Book Value per Share	\$13.29	\$14.89	\$15.42	\$16.83	\$16.99	\$17.12	\$18.99	\$19.79	\$11.75	\$11.81	\$22.07	\$24.97	\$32.06	\$25.92	\$25.92	\$30.47	\$34.08	\$42.04	\$35.89	\$35.89
<b>Total Debt</b>	<b>149</b>	<b>278</b>	<b>281</b>	<b>409</b>	<b>409</b>	<b>288</b>	<b>505</b>	<b>513</b>	<b>513</b>	<b>513</b>	<b>513</b>	<b>513</b>	<b>513</b>	<b>513</b>	<b>513</b>	<b>513</b>	<b>513</b>	<b>513</b>	<b>513</b>	<b>513</b>
Total Debt / EBITDA	6.9x	4.8x	6.1x	4.9x	2.0x	10.1x	6.9x	8.4x	4.3x	1.8x	14.6x	5.7x	6.5x	3.5x	1.5x	11.4x	4.6x	5.3x	2.9x	1.2x
Total Adjusted Debt / EBITDAR	-	-	-	-	3.7x	-	-	-	-	3.3x	-	-	-	-	3.0x	-	-	-	-	2.7x

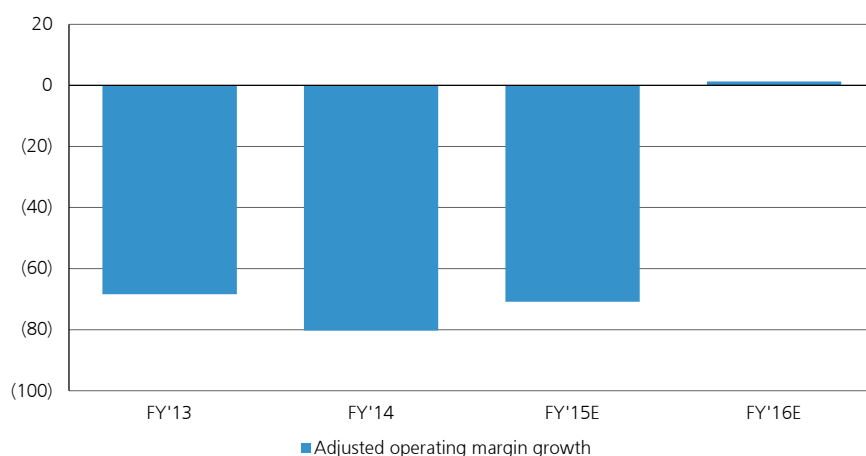
Source: Company reports, UBS estimates

## Mattress Firm (MFRM) – Neutral

Topics to Watch: For 2016, we believe the following factors will be the critical drivers for how the shares perform.

- **Can its comp growth re-accelerate?** For FY'16, we forecast MFRM's comps to grow 2.7%, which is in-line with our estimate for FY'15. We think Sleep Train could provide a nice lift to MFRM's comp in 2016. Assuming Sleep Train comps in the MSD-HSD range in 2016, it could add 130-170 bps to MFRM's overall comp in 2016. However, other parts of its business are unlikely to see any meaningful comp lift as the company will likely tighten investments to protect its margin. Further, the company could face additional disruption from the Sleepy's integration after the likely closure of the deal in 2H'16.
- **How will MFRM manage its debt level?** MFRM is one of the most levered companies in our hardline/broadline coverage universe. We expect MFRM to end FY'15 with an adjusted leverage ratio of 5.7x. Further, this leverage ratio could rise even further after additional debt is raised to finance the Sleepy's acquisition. MFRM is mindful of this and has some plans in place to bring down its leverage. Specifically, the company intends to sell 20 Sleepy's properties upon the completion of the deal and use the proceeds to pay down debt. However, we believe more needs to be done to bring down its leverage to more acceptable levels.
- **Will MFRM finally see some margin stability in 2016?** MFRM has seen operating margin contraction in the past few years as its acquisitions and experiment with different concepts (like Mattress Pro) have taken a toll. However, most of the heavy lifting seems to be behind it now. Mattress Pro & Mattress Discounters are effectively converted to Mattress Firm & Sleep Train banners respectively. Further, its EBITDA margin in its Chicago market has improved post integration and Sleep Train continues to generate strong profitability. All in, this leads us to believe that the company could show signs of margin stability in 2016. However, with the Sleepy's acquisition scheduled to close by 1H'16, we believe 2H'16 could see some renewed integration related headwinds.

**Figure 50: MFRM adjusted operating margin expansion (in bps)**



Source: Company Reports, UBS Estimates. Does not include any potential impact from Sleepy's acquisition

## What to do with the stock?

We think MFRM has great long term opportunities but we also expect some near term pain. Post the completion of the Sleepy's deal, MFRM will be the only truly national mattress retailer with over 3,500 stores across the country. Its big opportunity lies in its ability to grow margins while consolidating its top position. But, as evidenced from its prior acquisitions, it is easier said than done. Further, with the lack of potential catalysts on the horizon (after the Sleepy's acquisition), the market may not be willing to give a premium multiple to the stock. Our new \$46 price target (\$57 prior) equates to 13x our CY'17 EPS estimate of \$3.50 and is based on a DCF/multiple blend analysis.

Figure 51: MFRM financial model summary (\$ millions except per share)

	1Q14	2Q14	3Q14	4Q14	2014	1Q15	2Q15	3Q15	4Q15E	2015E	1Q16E	2Q16E	3Q16E	4Q16E	2016E	1Q17E	2Q17E	3Q17E	4Q17E	2017E
<b>Income Statement</b>																				
<b>Sales from Retail Ops</b>	<b>\$334</b>	<b>\$410</b>	<b>\$464</b>	<b>\$598</b>	<b>\$1,806</b>	<b>\$563</b>	<b>\$661</b>	<b>\$700</b>	<b>\$623</b>	<b>\$2,546</b>	<b>\$627</b>	<b>\$737</b>	<b>\$777</b>	<b>\$694</b>	<b>\$2,834</b>	<b>\$687</b>	<b>\$801</b>	<b>\$838</b>	<b>\$743</b>	<b>\$3,070</b>
Yr./Yr. Change	20.9%	35.5%	42.3%	91.7%	48.4%	68.7%	61.3%	50.7%	4.1%	41.0%	11.4%	11.4%	11.0%	11.4%	11.3%	9.7%	8.8%	7.9%	7.1%	8.3%
Comp Store Sales	4.3%	9.7%	8.5%	1.9%	5.8%	1.3%	2.8%	3.8%	2.5%	2.7%	2.7%	2.7%	2.7%	2.7%	2.7%	2.5%	2.5%	2.5%	2.5%	2.5%
Gross Profit	121	163	183	222	\$689	201	258	265	234	\$957	225	288	296	262	\$1,071	249	315	321	282	\$1,166
% of Sales	36.6%	40.1%	39.7%	37.3%	38.4%	36.0%	39.1%	38.1%	37.7%	37.8%	36.2%	39.3%	38.3%	37.9%	38.0%	36.4%	39.5%	38.5%	38.1%	38.2%
Yr./Yr. Change (bps)	(171)	(15)	55	22	(28)	(62)	(98)	(160)	41	(62)	19	19	19	19	19	20	20	20	20	19
Sales and Marketing Expenses	76	100	110	142	\$427	132	169	168	145	\$614	143	186	185	159	\$673	156	201	198	169	\$725
% of Sales	22.7%	24.4%	23.6%	23.8%	23.7%	23.4%	25.6%	24.1%	23.3%	24.1%	22.8%	25.3%	23.8%	23.0%	23.8%	22.7%	25.1%	23.6%	22.8%	23.6%
Yr./Yr. Change (bps)	(41)	(65)	74	(42)	(13)	76	119	45	(50)	46	(60)	(30)	(30)	(30)	(37)	(15)	(15)	(15)	(15)	(15)
G&A Expenses	31	37	43	57	\$167	51	43	50	46	\$190	54	46	53	50	\$203	58	49	56	52	\$215
% of Sales	9.2%	9.0%	9.2%	9.5%	9.2%	9.1%	6.5%	7.1%	7.4%	7.5%	8.6%	6.2%	6.8%	7.2%	7.2%	8.4%	6.1%	6.7%	7.0%	7.0%
Yr./Yr. Change (bps)	225	247	271	216	243	(7)	(251)	(212)	(210)	(179)	(55)	(25)	(25)	(20)	(30)	(15)	(15)	(15)	(15)	(15)
<b>Operating Income</b>	<b>15</b>	<b>27</b>	<b>32</b>	<b>24</b>	<b>\$98</b>	<b>19</b>	<b>46</b>	<b>48</b>	<b>43</b>	<b>\$156</b>	<b>29</b>	<b>56</b>	<b>59</b>	<b>53</b>	<b>\$198</b>	<b>35</b>	<b>66</b>	<b>68</b>	<b>61</b>	<b>\$230</b>
% of Sales	4.6%	6.6%	6.8%	4.0%	5.4%	3.3%	6.9%	6.8%	7.0%	6.1%	4.7%	7.6%	7.6%	7.6%	7.0%	5.1%	8.2%	8.1%	8.2%	7.5%
Yr./Yr. Change (bps)	(354)	(197)	(293)	(141)	(255)	(128)	32	2	300	70	133	75	74	69	86	46	59	51	55	52
Interest, Net	-3	-3	-4	-12	(\$22)	-10	-10	-10	-10	(\$41)	-9	-8	-8	-8	(\$33)	-7	-6	-6	-6	(\$26)
Pretax Income	13	23	25	12	\$73	9	36	38	33	\$115	21	48	51	45	\$165	28	60	61	55	\$204
Income Taxes	5	9	10	5	\$29	3	14	14	13	\$43	8	18	19	17	\$63	11	23	23	21	\$77
Tax Rate	38.8%	39.1%	38.3%	45.3%	39.8%	36.1%	38.5%	36.6%	38.0%	37.5%	38.0%	38.0%	38.0%	38.0%	38.0%	38.0%	38.0%	38.0%	38.0%	38.0%
Net Income	8	14	16	7	\$44	5	22	24	21	\$72	13	30	32	28	\$102	18	37	38	34	\$126
<b>EPS</b>	<b>\$0.22</b>	<b>\$0.41</b>	<b>\$0.45</b>	<b>\$0.19</b>	<b>\$1.27</b>	<b>\$0.15</b>	<b>\$0.61</b>	<b>\$0.67</b>	<b>\$0.56</b>	<b>\$2.01</b>	<b>\$0.36</b>	<b>\$0.84</b>	<b>\$0.88</b>	<b>\$0.76</b>	<b>\$2.85</b>	<b>\$0.49</b>	<b>\$1.03</b>	<b>\$1.06</b>	<b>\$0.92</b>	<b>\$3.50</b>
Yr./Yr. Change	-36.5%	0.4%	-15.4%	-26.3%	-17.9%	-31.4%	48.4%	49.4%	202.8%	57.6%	134.6%	36.3%	31.3%	35.3%	41.9%	35.9%	22.7%	20.1%	20.4%	23.0%
Avg Shares Outstanding	34	35	35	35	35	36	36	36	36	36	36	36	36	37	36	36	36	36	37	36
Total Stores, end of period	1,463	1,578	2,084	2,192	2,192	2,263	2,325	2,399	2,452	2,452	2,522	2,592	2,662	2,732	2,732	2,777	2,822	2,867	2,912	2,912
Yr./Yr. Change	210	295	762	834	834	800	747	315	260	260	259	267	263	280	280	255	230	205	180	180
Square Footage, end of period	7	7	10	10	10	10	11	11	11	11	12	12	12	13	13	13	13	13	13	13
Yr./Yr. Change	24.5%	32.0%	71.9%	70.9%	70.9%	58.5%	50.2%	15.6%	12.0%	12.0%	11.6%	11.7%	11.1%	11.6%	11.6%	10.2%	8.9%	7.7%	6.6%	6.6%
<b>Cash Flow Statement</b>																				
CFFO	7	51	21	25	105	30	89	45	19	148	20	51	54	50	175	24	61	63	61	209
Yr./Yr. Change	-55%	108%	-36%	-23%	1%	318%	75%	114%	-24%	41%	-32%	-43%	18%	161%	19%	19%	17%	22%	19%	19%
<b>FCF</b>	<b>(12)</b>	<b>36</b>	<b>1</b>	<b>0</b>	<b>25</b>	<b>(5)</b>	<b>55</b>	<b>18</b>	<b>(5)</b>	<b>27</b>	<b>(2)</b>	<b>26</b>	<b>26</b>	<b>26</b>	<b>76</b>	<b>(0)</b>	<b>33</b>	<b>33</b>	<b>35</b>	<b>101</b>
Yr./Yr. Change	-870%	224%	-95%	-98%	-48%	-63%	54%	1790%	-1593%	9%	-60%	-54%	48%	-581%	179%	-93%	29%	26%	35%	33%
EBITDA	24	36	42	37	139	33	60	64	58	215	45	75	78	70	268	53	87	90	80	310
Yr./Yr. Change	-16%	10%	6%	48%	10%	36%	65%	54%	56%	54%	37%	24%	22%	22%	25%	18%	16%	14%	14%	15%
<b>Balance Sheet</b>																				
Cash & S/T Investments	12	18	5	13	13	11	11	10	25	25	5	31	57	83	83	103	136	169	204	204
Cash per Share	0	1	0	0	0	0	0	0	1	1	0	1	2	2	2	3	4	5	6	6
Inventory, end of period	97	105	158	164	164	168	159	164	186	186	186	177	181	205	205	203	192	195	216	216
Yr./Yr. Change	36%	66%	97%	101%	101%	72%	52%	4%	14%	14%	11%	11%	11%	10%	10%	9%	8%	8%	6%	6%
Ending Inventory per Sq Ft	15	15	17	16	16	16	15	15	17	17	16	15	15	16	16	16	15	15	16	16
Yr./Yr. Change	9%	26%	15%	17%	17%	9%	1%	-10%	2%	2%	0%	-1%	0%	-2%	-2%	-1%	0%	0%	-1%	-1%
Total Assets	898	965	1,556	1,609	1,609	1,641	1,642	1,659	1,698	1,698	1,704	1,728	1,767	1,815	1,815	1,859	1,887	1,930	1,983	1,983
Total Liabilities	556	605	1,134	1,174	1,174	1,196	1,172	1,163	1,172	1,172	1,203	1,197	1,204	1,224	1,224	1,251	1,242	1,247	1,266	1,266
Total shareholders' equity	342	359	422	435	435	446	470	496	526	526	501	531	562	590	590	608	645	683	717	717
Book Value per Share	\$9.94	\$10.41	\$12.16	\$12.27	\$12.52	\$12.52	\$13.20	\$13.96	\$14.46	\$14.71	\$14.01	\$14.84	\$15.74	\$16.15	\$16.42	\$16.91	\$17.93	\$19.02	\$19.51	\$19.83
Total Debt	300	302	759	770	770	771	715	698	708	708	728	728	728	728	728	748	748	748	748	748
Total Debt / EBITDA	12.4x	8.3x	18.2x	20.8x	5.5x	23.5x	11.8x	10.9x	12.2x	3.3x	16.2x	9.7x	9.3x	10.3x	2.7x	14.1x	8.6x	8.4x	9.3x	2.4x
Total Adjusted Debt / EBITDAR	-	-	-	-	7.1x	-	-	-	-	5.7x	-	-	-	-	5.2x	-	-	-	-	5.0x

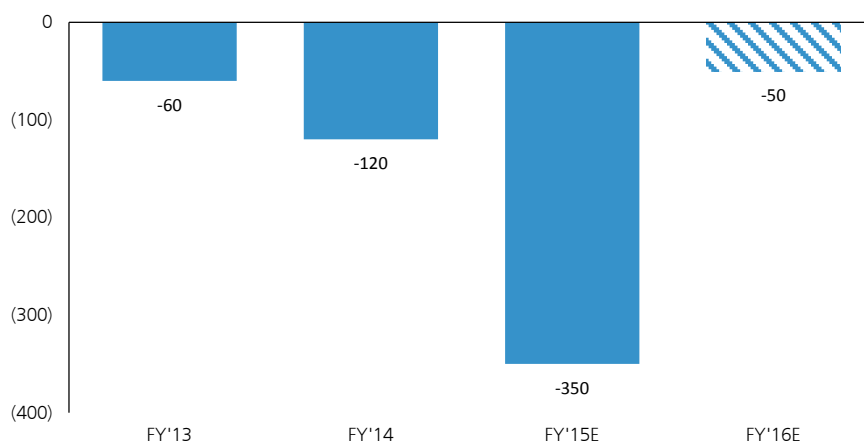
Source: Company reports, UBS estimates

## Bed Bath and Beyond (BBBY) - Neutral

Topics to Watch: For 2016, we believe the following factors will be the critical drivers for how the shares perform.

- **Will its share losses moderate in 2016?** We think BBBY will experience further market share erosion in 2016. BBBY's comp has underperformed the industry lately and the spread likely widened further in FY'15. We suspect that the company is losing share to emerging players like Wayfair and HomeGoods. We believe the company's investment in technology and labor should help lessen these share losses a bit in FY'16. However, going forward these investments could well be an increased cost of doing business in a competitive home furnishing sector. We estimate BBBY's FY'16 comp sales to grow 2.0%, which is above our 0.9% estimate for FY'15, but below the 2.4% and 2.5% comp growth seen in FY'13 and FY'14 respectively.

**Figure 52: Spread between HF Retail Sales and BBBY Comp (bps)**



Source: Company Reports, UBS Estimates

- **Can BBBY reverse its margin declines in FY'16?** We expect another year of margin contraction for BBBY. Coupon usage at its stores will likely remain at elevated levels in 2016, given their easy availability. This should continue to pressure its gross margin next year. In addition, the company is likely to incur higher compensation & benefit expenses due to its labor investments. Further, BBBY will likely continue to invest in technology and other initiatives in 2016. While we think these investments will probably improve BBBY's competitive positioning in the longer-run, it will impact its SG&A in the near term. All in, we forecast -80 bps of operating margin contraction to 11.2% in FY'16.
- **Will the company continue to aggressively buy-back shares?** BBBY expects to complete its remaining prior repurchase authorization of \$110 mm by early 4Q'15. Further, it anticipates that its additional \$2.5 bn authorization will be completed by FY'19. Assuming that BBBY intends to buy-back shares equally over the course of the next couple of years, it implies that its annual run-rate could slow down from the \$1 b+ seen in the last few years. However, there is also a chance that BBBY could front load its buybacks to take advantage of the recent fall in its share price. Specifically, for FY'16 we forecast

BBBY buying back shares worth \$1 bn, which is higher than our forecast of ~\$923 mm for FY'15, but below its FY'12-FY'14 average of ~\$1.7 bn.

## What to do with the stock?

BBBY is facing a number of headwinds. Its sales growth has stagnated in the past few years as it has lost share to emerging players in the home furnishing space. At the same time it is facing margin contraction due to increased investments in eCommerce and other initiatives. Although the company is taking the right steps by investing in its future growth, it is unclear as to when it will see tangible benefits from its investments. Our new \$52 price target (\$64 prior) equates to 9x our CY'17 EPS estimate of \$5.74 and is based on a DCF/multiple blend analysis.

We think it is useful to examine how our price target would respond to various changes in our assumptions for BBBY's earnings outlook over the next few years and the valuation multiple that would be associated with those scenarios. The following figure highlights our base case, a high case, and a low case.

**Figure 53: BBBY price target sensitivity analysis**

	Base Case (Published estimates)					High Case			Low Case		
	2013A	2014A	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E
Comparable Store Sales Growth	2.5%	2.4%	0.9%	1.5%	2.0%	1.0%	3.0%	3.5%	-1.0%	-1.0%	-1.0%
Growth Contribution from New Stores	2.9%	0.9%	0.8%	0.9%	1.3%	0.8%	0.9%	1.3%	0.8%	0.9%	1.3%
Total Sales Growth	5.4%	3.3%	1.7%	2.4%	3.3%	1.8%	3.9%	4.8%	-0.2%	-0.1%	0.3%
<b>Total Sales</b>	<b>11,504</b>	<b>11,881</b>	<b>12,081</b>	<b>12,373</b>	<b>12,777</b>	<b>12,098</b>	<b>12,572</b>	<b>13,171</b>	<b>11,861</b>	<b>11,851</b>	<b>11,882</b>
<b>Operating Income</b>	<b>1,615</b>	<b>1,554</b>	<b>1,380</b>	<b>1,308</b>	<b>1,274</b>	<b>1,492</b>	<b>1,488</b>	<b>1,519</b>	<b>1,374</b>	<b>1,136</b>	<b>960</b>
Operating Income Margin	14.0%	13.1%	11.4%	10.6%	10.0%	12.3%	11.8%	11.5%	11.6%	9.6%	8.1%
Operating Income Yr. / Yr. Change	-97	-95	-166	-85	-60	-75	-50	-30	-150	-200	-150
Interest Expense	(1)	(50)	(83)	(84)	(85)	(83)	(84)	(85)	(83)	(84)	(85)
Provision for Income Taxes	591	546	472	459	446	513	526	537	470	394	328
Income Taxes Rate	36.6%	36.3%	36.4%	37.5%	37.5%	36.4%	37.5%	37.5%	36.4%	37.5%	37.5%
<b>Diluted Net Income</b>	<b>1,022</b>	<b>958</b>	<b>825</b>	<b>766</b>	<b>744</b>	<b>896</b>	<b>878</b>	<b>897</b>	<b>821</b>	<b>658</b>	<b>548</b>
<b>Diluted EPS - reported</b>	<b>\$4.79</b>	<b>\$5.07</b>	<b>\$4.99</b>	<b>\$5.18</b>	<b>\$5.74</b>	<b>\$5.43</b>	<b>\$5.94</b>	<b>\$6.92</b>	<b>\$4.97</b>	<b>\$4.45</b>	<b>\$4.22</b>
Shares outstanding - diluted	213.4	188.9	165.2	147.8	129.7	165.2	147.8	129.7	165.2	147.8	129.7
NTM PE Multiple:			10x	10x	9x	13x	12x	10x	5x	6x	6x
<b>Estimated Value:</b>			<b>\$52</b>	<b>\$52</b>	<b>\$52</b>	<b>\$71</b>	<b>\$71</b>	<b>\$69</b>	<b>\$25</b>	<b>\$27</b>	<b>\$25</b>
<b>Upside / Downside (vs. \$46.51):</b>			<b>12%</b>	<b>12%</b>	<b>12%</b>	<b>52%</b>	<b>53%</b>	<b>49%</b>	<b>-47%</b>	<b>-43%</b>	<b>-46%</b>

Source: Company reports, UBS estimates



Figure 54: BBBY financial model summary (\$ millions except per share)

	1Q14	2Q14	3Q14	4Q14	2014	1Q15	2Q15	3Q15E	4Q15E	2015E	1Q16E	2Q16E	3Q16E	4Q16E	2016E	1Q17E	2Q17E	3Q17E	4Q17
<b>Income Statement</b>																			
<b>Total Sales</b>	<b>2,656.7</b>	<b>2,944.9</b>	<b>2,943.0</b>	<b>3,336.6</b>	<b>11,881.2</b>	<b>2,738.5</b>	<b>2,995.5</b>	<b>2,952.0</b>	<b>3,399.8</b>	<b>12,085.8</b>	<b>2,823.1</b>	<b>3,091.5</b>	<b>3,044.6</b>	<b>3,506.6</b>	<b>12,465.9</b>	<b>2,913.4</b>	<b>3,193.4</b>	<b>3,147.9</b>	<b>3,623.</b>
Yr./Yr. Change	1.7%	4.3%	2.7%	4.2%	3.3%	3.1%	1.7%	0.3%	1.9%	1.7%	3.1%	3.2%	3.1%	3.1%	3.1%	3.2%	3.3%	3.4%	3.3%
Comp Store Sales	0.4%	3.4%	1.7%	3.7%	2.4%	2.2%	0.7%	-0.4%	1.0%	0.9%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Gross Profit	1,031	1,134	1,129	1,326	4,620	1,044	1,141	1,112	1,332	4,629	1,067	1,167	1,136	1,362	4,731	1,092	1,196	1,165	1,391
% of Sales	38.8%	38.5%	38.4%	39.7%	38.9%	38.1%	38.1%	37.7%	39.2%	38.3%	37.8%	37.7%	37.3%	38.8%	38.0%	37.5%	37.4%	37.0%	38.5%
Yr./Yr. Change (bps)	(74)	(93)	(79)	(77)	(80)	(68)	(42)	(70)	(55)	(58)	(35)	(35)	(35)	(35)	(35)	(30)	(30)	(30)	(30)
SG&A Expense	730	765	776	794	3,065	771	791	805	834	3,201	807	830	844	876	3,358	842	867	882	916
% of Sales	27.5%	26.0%	26.4%	23.8%	25.8%	28.1%	26.4%	27.3%	24.5%	26.5%	28.6%	26.8%	27.7%	25.0%	26.9%	28.9%	27.1%	28.0%	25.3%
Yr./Yr. Change (bps)	31	36	30	(26)	15	66	41	90	75	69	45	45	45	45	45	30	30	30	30
<b>Operating Income</b>	<b>301</b>	<b>369</b>	<b>353</b>	<b>532</b>	<b>1,554</b>	<b>273</b>	<b>350</b>	<b>307</b>	<b>498</b>	<b>1,428</b>	<b>259</b>	<b>337</b>	<b>292</b>	<b>486</b>	<b>1,373</b>	<b>250</b>	<b>329</b>	<b>283</b>	<b>480</b>
% of Sales	11.3%	12.5%	12.0%	15.9%	13.1%	10.0%	11.7%	10.4%	14.6%	11.8%	9.2%	10.9%	9.6%	13.8%	11.0%	8.6%	10.3%	9.0%	13.2%
Yr./Yr. Change (bps)	(105)	(128)	(109)	(50)	(95)	(134)	(83)	(160)	(130)	(127)	(80)	(80)	(80)	(80)	(80)	(60)	(60)	(60)	(60)
Interest, Net	(2)	(10)	(20)	(19)	(50)	(20)	(25)	(20)	(20)	(85)	(20)	(25)	(20)	(20)	(86)	(20)	(25)	(20)	(20)
Pretax Income	299	359	333	513	1,504	253	325	287	478	1,343	239	311	272	465	1,288	230	303	262	460
Income Taxes	112	135	108	192	546	95	123	109	182	509	90	117	102	174	482	86	114	98	172
Tax Rate	37.3%	37.7%	32.3%	37.4%	36.3%	37.5%	38.0%	38.0%	38.0%	37.9%	37.5%	37.5%	37.5%	37.5%	37.5%	37.5%	37.5%	37.5%	37.5%
Net Income	187	224	225	321	958	158	202	178	297	834	149	195	170	291	805	144	190	164	288
<b>EPS</b>	<b>\$0.93</b>	<b>\$1.17</b>	<b>\$1.23</b>	<b>\$1.80</b>	<b>\$5.07</b>	<b>\$0.93</b>	<b>\$1.21</b>	<b>\$1.08</b>	<b>\$1.83</b>	<b>\$5.03</b>	<b>\$0.94</b>	<b>\$1.26</b>	<b>\$1.13</b>	<b>\$1.99</b>	<b>\$5.30</b>	<b>\$1.01</b>	<b>\$1.36</b>	<b>\$1.21</b>	<b>\$2.18</b>
Yr./Yr. Change	-0.2%	0.7%	9.8%	12.5%	5.8%	0.0%	3.5%	-11.9%	1.3%	-0.8%	1.9%	4.3%	4.7%	9.1%	5.4%	6.7%	8.1%	7.2%	9.5%
Avg Shares Outstanding	202	191	184	178	189	171	167	165	162	166	158	154	150	146	152	143	139	135	132
Total Stores, end of period	1,500	1,506	1,510	1,513	1,513	1,514	1,520	1,527	1,533	1,533	1,557	1,545	1,550	1,557	1,557	1,564	1,572	1,577	1,581
Yr./Yr. Change	22	22	19	17	17	14	14	17	20	20	43	25	23	24	24	7	27	27	25
Square Footage, end of period	43	43	43	43	43	43	44	44	44	44	44	44	45	45	45	45	45	46	46
Yr./Yr. Change	1.3%	1.6%	1.5%	1.3%	1.3%	1.1%	1.2%	1.4%	1.6%	1.6%	2.1%	2.0%	1.8%	2.0%	2.0%	2.0%	2.3%	2.3%	2.1%
<b>Cash Flow Statement</b>																			
FFO	184	361	-41	682	1,186	154	255	271	492	1,172	116	198	412	368	1,094	206	204	412	262
Yr./Yr. Change	-32%	62%	-138%	-13%	-14%	-16%	-29%	-764%	-28%	-1%	-25%	-22%	52%	-25%	-7%	78%	3%	0%	-29%
FCF	117	273	(116)	582	855	82	167	174	380	802	41	107	311	253	712	129	109	308	142
Yr./Yr. Change	-44%	73%	-1606%	-16%	-20%	-30%	-39%	-249%	-35%	-6%	-50%	-36%	79%	-33%	-11%	213%	2%	-1%	-44%
EBITDA	359	428	414	593	1,793	336	415	370	571	1,692	318	402	356	559	1,635	311	396	349	556
Yr./Yr. Change	-5%	-3%	-4%	1%	-2%	-6%	-3%	-11%	-4%	-6%	-5%	-3%	-4%	-2%	-3%	-2%	-1%	-2%	-1%
<b>Balance Sheet</b>																			
Cash & S/T Investments	713	1,287	1,179	986	986	692	696	745	1,000	1,000	797	654	715	717	717	621	505	589	1,256
Cash per Share	4	7	6	6	5	4	4	5	6	6	5	4	5	5	9	4	4	4	10
Inventory, end of period	2,700	2,759	3,066	2,732	2,732	2,844	2,875	3,110	2,809	2,809	2,910	2,984	3,226	2,890	2,890	3,018	3,098	3,351	2,977
Yr./Yr. Change	6%	6%	6%	6%	6%	5%	4%	1%	3%	3%	2%	4%	4%	3%	3%	4%	4%	4%	3%
Ending Inventory per Sq Ft	63	64	71	63	63	66	66	71	64	64	66	67	72	64	64	67	68	73	65
Yr./Yr. Change	5%	5%	5%	5%	5%	4%	3%	0%	1%	1%	0%	2%	2%	1%	1%	2%	1%	2%	1%
Total Assets	6,362	7,034	7,336	6,759	6,759	6,599	6,651	6,439	6,421	6,421	6,368	6,358	6,654	6,352	6,352	6,433	6,460	6,789	7,114
Total Liabilities	2,468	4,095	4,147	4,016	4,016	4,047	4,083	4,293	4,091	4,091	4,121	4,154	4,517	4,161	4,161	4,312	4,360	4,738	4,237
Total shareholders' equity	3,894	2,939	3,189	2,743	2,743	2,552	2,568	2,146	2,331	2,331	2,247	2,204	2,136	2,191	2,191	2,122	2,099	2,051	2,876
Book Value per Share	\$19.27	\$15.35	\$17.35	\$15.40	\$14.52	\$14.91	\$15.41	\$13.04	\$14.35	\$14.04	\$14.19	\$14.29	\$14.22	\$14.99	\$26.43	\$14.88	\$15.11	\$15.15	\$21.8
Total Debt	0	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500	1,500
Total Debt / EBITDA	0.0x	0.0x	0.0x	0.0x	0.8x	0.0x	0.0x	0.0x	0.0x	0.9x	0.0x	0.0x	0.0x	0.0x	0.9x	0.0x	0.0x	0.0x	0.0x
Total Adjusted Debt / EBITDAR	0.0x	0.0x	0.0x	0.0x	2.6x	0.0x	0.0x	0.0x	0.0x	2.7x	0.0x	0.0x	0.0x	0.0x	3.0x	0.0x	0.0x	0.0x	0.0x

Source: Company reports, UBS estimates

## Williams Sonoma (WSM) - Neutral

Topics to Watch: For 2016, we believe the following factors will be the critical drivers for how the shares perform.

- **Will Williams-Sonoma sustain its mid-single digit brand comp growth in 2016?** While WSM saw a slight moderation in its brand comp growth in the first 3 quarters of 2015, it still grew at a healthy mid-single digit range. Looking into 2016, we think that the sustainability of this performance will be closely monitored by the market. We forecast WSM's brand comp to grow 4.6% in FY'16, driven by strong growth in its West Elm and Pottery Barn brands. If the company is able to maintain this performance consistently across quarters, it is likely to be well received by the market.

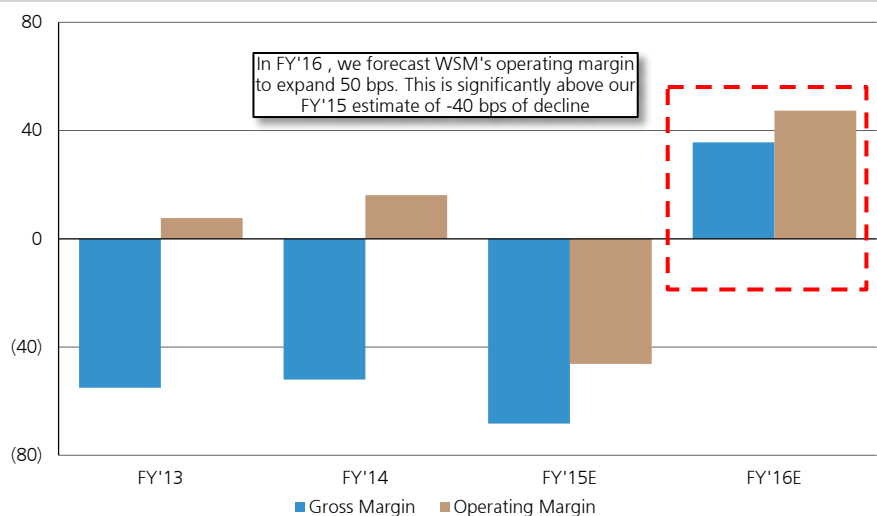
Figure 55: WSM Comparable Brand Revenue

	(mm's, except per share amounts)														
	2015E					2016E					2017E				
	May-15	Aug-15	Nov-15	Jan-16 E	FY'15 E	May-16 E	Jul-16 E	Oct-16 E	Jan-17 E	FY'16 E	Apr-17 E	Jul-17 E	Oct-17 E	Jan-18 E	FY'17 E
Comparable Brand Revenue by Concept															
Pottery Barn	2.4%	6.4%	2.0%	7.0%	4.5%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%	7.0%
Williams-Sonoma	2.7%	-0.3%	1.2%	2.0%	1.4%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
Pottery Barn Kids	0.8%	3.3%	4.7%	4.0%	3.2%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
West Elm	15.3%	15.7%	15.7%	10.0%	14.2%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%	8.0%
PBteen	3.0%	3.9%	-0.9%	4.0%	2.5%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%	4.0%
Total Company	4.6%	6.3%	4.5%	5.1%	4.3%	4.8%	4.8%	4.6%	4.4%	4.6%	4.8%	4.8%	4.6%	4.4%	4.6%
Calc. Comp Brand Revenue	3.7%	5.6%	3.7%	2.4%	3.7%	3.4%	3.4%	4.0%	4.1%	3.8%	2.6%	2.6%	2.6%	2.6%	2.6%
2-Year Trend, by Concept															
Pottery Barn	12.1%	10.8%	9.0%	9.9%	10.3%	9.4%	13.4%	9.0%	14.0%	11.5%	14.0%	14.0%	14.0%	14.0%	14.0%
Williams-Sonoma	8.7%	3.1%	5.5%	4.8%	5.2%	3.7%	0.7%	2.2%	3.0%	2.4%	2.0%	2.0%	2.0%	2.0%	2.0%
Pottery Barn Kids	8.9%	8.9%	13.3%	6.7%	9.1%	2.8%	5.3%	6.7%	6.0%	5.2%	4.0%	4.0%	4.0%	4.0%	4.0%
West Elm	34.1%	32.4%	33.1%	29.6%	32.4%	23.3%	23.7%	23.7%	18.0%	22.2%	16.0%	16.0%	16.0%	16.0%	16.0%
PBteen	15.0%	2.9%	10.8%	7.0%	8.2%	7.0%	7.9%	3.1%	8.0%	6.5%	8.0%	8.0%	8.0%	8.0%	8.0%
Total Company	14.6%	12.0%	13.2%	10.2%	11.4%	9.4%	11.1%	9.1%	9.5%	9.0%	9.5%	9.5%	9.2%	8.8%	9.3%

Source: Company Reports, UBS Estimates

- **Can WSM expand its operating margin in 2016?** We believe that the company should be able to grow its operating margin in FY'16. The company saw relatively flat operating margin performances in FY'13 & FY'14 and is on track to see some contraction in FY'15. However, in FY'16, WSM will likely see nice gross margin expansion driven by both occupancy leverage and moderating merchandise costs (after 4 straight years of deleverage). Further, the company should also leverage its SG&A as it improves its advertising efficiency, labor costs, and other expenses on a higher sales base. All in, we forecast 50 bps of operating margin expansion to 10.5% in FY'16.

**Figure 56: WSM margin picture (in bps)**



Source: Company Reports, UBS Estimates

- **Will its international business be a more meaningful driver of overall sales growth?** International represented ~7% of WSM's 3Q'15 sales and it grew 26.5% YoY during the quarter. WSM is increasingly placing a strong focus on its overseas operations. For example, the company intends to open more stores in Mexico and also pursue more opportunities for shop-in-shop partnerships around the world. In 2016, we expect the company to grow its international operations at its current run-rate, which will help support its overall top-line performance.

## What to do with the stock?

WSM has a few things going for it. Its brand comps continue to grow at a healthy mid-single digit range driven by its West Elm brand. It has also been able to leverage SG&A nicely despite some port issues impacting operations. However, its Williams Sonoma and Pottery Barn brands have shown some quarter on quarter variability in performance. In addition, its merchandise margin continues to remain under pressure. We prefer to remain on the sidelines until there is more evidence of consistency. Our \$70 PT equates to 17x our CY'17 EPS estimate of \$4.23 and is based on a DCF/multiple blend analysis.

We think it is useful to examine how our price target would respond to various changes in our assumptions for WSM's earnings outlook over the next few years and the valuation multiple that would be associated with those scenarios. The following figure highlights our base case, a high case, and a low case.

Figure 57: WSM price target sensitivity analysis

	Base Case (Published estimates)					High Case			Low Case		
	2013A	2014A	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E
Comparable Store Sales Growth	5.5%	1.6%	2.9%	2.0%	1.0%	4.0%	3.5%	2.5%	0.0%	0.0%	-0.5%
Direct-to-Customers Contribution	4.0%	4.7%	0.8%	1.8%	1.6%	0.8%	1.8%	1.6%	0.8%	1.8%	1.6%
Growth Contribution from New Stores	-0.9%	0.8%	2.7%	1.9%	1.5%	2.7%	1.9%	1.5%	2.7%	1.9%	1.5%
Total Sales Growth	8.5%	7.1%	6.5%	5.7%	4.1%	7.5%	7.2%	5.6%	3.5%	3.7%	2.6%
<b>Total Sales</b>	<b>4,388</b>	<b>4,699</b>	<b>5,002</b>	<b>5,286</b>	<b>5,505</b>	<b>5,052</b>	<b>5,416</b>	<b>5,718</b>	<b>4,864</b>	<b>5,044</b>	<b>5,174</b>
<b>Operating Income</b>	<b>455</b>	<b>495</b>	<b>504</b>	<b>557</b>	<b>589</b>	<b>517</b>	<b>595</b>	<b>654</b>	<b>483</b>	<b>508</b>	<b>511</b>
Operating Income Margin	10.4%	10.5%	10.1%	10.5%	10.7%	10.2%	11.0%	11.4%	9.9%	10.1%	9.9%
Operating Income Yr. / Yr. Change	8	16	-46	47	15	-30	75	45	-60	15	-20
Interest Expense	0	0	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)	(1)
Provision for Income Taxes	175	191	188	214	226	193	229	251	180	196	197
Income Taxes Rate	38.4%	38.5%	37.4%	38.5%	38.5%	37.4%	38.5%	38.5%	37.4%	38.5%	38.5%
<b>Diluted Net Income</b>	<b>280</b>	<b>304</b>	<b>315</b>	<b>342</b>	<b>362</b>	<b>323</b>	<b>365</b>	<b>402</b>	<b>302</b>	<b>312</b>	<b>314</b>
<b>Diluted EPS - reported</b>	<b>\$2.86</b>	<b>\$3.21</b>	<b>\$3.42</b>	<b>\$3.85</b>	<b>\$4.23</b>	<b>\$3.51</b>	<b>\$4.11</b>	<b>\$4.70</b>	<b>\$3.28</b>	<b>\$3.51</b>	<b>\$3.67</b>
Shares outstanding - diluted	98.1	94.8	92.2	88.9	85.5	92.2	88.9	85.5	92.2	88.9	85.5
NTM PE Multiple:			20x	18x	17x	24x	20x	18x	18x	17x	13x
Estimated Value:			\$70	\$70	\$70	\$84	\$82	\$85	\$59	\$60	\$48
Dividend:			\$1.38	\$1.40	\$1.40	\$1.38	\$1.40	\$1.40	\$1.38	\$1.40	\$1.40
<b>Upside / Downside (vs. \$56.49):</b>			<b>26%</b>	<b>26%</b>	<b>26%</b>	<b>52%</b>	<b>48%</b>	<b>52%</b>	<b>7%</b>	<b>8%</b>	<b>-13%</b>

Source: Company reports, UBS estimates

Figure 58: WSM financial model summary (\$ millions except per share)

	1Q14	2Q14	3Q14	4Q14	2014	1Q15	2Q15	3Q15E	4Q15E	2015E	1Q16E	2Q16E	3Q16E	4Q16E	2016E	1Q17E	2Q17E	3Q17E	4Q17E	2017E
<b>Income Statement</b>																				
<b>Total Sales</b>	<b>974</b>	<b>1,039</b>	<b>1,143</b>	<b>1,542</b>	<b>4,698.7</b>	<b>1,031</b>	<b>1,127</b>	<b>1,232</b>	<b>1,612</b>	<b>5,002.0</b>	<b>1,093</b>	<b>1,194</b>	<b>1,301</b>	<b>1,699</b>	<b>5,286.4</b>	<b>1,138</b>	<b>1,243</b>	<b>1,355</b>	<b>1,769</b>	<b>5,504.5</b>
Yr./Yr. Change	9.7%	5.8%	8.7%	5.2%	7.1%	5.8%	8.5%	7.8%	4.5%	6.5%	6.0%	6.0%	5.6%	5.4%	5.7%	4.1%	4.1%	4.1%	4.1%	4.1%
Comp Store Sales	2.4%	2.2%	2.5%	0.0%	1.6%	1.0%	5.0%	4.5%	1.5%	2.9%	2.0%	2.0%	2.0%	2.0%	2.0%	1.0%	1.0%	1.0%	1.0%	1.0%
Gross Profit	368	382	431	619	1,801	379	407	451	649	1,886	411	436	479	687	2,013	430	456	501	718	2,105
% of Sales	37.8%	36.8%	37.7%	40.1%	38.3%	36.8%	36.1%	36.6%	40.3%	37.7%	37.6%	36.5%	36.8%	40.5%	38.1%	37.8%	36.7%	37.0%	40.6%	38.2%
Yr./Yr. Change (bps)	17	(79)	(81)	(51)	(52)	(105)	(69)	(112)	15	(62)	85	45	20	20	39	15	15	15	15	15
SG&A Expense	294	297	327	388	1,306	307	323	341	408	1,379	324	341	358	428	1,451	335	353	371	443	1,503
% of Sales	30.2%	28.6%	28.6%	25.2%	27.8%	29.8%	28.7%	27.6%	25.3%	27.6%	29.6%	28.5%	27.5%	25.2%	27.4%	29.5%	28.4%	27.4%	25.1%	27.3%
Yr./Yr. Change (bps)	6	(105)	(118)	(61)	(68)	(41)	13	(94)	15	(22)	(15)	(15)	(10)	(10)	(12)	(15)	(15)	(15)	(15)	(15)
<b>Operating Income</b>	<b>74.3</b>	<b>85.3</b>	<b>104.7</b>	<b>230.5</b>	<b>494.9</b>	<b>71.9</b>	<b>83.3</b>	<b>110.7</b>	<b>240.9</b>	<b>506.9</b>	<b>87.2</b>	<b>95.5</b>	<b>120.7</b>	<b>259.0</b>	<b>562.4</b>	<b>94.2</b>	<b>103.1</b>	<b>129.8</b>	<b>274.9</b>	<b>602.1</b>
% of Sales	7.6%	8.2%	9.2%	14.9%	10.5%	7.0%	7.4%	9.0%	14.9%	10.1%	8.0%	8.0%	9.3%	15.2%	10.6%	8.3%	8.3%	9.6%	15.5%	10.9%
Yr./Yr. Change (bps)	11	26	36	10	16	-65	-82	-18	0	-40	100	60	30	30	50	30	30	30	30	30
Interest, Net	(0.1)	0.0	0.1	(0.0)	0.1	0.0	0.3	0.3	0.0	0.6	0.0	0.3	0.3	0.0	0.6	0.0	0.3	0.3	0.0	0.6
Pretax Income	74.4	85.3	104.6	230.5	494.8	71.9	83.1	110.3	240.9	506.3	87.2	95.2	120.4	259.0	561.8	94.2	102.9	129.5	274.9	601.5
Income Taxes	28.2	34.5	39.7	88.0	190.5	27.1	29.4	39.9	92.8	189.2	33.6	36.7	46.4	99.7	216.3	36.3	39.6	49.8	105.8	231.6
Tax Rate																				
Net Income	46.2	50.7	64.9	142.4	304.3	44.8	53.7	70.5	148.2	317.1	53.6	58.6	74.0	159.3	345.5	57.9	63.3	79.6	169.1	369.9
<b>EPS</b>	<b>\$0.48</b>	<b>\$0.53</b>	<b>\$0.68</b>	<b>\$1.52</b>	<b>\$3.21</b>	<b>\$0.48</b>	<b>\$0.58</b>	<b>\$0.77</b>	<b>\$1.62</b>	<b>\$3.44</b>	<b>\$0.59</b>	<b>\$0.65</b>	<b>\$0.83</b>	<b>\$1.81</b>	<b>\$3.88</b>	<b>\$0.67</b>	<b>\$0.73</b>	<b>\$0.93</b>	<b>\$2.00</b>	<b>\$4.32</b>
Yr./Yr. Change	16.4%	7.1%	18.0%	10.3%	12.9%	-0.6%	9.5%	12.3%	6.6%	7.3%	23.4%	12.8%	8.8%	11.9%	12.8%	12.4%	12.3%	11.8%	10.3%	11.3%
Avg Shares Outstanding	96	96	95	94	95	93	93	92	91	92	90	90	89	88	89	87	86	85	85	86
Total Stores, end of period	589	589	603	601	601	603	612	623	616	616	619	622	625	628	628	631	634	637	640	640
Yr./Yr. Change	2	-1	8	16	16	14	23	20	15	15	16	10	2	12	12	12	12	12	12	12
Square Footage, end of period	3.6	3.6	3.7	3.7	3.7	3.7	3.8	3.8	3.9	3.9	3.9	3.9	3.9	4.0	4.0	4.0	4.1	4.0	4.1	4.1
Yr./Yr. Change	0%	0%	2%	3%	3%	3%	5%	4%	5%	5%	6%	4%	2%	3%	3%	3%	3%	3%	3%	3%
<b>Cash Flow Statement</b>																				
FFO	-70	81	112	340	461.7	-67	104	56	404	495.9	-66	102	59	437	537.1	-66	110	65	460	574.5
Yr./Yr. Change	18%	-35%	32%	11%	2%	-5%	29%	-50%	19%	7%	-2%	-2%	5%	8%	8%	0%	8%	10%	5%	7%
<b>FCF</b>	<b>(108)</b>	<b>35</b>	<b>63</b>	<b>267</b>	<b>256.9</b>	<b>(107)</b>	<b>57</b>	<b>7</b>	<b>339</b>	<b>295.4</b>	<b>(111)</b>	<b>52</b>	<b>4</b>	<b>365</b>	<b>315.1</b>	<b>(113)</b>	<b>58</b>	<b>8</b>	<b>386</b>	<b>343.3</b>
Yr./Yr. Change	1%	-52%	71%	4%	-1%	-1%	63%	-89%	27%	15%	4%	-10%	-38%	8%	7%	2%	11%	86%	6%	9%
EBITDA	113.0	126.0	146.5	271.6	887.4	113.4	125.1	152.5	289.3	680.4	131.2	139.7	164.9	309.9	745.8	140.0	149.2	175.8	328.0	793.0
Yr./Yr. Change	9%	9%	13%	6%	47%	0%	-1%	4%	7%	-23%	16%	12%	8%	7%	10%	7%	7%	7%	6%	6%
<b>Balance Sheet</b>																				
Cash & S/T Investments	127.2	70.6	107.7	222.9	222.9	78.9	119.8	72.3	353.8	353.8	295.1	252.7	162.2	433.1	433.1	381.7	346.3	260.8	553.3	553.3
Cash per Share	1.3	0.7	1.1	2.4	2.4	0.8	1.3	0.8	3.9	3.8	3.3	2.8	1.8	4.9	4.9	4.4	4.0	3.1	6.5	6.5
Inventory, end of period	850	895	980	888	888	943	1,031	1,102	957	957	986	1,085	1,160	1,005	1,005	1,025	1,127	1,205	1,044	1,044
Yr./Yr. Change	29%	21%	9%	9%	9%	11%	15%	13%	8%	8%	5%	5%	5%	5%	5%	4%	4%	4%	4%	4%
Ending Inventory per Sq Ft	236	249	266	241	241	254	274	287	248	248	262	269	277	285	253	253	278	299	255	255
Yr./Yr. Change	28%	22%	7%	6%	6%	8%	10%	8%	3%	3%	3%	-2%	-4%	15%	2%	-3%	3%	8%	-10%	1%
Total Assets	2,168	2,164	2,304	2,330	2,330	2,251	2,396	2,436	2,555	2,555	2,554	2,634	2,636	2,737	2,737	2,731	2,823	2,833	2,949	2,949
Total Liabilities	960	985	1,168	1,106	1,106	1,064	1,255	1,319	1,348	1,348	1,240	1,356	1,377	1,407	1,407	1,280	1,401	1,424	1,458	1,458
Total shareholders' equity	1,208	1,178	1,136	1,225	1,225	1,187	1,141	1,117	1,207	1,207	1,314	1,279	1,259	1,330	1,330	1,450	1,421	1,409	1,491	1,491
Book Value per Share	\$12.64	\$12.30	\$11.97	\$13.08	\$12.91	\$12.72	\$12.33	\$12.16	\$13.21	\$13.10	\$14.52	\$14.28	\$14.20	\$15.15	\$14.95	\$16.68	\$16.50	\$16.51	\$17.64	\$17.42
Total Debt	4	2	92	2	2	62	150	200	200	200	200	200	200	200	200	200	200	200	200	200
Total Debt / EBITDA	0.0x	0.0x	0.6x	0.0x	0.0x	0.5x	1.2x	1.3x	0.7x	0.3x	1.5x	1.4x	1.2x	0.6x	0.3x	1.4x	1.3x	1.1x	0.6x	0.3x
Total Adjusted Debt / EBITDAR	0.0x	0.0x	0.0x	0.0x	1.7x	0.0x	0.0x	0.0x	0.0x	2.4x	0.0x	0.0x	0.0x	0.0x	2.2x	0.0x	0.0x	0.0x	0.0x	2.1x

Source: Company reports, UBS estimates

## Pier 1 Imports (PIR) - Sell

Topics to Watch: For 2016, we believe the following factors will be the critical drivers for how the shares perform.

- **Will PIR's eCommerce channel help attract incremental customers?** We think a majority of its recent online growth has come from cannibalizing customers out of its stores. As a result, overall top-line growth has been muted. For example, PIR's online sales grew ~190% in CY'14, followed by another 88% in 1H'15 (CY), but its stores sales declined -2.4% and -5.8% respectively, over the same period. We think PIR's product assortment do not have a universal appeal which is limiting its ability to get new customers. Should the company succeed in introducing more newness and variety to its product base, it would help capture incremental buyers.

**Figure 59: PIR's Store sales have declined consecutively for the last 6 quarters**

PIR Margin Breakdown	2015					2016		
	1Q'15	2Q'15	3Q'15	4Q'15	CY'14	1Q'16	2Q'16	3Q'16
<b>PIR Sales (\$ mm)</b>	\$419.1	\$418.6	\$484.5	\$543.6	\$1,865.8	\$432.0	\$430.0	\$472.5
% Growth	6.1%	5.8%	4.1%	5.4%	5.3%	3.1%	2.7%	-2.5%
<b>eCommerce Sales (\$ mm)</b>	\$37.3	\$40.6	\$59.6	\$67.7	\$205.2	\$73.4	\$73.1	\$75.6
% Growth	148.3%	177.4%	204.8%	212.7%	189.6%	96.9%	80.0%	26.9%
as % of sales	8.9%	9.7%	12.3%	12.5%	11.0%	17.0%	17.0%	16.0%
<b>Store Sales (\$ mm)</b>	\$381.8	\$378.0	\$424.9	\$475.9	\$1,660.5	\$358.6	\$356.9	\$396.9
% Growth	0.5%	-0.8%	-4.7%	-3.7%	-2.4%	-6.1%	-5.6%	-6.6%

Source: Company Reports, UBS

- **Can the company stabilize its inventory position?** We think the company will make some progress in reducing its inventory in 2016. In 2015, this was a major issue as excess inventory caused the company to resort to higher promotions and clearance markdown, leading to significant merchandise margin declines. More recently, we think the company has made good progress on this front. Its 3Q'15 inventory was down -6% YoY compared to an average of 11% growth in 1H'15. We expect the company to reduce inventory by -4% in CY'16, which should lead to some stability in its merchandise margin going forward.
- **Can the company reverse its margin declines?** In CY'16, we model -20 bps of margin decline which would be an improvement from the -300 bps that we expect for CY'15. We think some stability in its inventory position should help, but its merchandise margin is unlikely to improve as the HF environment will probably remain intensely promotional in CY'16, especially at PIR's price points. In addition, rising higher delivery & fulfillment expenses from its faster growing eCommerce operations will likely continue to hurt its gross margin. However, its SG&A should see some leverage from tighter expense control.

## What to do with the stock?

We remain cautious on PIR. With every passing quarter it is becoming more evident that the company is struggling to attract new customers. In addition, its margin profile looks bleak as promotions are taking a toll on its merchandise margin while higher delivery and fulfillment costs associated with its eCommerce operation are impacting overall gross margin. Further, a tough home furnishing environment lately is only making its job of scripting a turnaround all the more difficult. Our new \$4.50 price target (\$5 previously) equates to 10x our CY'17 EPS estimate of \$0.47 and is based on a DCF/multiple blend analysis.

We think it is useful to examine how our price target would respond to various changes in our assumptions for PIR's earnings outlook over the next few years and the valuation multiple that would be associated with those scenarios. The following figure highlights our base case, a high case, and a low case.

**Figure 60: PIR price target sensitivity analysis**

Calendar Year	Base Case (Published estimates)					Upside Case			Downside Case		
	2013A	2014A	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E
Comparable Store Sales Growth	2.4%	4.7%	-0.1%	2.0%	2.0%	0.5%	2.5%	2.5%	0.0%	1.5%	1.5%
Growth Contribution from New Stores	1.5%	0.6%	-0.4%	0.0%	0.0%	-0.4%	0.0%	0.0%	-0.4%	0.0%	0.0%
Total Sales Growth	3.9%	5.3%	-0.4%	2.0%	2.0%	0.1%	2.5%	2.5%	-0.4%	1.5%	1.5%
<b>Total Sales</b>	<b>1,772</b>	<b>1,866</b>	<b>1,858</b>	<b>1,895</b>	<b>1,933</b>	<b>1,868</b>	<b>1,915</b>	<b>1,963</b>	<b>1,859</b>	<b>1,887</b>	<b>1,915</b>
<b>Operating Income</b>	<b>176</b>	<b>127</b>	<b>71</b>	<b>69</b>	<b>68</b>	<b>81</b>	<b>92</b>	<b>104</b>	<b>62</b>	<b>49</b>	<b>35</b>
Operating Income Margin	9.9%	6.8%	3.8%	3.6%	3.5%	4.3%	4.8%	5.3%	3.3%	2.6%	1.8%
Operating Income Yr. / Yr. Change	-177	-308	-302	-18	-10	-250	50	50	-350	-75	-75
Interest Expense	(1)	(7)	(12)	(12)	(12)	(12)	(12)	(12)	(12)	(12)	(12)
Other Income, Net	0	0	0	0	0	0	0	0	0	0	0
Provision for Income Taxes	67	45	22	21	21	26	30	35	19	14	9
Income Taxes Rate	38.4%	37.6%	37.4%	37.4%	37.4%	37.4%	37.4%	37.4%	37.4%	37.4%	37.4%
<b>Diluted Net Income</b>	<b>108</b>	<b>75</b>	<b>37</b>	<b>36</b>	<b>35</b>	<b>43</b>	<b>51</b>	<b>58</b>	<b>31</b>	<b>23</b>	<b>15</b>
<b>Diluted EPS - reported</b>	<b>\$1.01</b>	<b>\$0.82</b>	<b>\$0.43</b>	<b>\$0.45</b>	<b>\$0.47</b>	<b>\$0.50</b>	<b>\$0.63</b>	<b>\$0.77</b>	<b>\$0.37</b>	<b>\$0.29</b>	<b>\$0.19</b>
Shares outstanding - diluted	106.2	92.1	85.7	79.8	75.3	85.7	79.8	75.3	85.7	79.8	75.3
NTM PE Multiple:			10x	10x	10x	11x	11x	11x	6x	8x	11x
Estimated Value:			\$4.50	\$4.50	\$4.50	\$6	\$7	\$8	\$2	\$2	\$2
Dividend:			\$0.28	\$0.28	\$0.28	\$0.28	\$0.28	\$0.28	\$0.28	\$0.28	\$0.28
<b>Upside / Downside (vs. \$4.70):</b>			<b>2%</b>	<b>2%</b>	<b>2%</b>	<b>24%</b>	<b>54%</b>	<b>87%</b>	<b>-47%</b>	<b>-45%</b>	<b>-49%</b>

Source: Company reports, UBS estimates

Figure 61: PIR financial model summary (\$ millions except per share)

	1Q15	2Q15	3Q15	4Q15	2015	1Q16	2Q16	3Q16	4Q16E	2016E	1Q17E	2Q17E	3Q17E	4Q17E	2017E	1Q18E	2Q18E	3Q18E	4Q18E	2018E
<b>Income Statement</b>																				
<b>Total Sales</b>	<b>419</b>	<b>419</b>	<b>485</b>	<b>544</b>	<b>1,866</b>	<b>432</b>	<b>430</b>	<b>473</b>	<b>523</b>	<b>1,858</b>	<b>441</b>	<b>439</b>	<b>482</b>	<b>533</b>	<b>1,895</b>	<b>449</b>	<b>447</b>	<b>492</b>	<b>544</b>	<b>1,933</b>
Yr./Yr. Change	6.1%	5.8%	4.1%	5.4%	5.3%	3.1%	2.7%	-2.5%	-3.8%	-0.4%	2.0%	2.0%	2.0%	2.0%	-0.4%	2.0%	2.0%	2.0%	2.0%	2.0%
Comp Store Sales	6.3%	4.5%	3.0%	6.4%	4.7%	2.8%	2.5%	-0.7%	-4.0%	-0.1%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%
Gross Profit	168	163	205	214	750	165	150	178	187	679	167	151	151	189	687	170	154	154	192	699
% of Sales	40.0%	38.9%	42.3%	39.4%	40.2%	38.1%	34.8%	37.8%	35.7%	36.6%	37.8%	34.5%	34.5%	35.4%	36.3%	37.7%	34.4%	34.4%	35.3%	36.2%
Yr./Yr. Change (bps)	(242)	(192)	(115)	(213)	(190)	(190)	(408)	(452)	(374)	(360)	(30)	(28)	(28)	(30)	(30)	(10)	(10)	(10)	(10)	(10)
SG&A Expense	131	135	161	149	576	139	128	146	145	559	139	131	131	148	568	142	134	134	151	579
% of Sales	31.4%	32.2%	33.2%	27.4%	30.9%	32.1%	29.9%	30.9%	27.8%	30.1%	31.6%	29.9%	29.9%	27.8%	30.0%	31.6%	29.9%	29.9%	27.8%	30.0%
Yr./Yr. Change (bps)	(40)	121	114	146	90	74	(235)	(229)	40	(80)	(50)	0	0	0	(12)	0	0	0	0	0
<b>Operating Income</b>	<b>26</b>	<b>17</b>	<b>32</b>	<b>53</b>	<b>127</b>	<b>14</b>	<b>8</b>	<b>20</b>	<b>29</b>	<b>71</b>	<b>15</b>	<b>7</b>	<b>7</b>	<b>28</b>	<b>69</b>	<b>15</b>	<b>7</b>	<b>7</b>	<b>28</b>	<b>68</b>
% of Sales	6.2%	3.9%	6.6%	9.8%	6.8%	3.1%	2.0%	4.2%	5.5%	3.8%	3.3%	1.7%	1.7%	5.2%	3.6%	3.2%	1.6%	1.6%	5.1%	3.5%
Yr./Yr. Change (bps)	(225)	(340)	(270)	(382)	(308)	(303)	(200)	(240)	(424)	(302)	20	(28)	(28)	(30)	(18)	(10)	(10)	(10)	(10)	(10)
Interest, Net	(2)	(2)	(3)	(1)	(7)	(3)	(3)	(3)	(3)	(12)	(3)	(3)	(3)	(3)	(12)	(3)	(3)	(3)	(3)	(12)
Pretax Income	24	15	29	53	120	11	5	17	26	59	12	4	4	25	57	12	4	4	25	56
Income Taxes	9	6	11	20	45	4	2	6	10	22	4	2	2	10	21	4	1	1	10	21
Tax Rate	37.5%	37.8%	38.4%	37.1%	37.6%	36.5%	39.0%	35.2%	39.0%	37.4%	36.5%	39.0%	39.0%	39.0%	37.4%	36.5%	39.0%	39.0%	39.0%	37.4%
Net Income	15	9	18	33	75	7	3	11	16	37	8	3	3	15	36	8	2	2	15	35
<b>EPS</b>	<b>\$0.16</b>	<b>\$0.10</b>	<b>\$0.20</b>	<b>\$0.37</b>	<b>\$0.82</b>	<b>\$0.08</b>	<b>\$0.04</b>	<b>\$0.13</b>	<b>\$0.19</b>	<b>\$0.43</b>	<b>\$0.09</b>	<b>\$0.03</b>	<b>\$0.03</b>	<b>\$0.20</b>	<b>\$0.45</b>	<b>\$0.10</b>	<b>\$0.03</b>	<b>\$0.03</b>	<b>\$0.21</b>	<b>\$0.47</b>
Yr./Yr. Change	-15.7%	-40.5%	-22.9%	-10.5%	-19.4%	-51.5%	-63.1%	-34.2%	-48.0%	-47.2%	20.7%	-14.3%	-14.3%	2.0%	3.8%	4.7%	-1.7%	-1.7%	5.9%	4.9%
Avg Shares Outstanding	95	93	91	89	92	89	87	84	83	86	82	80	80	78	80	77	76	76	74	75
Total Stores, end of period	1,067	1,073	1,074	1,065	1,065	1,063	1,053	1,055	1,035	1,035	1,025	1,015	1,015	995	995	990	985	985	975	975
Yr./Yr. Change	0.2%	0.7%	0.0%	-0.7%	-0.7%	-0.4%	-1.9%	-1.8%	-2.8%	-2.8%	-3.6%	-3.6%	-3.6%	-3.9%	-3.9%	-3.4%	-3.0%	-3.0%	-2.0%	-2.0%
Square Footage, end of period	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8
Yr./Yr. Change	0.4%	0.8%	0.1%	-0.5%	-0.5%	-0.2%	-1.6%	-1.6%	-2.7%	-2.7%	-3.5%	-3.6%	-3.6%	-3.9%	-3.9%	-3.4%	-3.0%	-3.0%	-2.0%	-2.0%
<b>Cash Flow Statement</b>																				
FFFO	27	-98	24	112	66	28	-61	74	86	148	-32	93	93	-15	32	32	94	94	-49	62
Yr./Yr. Change	-30%	97%	-66%	14%	-59%	4%	-38%	205%	-23%	125%	-214%	-253%	-253%	-118%	-78%	-198%	1%	1%	218%	94%
<b>FCF</b>	<b>12</b>	<b>(125)</b>	<b>5</b>	<b>92</b>	<b>(16)</b>	<b>19</b>	<b>(77)</b>	<b>61</b>	<b>70</b>	<b>93</b>	<b>(49)</b>	<b>76</b>	<b>76</b>	<b>(36)</b>	<b>(41)</b>	<b>14</b>	<b>76</b>	<b>76</b>	<b>(70)</b>	<b>(13)</b>
Yr./Yr. Change	-53%	61%	-90%	17%	-120%	60%	-38%	1025%	-23%	-674%	-361%	-198%	-198%	-151%	-145%	-129%	1%	1%	94%	-70%
EBITDA	\$38	\$30	\$46	\$68	\$182	\$27	\$22	\$34	\$39	\$122	\$29	\$22	\$22	\$46	\$131	\$29	\$22	\$22	\$46	\$132
Yr./Yr. Change	0%	0%	0%	0%	0%	0%	-24%	-27%	-43%	-33%	8%	-3%	-3%	17%	8%	0%	0%	0%	1%	1%
<b>Balance Sheet</b>																				
Cash & S/T Investments	\$221	\$43	\$33	\$100	\$100	\$97	\$41	\$49	\$107	\$107	\$65	\$129	\$129	\$67	\$67	\$70	\$134	\$134	\$37	\$37
Cash per Share	\$2.33	\$0.46	\$0.36	\$1.12	\$1.09	\$1.09	\$0.47	\$0.58	\$1.29	\$1.25	\$0.80	\$1.60	\$1.60	\$0.86	\$0.86	\$0.90	\$1.77	\$1.77	\$0.51	\$0.51
Inventory, end of period	418	514	536	479	479	502	534	503	489	489	514	547	547	471	471	525	558	558	451	451
Yr./Yr. Change	9%	16%	25%	27%	27%	20%	4%	-6%	2%	2%	2%	2%	2%	-4%	-4%	2%	2%	2%	-4%	-4%
Ending Inventory per Sq Ft	50	61	63	57	57	60	64	60	60	60	63	68	68	60	60	67	72	72	58	58
Yr./Yr. Change	9%	15%	25%	27%	27%	20%	6%	-5%	5%	5%	6%	6%	6%	0%	0%	6%	5%	5%	-2%	-2%
Total Assets	946	885	921	910	910	924	890	880	921	921	916	1,014	1,014	896	896	944	1,043	1,043	859	859
Total Liabilities	591	559	604	573	573	601	602	609	528	528	618	576	576	605	605	641	599	599	631	631
Total shareholders' equity	355	327	317	337	337	323	288	271	393	393	297	437	437	290	290	303	445	445	228	228
Book Value per Share	\$3.75	\$3.53	\$3.50	\$3.77	\$3.66	\$3.63	\$3.32	\$3.22	\$4.74	\$4.58	\$3.64	\$5.44	\$5.44	\$3.72	\$3.72	\$3.94	\$5.87	\$5.87	\$3.09	\$3.09
Total Debt	208	208	207	207	207	206	206	205	205	205	205	205	205	205	205	205	205	205	205	205
Total Debt / EBITDA	5.5x	7.0x	4.5x	3.0x	1.1x	7.6x	9.2x	6.1x	5.3x	1.7x	7.0x	9.4x	9.4x	4.5x	4.5x	7.0x	9.4x	9.4x	4.5x	4.5x
Total Adjusted Debt / EBITDAR					5.1x					5.9x					0.0x					0.0x

Source: Company reports, UBS estimates



## Staples (SPLS) - Buy

Topics to Watch: For 2016, we believe the following factors will be the critical drivers for how the shares perform.

- **Will litigation lead to a successful outcome on the ODP deal?** We think it is unlikely the transaction will go through. Given that the administrative litigation is scheduled to begin in May 2016, it will give FTC enough time to prepare a robust case against the merger. Separately, SPLS also noted that it is willing to continue its negotiations with the FTC to reach a settlement that addresses the FTC's concern. But we think that any settlement that is agreeable to all the parties involved seems unlikely at this point of time.
- **Could SPLS announce a material share repurchase program?** SPLS was focusing more on preserving cash ahead of the ODP merger and as a result it discontinued its share repurchase program in 2015. In 2016, we think the company could announce a material share repurchase program to shore up its EPS performance, although it is likely to wait for a few more months until there is absolute certainty regarding the fate of its ODP deal. We believe that the company has enough room to announce a big buy-back program should it want to tread that path. We are currently forecasting SPLS to end FY'15 with an adjusted leverage ratio of 3.3x. Raising another \$1b in debt to finance share buybacks would increase this ratio to 3.8x, which is still within acceptable levels. Additionally, SPLS could also use its ~\$800 mm cash balance to fund buy-backs.
- **Will SPLS accelerate its store closure program in 2016?** Given that the ODP deal now has a low probability of materializing, we think SPLS will take steps to improve its stand-alone business. As part of this process, the company could look to accelerate its store closures in a bid to improve its comp sales and margins. SPLS has highlighted that it is getting a sales transfer rate of 15% from its closed stores, which will likely help improve its comp growth going forward. The store closures should also help improve its margins as the bottom performing stores are likely closed first. We conservatively model only ~30 stores closures for FY'16, but SPLS may elect to close more to further rationalize its footprint.

## What to do with the stock?

We think risk-reward for SPLS is favorable at this level. With the ODP deal looking increasingly unlikely, the focus will probably shift back to the company's standalone performance. We think Staples has some options. Its comp and margin could benefit from higher store closures. The company could also announce a material share buy-back program to support EPS growth. Further, with the stock trading at 10x our CY'17 EPS estimate, there is likely limited downside from current levels. Our \$14 price target equates to 14x our CY'17 EPS estimate of \$0.97 and is based on a DCF/multiple blend analysis.

Figure 62: SPLS financial model summary (\$ millions except per share)

	1Q14	2Q14	3Q14	4Q14	2014	1Q15	2Q15	3Q15	4Q15E	2015E	1Q16E	2Q16E	3Q16E	4Q16E	2016E	1Q17E	2Q17E	3Q17E	4Q17E	2017E
<b>Income Statement</b>																				
<b>Total Sales</b>	<b>5,654</b>	<b>5,220</b>	<b>5,962</b>	<b>5,656</b>	<b>22,492</b>	<b>5,262</b>	<b>4,937</b>	<b>5,593</b>	<b>5,443</b>	<b>21,235</b>	<b>5,170</b>	<b>4,864</b>	<b>5,510</b>	<b>5,370</b>	<b>20,914</b>	<b>5,193</b>	<b>4,888</b>	<b>5,532</b>	<b>5,392</b>	<b>21,005</b>
Yr./Yr. Change	-2.8%	-1.8%	-2.5%	-3.7%	-2.7%	-6.9%	-5.4%	-6.2%	-3.8%	-5.6%	-1.8%	-1.5%	-1.5%	-1.3%	-1.5%	0.5%	0.5%	0.4%	0.4%	0.4%
Comp Store Sales	-4.0%	-5.0%	-4.0%	-1.0%	-3.4%	-3.0%	-2.0%	-2.0%	-2.0%	-2.2%	-2.0%	-2.0%	-2.0%	-2.0%	-2.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Gross Profit	1,421	1,313	1,607	1,486	5,827	1,347	1,264	1,522	1,438	5,571	1,329	1,250	1,505	1,425	5,508	1,337	1,259	1,514	1,433	5,543
% of Sales	25.1%	25.2%	27.0%	26.3%	25.9%	25.6%	25.6%	27.2%	26.4%	26.2%	25.7%	25.7%	27.3%	26.5%	26.3%	25.7%	25.8%	27.4%	26.6%	26.4%
Yr./Yr. Change (bps)	-85.8	-42.3	-12.0	61.9	-19.0	47.0	44.6	25.8	15.0	32.9	10.0	10.0	10.0	10.0	10.0	5.0	5.0	5.0	5.0	5.0
SG&A Expense	1,223	1,178	1,222	1,184	4,807	1,157	1,121	1,147	1,137	4,562	1,134	1,102	1,127	1,119	4,482	1,137	1,105	1,129	1,120	4,491
% of Sales	21.6%	22.6%	20.5%	20.9%	21.4%	22.0%	22.7%	20.5%	20.9%	21.5%	21.9%	22.7%	20.5%	20.8%	21.4%	21.9%	22.6%	20.4%	20.8%	21.4%
Yr./Yr. Change (bps)	77.9	77.3	69.3	128.1	88.5	35.6	13.7	1.3	-5.0	10.9	-5.0	-5.0	-5.0	-5.0	-5.1	-5.0	-5.0	-5.0	-5.0	-5.0
<b>Operating Income</b>	<b>182.8</b>	<b>120.2</b>	<b>368.9</b>	<b>286.6</b>	<b>958.6</b>	<b>173.0</b>	<b>126.0</b>	<b>358.0</b>	<b>285.1</b>	<b>942.1</b>	<b>177.7</b>	<b>131.4</b>	<b>360.9</b>	<b>289.3</b>	<b>959.4</b>	<b>183.7</b>	<b>137.0</b>	<b>367.9</b>	<b>295.9</b>	<b>984.5</b>
% of Sales	3.2%	2.3%	6.2%	5.1%	4.3%	3.3%	2.6%	6.4%	5.2%	4.4%	3.4%	2.7%	6.6%	5.4%	4.6%	3.5%	2.8%	6.7%	5.5%	4.7%
Yr./Yr. Change (bps)	-167	-123	-86	-69	-111	5	25	21	17	17	15	15	15	15	15	10	10	10	10	10
Interest, Net	0.7	0.8	0.6	0.8	2.9	(11.0)	(10.0)	(11.0)	(10.0)	(42.0)	(10.0)	(10.0)	(10.0)	(10.0)	(42.0)	(10.0)	(10.0)	(10.0)	(10.0)	(42.0)
Pretax Income	171.2	108.4	357.0	275.8	912.4	163.0	114.0	339.0	275.1	891.1	167.7	121.4	350.9	279.3	919.4	173.7	127.0	357.9	285.9	944.5
Income Taxes	57.4	36.3	119.6	78.9	292.2	54.0	38.0	113.0	92.1	297.1	55.9	40.5	117.0	93.1	306.5	57.9	42.3	119.3	95.3	314.8
Tax Rate																				
Net Income	113.9	72.1	237.4	196.8	620.2	109.0	76.0	226.0	182.9	593.9	111.8	81.0	233.9	186.2	612.9	115.8	84.6	238.6	190.6	629.6
<b>EPS</b>	<b>\$0.18</b>	<b>\$0.11</b>	<b>\$0.37</b>	<b>\$0.31</b>	<b>\$0.96</b>	<b>\$0.17</b>	<b>\$0.12</b>	<b>\$0.35</b>	<b>\$0.28</b>	<b>\$0.92</b>	<b>\$0.17</b>	<b>\$0.13</b>	<b>\$0.36</b>	<b>\$0.29</b>	<b>\$0.95</b>	<b>\$0.18</b>	<b>\$0.13</b>	<b>\$0.37</b>	<b>\$0.29</b>	<b>\$0.97</b>
Yr./Yr. Change	-32.5%	-31.1%	-10.9%	-4.8%	-16.9%	-4.2%	1.2%	-4.4%	-8.0%	-4.7%	2.4%	6.7%	3.5%	1.8%	3.2%	3.6%	4.6%	2.0%	2.3%	2.7%
Avg Shares Outstanding	649	647	644	643	646	645	647	646	646	646	646	646	646	646	646	646	646	646	646	646
Total Stores, end of period	2,153	2,073	2,042	2,002	2,002	1,974	1,959	1,941	1,921	1,921	1,915	1,908	1,902	1,895	1,895	1,889	1,882	1,876	1,869	1,869
Yr./Yr. Change	-2.2%	-5.5%	-6.6%	-7.7%	-7.7%	-8.3%	-5.5%	-4.9%	-4.0%	-4.0%	-3.0%	-2.6%	-2.0%	-1.4%	-1.4%	-1.4%	-1.4%	-1.4%	-1.4%	-1.4%
Square Footage, end of period	38.6	37.2	36.6	35.9	35.9	35.4	35.1	34.8	34.4	34.4	34.3	34.1	34.0	33.9	33.9	33.8	33.6	33.5	33.4	33.4
Yr./Yr. Change	-2.2%	-5.5%	-6.7%	-7.9%	-7.9%	-8.5%	-5.6%	-5.0%	-4.1%	-4.1%	-3.1%	-2.7%	-2.1%	-1.4%	-1.4%	-1.4%	-1.4%	-1.4%	-1.4%	-1.4%
<b>Cash Flow Statement</b>																				
CFFO	359.9	-56.3	604.6	134.8	1,042.9	300.0	0.0	403.0	250.7	1,030.1	289.3	46.2	550.3	207.4	1,093.3	311.2	49.3	557.5	168.4	1,086.5
Yr./Yr. Change	3.5%	NM	14.6%	-42.2%	-5.9%	-16.6%	-100.0%	-33.3%	86.0%	-1.2%	-3.6%	#DIV/0!	36.6%	-17.3%	6.1%	7.6%	6.6%	1.3%	-18.8%	-0.6%
FCF	311.8	(118.0)	513.3	(25.0)	682.1	240.0	(78.0)	326.0	87.4	651.8	193.7	(43.8)	448.4	108.0	706.4	215.2	(41.2)	455.2	68.7	697.9
Yr./Yr. Change	1.8%	42.3%	14.7%	-137.8%	-7.5%	-23.0%	-33.9%	-36.5%	-449.3%	-4.4%	-19.3%	-43.9%	37.5%	23.6%	8.4%	11.1%	-5.9%	1.5%	-36.4%	-1.2%
EBITDA	300.0	232.5	439.8	391.5	1,363.8	274.0	257.0	469.0	385.9	1,385.9	277.0	260.5	470.3	388.8	1,396.6	283.4	266.7	477.7	395.8	1,423.6
Yr./Yr. Change	-24.8%	-23.2%	-19.1%	-13.9%	-19.8%	-8.7%	10.5%	6.6%	-1.4%	1.6%	1.1%	1.4%	0.3%	0.8%	0.8%	2.3%	2.4%	1.6%	1.8%	1.9%
<b>Balance Sheet</b>																				
Cash & S/T Investments	792.9	417.2	770.0	627.2	627.2	795.0	611.0	782.0	815.7	815.7	955.7	858.2	1,252.9	1,307.2	1,307.2	1,468.6	1,373.7	1,775.2	1,790.1	1,790.1
Cash per Share	\$1.22	\$0.64	\$1.20	\$0.98	\$0.97	\$1.23	\$0.94	\$1.21	\$1.26	\$1.26	\$1.48	\$1.33	\$1.94	\$2.02	\$2.02	\$2.27	\$2.13	\$2.75	\$2.77	\$2.77
Inventory, end of period	2,336	2,541	2,350	2,144	2,144	2,211	2,360	2,156	2,046	2,046	2,216	2,390	2,121	2,060	2,060	2,225	2,401	2,128	2,110	2,110
Yr./Yr. Change	-2%	1%	-3%	-8%	-8%	-13%	0%	1%	-5%	-5%	-6%	11%	4%	1%	1%	5%	17%	3%	-5%	-12%
Ending Inventory per Sq Ft	60	68	64	60	60	63	67	62	59	59	65	70	62	61	61	66	71	63	63	63
Yr./Yr. Change	0%	7%	4%	0%	0%	-9%	5%	4%	0%	0%	-4%	13%	5%	2%	2%	6%	17%	4%	-4%	-11%
Total Assets	11,443	11,278	11,304	10,314	10,314	10,438	10,326	10,318	10,069	10,069	10,332	10,452	10,729	10,494	10,494	10,813	10,939	11,218	10,985	10,985
Total Liabilities	5,272	5,206	5,272	5,000	5,000	5,102	5,103	4,971	4,728	4,728	4,941	5,039	5,145	4,785	4,785	5,050	5,150	5,254	4,891	4,891
Total shareholders' equity	6,171	6,072	6,033	5,313	5,313	5,336	5,223	5,347	5,341	5,341	5,391	5,412	5,584	5,709	5,709	5,763	5,788	5,964	6,094	6,094
Book Value per Share	9.5x	9.4x	9.4x	8.3x	8.2x	8.3x	8.1x	8.3x	8.3x	8.3x	8.3x	8.4x	8.6x	8.8x	8.8x	8.9x	9.0x	9.2x	9.4x	9.4x
Total Debt	1,199	1,128	1,118	1,116	1,116	1,113	1,108	1,035	1,187	1,187	1,211	1,235	1,258	1,282	1,282	1,306	1,330	1,354	1,377	1,377
Total Debt / EBITDA	4.0x	4.8x	2.5x	2.9x	0.8x	4.1x	4.3x	2.2x	3.1x	0.9x	4.4x	4.7x	2.7x	3.3x	0.9x	4.6x	5.0x	2.8x	3.5x	1.0x
Total Adjusted Debt / EBITDAR					3.5x				3.3x						3.3x					0.6x

Source: Company reports, UBS estimates

## Office Depot (ODP) – Neutral

Topics to Watch: For 2016, we believe the following factors will be the critical drivers for how the shares perform.

- **Will litigation lead to a favorable outcome on its proposed merger with SPLS?** As per the terms agreed upon when entering into the merger agreement with SPLS, the deal is now being pursued through litigation. However, we believe that the probability of the transaction materializing is low. We think FTC has enough time in hand to prepare a robust case against the merger. While SPLS has expressed its willingness to continue its negotiations with the FTC, we think any settlement that addresses the concerns of all parties involved seems unlikely.
- **Will store closures continue to drive positive retail comps in 2016?** ODP surprised the market with positive comp performances in both 2Q'15 and 3Q'15. We think this was probably helped by strong sales transfers from its closed stores. Its transfer rate has likely been higher than that of SPLS as it has had the advantage of closing stores across 2 banners (ODP+OMX), with more stores being closer to each other. ODP closed 172 stores in FY'14 followed by another 125 stores in the first 3 quarters in FY'15. Going forward, we believe that the pace of store closures will slow down as most of the bottom performing stores are likely already closed. Additionally, ODP will be lapping tough compares in 2016 which should limit its comp growth. We forecast 0.8% comp for FY'16 which is below the 1.3% that we forecast in FY'15.
- **Can ODP improve its business solutions segment in 2016?** ODP saw an accelerated decline in its business solutions segment in the first 3 quarters of 2015. We think that disruptions caused by its pending acquisition by SPLS likely had an impact. In addition, it also reflects overall weak demand for office supply products by corporate customers. We expect ODP to make a renewed push to win back new customers. This should help its business solutions segment to an extent, although overall weak demand trends will likely cap the benefits. We forecast a -2% decline for its Business Solutions segment in FY'16, which is better than our -4.6% estimate for FY'15.

## What to do with the stock?

ODP shares are likely to trade sideways in 2016. With low probability of its SPLS deal materializing, the focus will shift to its base business. We think ODP has a number of challenges to overcome. While its retail business has comped positively YTD in 2015, it will get increasingly harder for it to sustain that performance going forward. In addition, its business solutions and international segment saw accelerated decline YTD in 2015 which will be hard to reverse given persisting weak demand trends for core office supply products. However, with the stock trading at 9x our CY'17 EPS estimate, it appropriately prices in the challenges that lie ahead. Our \$6 PT equates to 10x our CY'17 EPS estimate of \$0.61 and is based on a DCF/multiple blend analysis.

Figure 63: ODP financial model summary (\$ millions except per share)

	1Q14	2Q14	3Q14	4Q14	2014	1Q15	2Q15	3Q15	4Q15E	2015E	1Q16E	2Q16E	3Q16E	4Q16E	2016E	1Q17E	2Q17E	3Q17E	4Q17E	2017E
<b>Income Statement</b>																				
<b>Total Sales</b>	<b>\$4,286</b>	<b>\$3,782</b>	<b>\$4,041</b>	<b>\$3,832</b>	<b>\$15,942</b>	<b>\$3,877</b>	<b>\$3,440</b>	<b>\$3,690</b>	<b>\$3,592</b>	<b>\$14,599</b>	<b>\$3,752</b>	<b>\$3,352</b>	<b>\$3,628</b>	<b>\$3,529</b>	<b>\$14,261</b>	<b>\$3,719</b>	<b>\$3,327</b>	<b>\$3,595</b>	<b>\$3,489</b>	<b>\$14,129</b>
Yr./Yr. Change	57.7%	56.4%	54.3%	9.9%	41.8%	-9.5%	-9.0%	-8.7%	-6.3%	-8.4%	-3.2%	-2.6%	-1.7%	-1.8%	-2.3%	-0.9%	-0.7%	-0.9%	-1.1%	-0.9%
Comp Store Sales	-3.0%	-3.0%	-3.0%	-2.0%	-2.8%	-2.0%	1.0%	3.0%	3.0%	1.3%	2.0%	1.0%	0.0%	0.0%	0.8%	0.0%	0.0%	0.0%	0.0%	0.0%
Gross Profit	999	867	979	891	3,737	937	814	936	844	3,531	920	805	933	842	3,499	919	806	932	839	3,496
% of Sales	23.3%	22.9%	24.2%	23.3%	23.4%	24.2%	23.7%	25.4%	23.5%	24.2%	24.5%	24.0%	25.7%	23.9%	24.5%	24.7%	24.2%	25.9%	24.1%	24.7%
Yr./Yr. Change (bps)	(96)	34	7	68	8	86	74	114	25	75	35	35	35	35	35	20	20	20	20	20
SG&A Expense	930	849	853	813	3,445	801	741	773	726	3,041	755	704	740	694	2,892	744	695	730	683	2,851
% of Sales	21.7%	22.4%	21.1%	21.2%	21.6%	20.7%	21.5%	20.9%	20.2%	20.8%	20.1%	21.0%	20.4%	19.7%	20.3%	20.0%	20.9%	20.3%	19.6%	20.2%
Yr./Yr. Change (bps)	(131)	(73)	(151)	(122)	(116)	(104)	(91)	(16)	(100)	(78)	(55)	(55)	(55)	(55)	(55)	(10)	(10)	(10)	(10)	(10)
<b>Operating Income</b>	<b>\$69</b>	<b>\$18</b>	<b>\$126</b>	<b>\$78</b>	<b>\$292</b>	<b>\$136</b>	<b>\$73</b>	<b>\$163</b>	<b>\$118</b>	<b>\$490</b>	<b>\$165</b>	<b>\$101</b>	<b>\$193</b>	<b>\$148</b>	<b>\$607</b>	<b>\$175</b>	<b>\$111</b>	<b>\$202</b>	<b>\$156</b>	<b>\$644</b>
% of Sales	1.6%	0.5%	3.1%	2.0%	1.8%	3.5%	2.1%	4.4%	3.3%	3.4%	4.4%	3.0%	5.3%	4.2%	4.3%	4.7%	3.3%	5.6%	4.5%	4.6%
Yr./Yr. Change (bps)	35	107	158	189	124	190	165	130	125	152	90	90	90	90	90	30	30	30	30	30
Interest, Net	(18)	(12)	(18)	(17)	(65)	(18)	(16)	(17)	(17)	(68)	(16)	(16)	(16)	(16)	(64)	(17)	(17)	(17)	(17)	(68)
Pretax Income	51	6	108	61	226	118	57	146	101	422	149	85	177	132	543	158	94	185	139	576
Income Taxes	14	0	56	21	91	47	25	59	41	172	63	36	74	55	228	66	39	78	59	242
Tax Rate	27.5%	4.1%	51.9%	34.4%	40.4%	39.8%	43.9%	40.4%	40.4%	40.7%	42.0%	42.0%	42.0%	42.0%	42.0%	42.0%	42.0%	42.0%	42.0%	42.0%
Net Income	37	(12)	52	40	117	71	32	87	60	250	87	49	103	76	315	92	54	107	81	334
<b>EPS</b>	<b>\$0.07</b>	<b>(\$0.02)</b>	<b>\$0.10</b>	<b>\$0.07</b>	<b>\$0.22</b>	<b>\$0.13</b>	<b>\$0.06</b>	<b>\$0.16</b>	<b>\$0.11</b>	<b>\$0.46</b>	<b>\$0.16</b>	<b>\$0.09</b>	<b>\$0.19</b>	<b>\$0.14</b>	<b>\$0.58</b>	<b>\$0.17</b>	<b>\$0.10</b>	<b>\$0.20</b>	<b>\$0.15</b>	<b>\$0.61</b>
Yr./Yr. Change	1507.3%	-77.4%	490.5%	-326.4%	-294.0%	90.1%	-361.1%	63.3%	46.9%	109.6%	19.1%	54.3%	18.0%	26.9%	25.1%	5.8%	9.7%	4.5%	5.9%	6.0%
Avg Shares Outstanding	530	535	535	535	534	535	547	548	548	545	548	548	548	548	548	548	548	548	548	548
Total Stores, end of period	2,046	2,013	1,996	1,891	1,891	1,871	1,772	1,769	1,732	1,732	1,726	1,720	1,714	1,657	1,657	1,651	1,645	1,639	1,542	1,542
Yr./Yr. Change	65.7%	63.4%	47.7%	-17.2%	-17.2%	-8.6%	-12.0%	-11.4%	-8.4%	-8.4%	-7.7%	-2.9%	-3.1%	-4.3%	-4.3%	-4.3%	-4.4%	-4.4%	-6.9%	-6.9%
Square Footage, end of period	46	46	45	43	43	42	40	40	39	39	39	39	39	38	38	37	37	37	35	35
Yr./Yr. Change	65.0%	62.9%	63.3%	-7.8%	-7.8%	-8.6%	-12.0%	-11.5%	-8.4%	-8.4%	-7.7%	-2.9%	-2.9%	-4.3%	-4.3%	-4.3%	-4.4%	-4.4%	-6.9%	-6.9%
<b>Cash Flow Statement</b>																				
<b>FFO</b>	<b>-74</b>	<b>-88</b>	<b>197</b>	<b>121</b>	<b>156</b>	<b>-46</b>	<b>-89</b>	<b>135</b>	<b>370</b>	<b>370</b>	<b>43</b>	<b>43</b>	<b>189</b>	<b>311</b>	<b>586</b>	<b>45</b>	<b>48</b>	<b>194</b>	<b>313</b>	<b>601</b>
Yr./Yr. Change	-21%	28943%	-871%	846%	-246%	-38%	1%	-31%	206%	137%	-193%	-149%	40%	-16%	58%	7%	10%	2%	1%	2%
<b>FCF</b>	<b>(113)</b>	<b>(115)</b>	<b>216</b>	<b>88</b>	<b>76</b>	<b>(83)</b>	<b>(133)</b>	<b>84</b>	<b>319</b>	<b>187</b>	<b>(16)</b>	<b>(9)</b>	<b>133</b>	<b>256</b>	<b>365</b>	<b>(12)</b>	<b>(4)</b>	<b>138</b>	<b>259</b>	<b>382</b>
Yr./Yr. Change	-8%	236%	-65%	-136%	-64%	-27%	16%	-61%	263%	146%	-81%	-94%	59%	-20%	95%	-21%	-55%	4%	1%	5%
<b>EBITDA</b>	<b>\$146</b>	<b>\$96</b>	<b>\$204</b>	<b>\$158</b>	<b>\$604</b>	<b>\$210</b>	<b>\$149</b>	<b>\$233</b>	<b>\$190</b>	<b>\$782</b>	<b>\$235</b>	<b>\$165</b>	<b>\$260</b>	<b>\$213</b>	<b>\$873</b>	<b>\$440</b>	<b>\$377</b>	<b>\$471</b>	<b>\$428</b>	<b>\$917</b>
Yr./Yr. Change	76%	191%	129%	127%	120%	44%	55%	14%	20%	29%	12%	11%	12%	12%	12%	87%	129%	81%	101%	5%
<b>Balance Sheet</b>																				
<b>Cash &amp; S/T Investments</b>	<b>\$1,071</b>	<b>\$768</b>	<b>\$965</b>	<b>\$1,071</b>	<b>\$1,071</b>	<b>\$927</b>	<b>\$867</b>	<b>\$958</b>	<b>\$1,277</b>	<b>\$1,277</b>	<b>\$1,262</b>	<b>\$1,253</b>	<b>\$1,386</b>	<b>\$1,642</b>	<b>\$1,642</b>	<b>\$1,630</b>	<b>\$1,626</b>	<b>\$1,765</b>	<b>\$2,024</b>	<b>\$2,024</b>
Cash per Share	\$2.02	\$1.44	\$1.80	\$2.00	\$2.00	\$1.73	\$1.59	\$1.75	\$2.33	\$2.35	\$2.30	\$2.29	\$2.53	\$3.00	\$3.00	\$2.97	\$2.97	\$3.22	\$3.69	\$3.69
Inventory, end of period	1,638	1,653	1,580	1,638	1,638	1,554	1,554	1,586	1,561	1,561	1,497	1,507	1,552	1,526	1,526	1,480	1,492	1,534	1,505	1,505
Yr./Yr. Change	61%	52%	53%	-10%	-10%	-5%	-6%	0%	-5%	-5%	-4%	-3%	-2%	-2%	-2%	-2%	-4%	0%	-1%	2%
Ending Inventory per Sq Ft	35	36	35	38	38	37	39	40	40	40	38	39	40	41	41	39	40	41	43	43
Yr./Yr. Change	-2%	-7%	-6%	-2%	-2%	4%	7%	13%	4%	4%	4%	0%	1%	2%	2%	2%	0%	2%	6%	9%
Total Assets	6,844	6,973	6,780	6,844	6,844	6,548	6,360	6,459	6,601	6,601	6,495	6,446	6,695	6,863	6,863	6,790	6,751	6,998	7,164	7,164
Total Liabilities	5,223	5,125	5,001	5,223	5,223	4,926	4,777	4,879	3,957	3,957	3,764	3,666	3,812	3,904	3,904	3,739	3,645	3,785	3,871	3,871
Total shareholders' equity	1,621	1,792	1,778	1,621	1,621	1,622	1,583	1,580	2,644	2,644	2,731	2,780	2,883	2,959	2,959	3,051	3,105	3,212	3,293	3,293
Book Value per Share	\$3.06	\$3.35	\$3.32	\$3.03	\$3.03	\$3.03	\$2.89	\$2.88	\$4.83	\$4.86	\$4.98	\$5.07	\$5.26	\$5.40	\$5.40	\$5.57	\$5.67	\$5.86	\$6.01	\$6.01
Total Debt	706	714	710	706	706	710	707	699	699	699	699	699	699	699	699	699	699	699	699	699
Total Debt / EBITDA	4.8x	7.4x	3.5x	4.5x	1.2x	3.4x	4.7x	3.0x	3.7x	0.9x	3.0x	4.2x	2.7x	3.3x	0.8x	1.6x	1.9x	1.5x	1.6x	0.7x
Total Adjusted Debt / EBITDAR					4.0x					3.2x					0.0x					0.0x

Source: Company Reports and UBS estimates

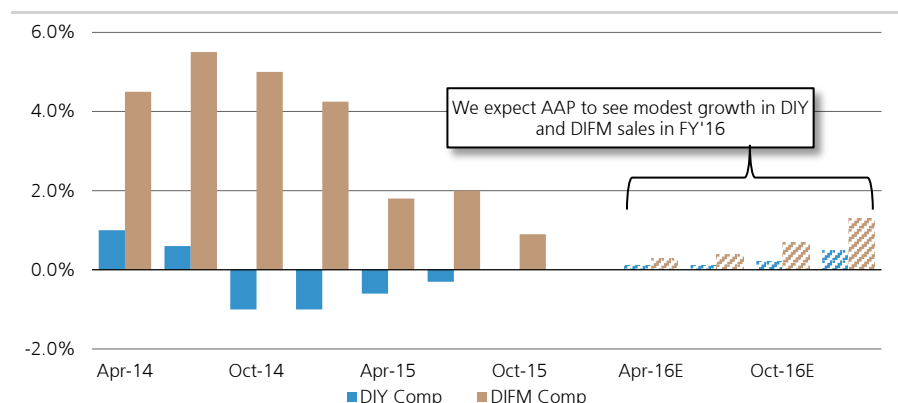
## Advance Auto Parts (AAP) – Buy

Topics to watch: For 2016, we believe the following factors will be the critical drivers for how the shares perform:

- **Could AAP elect to sell to a competitor in the upcoming year?** Media reports such as Bloomberg suggest that AAP has been approached by at least one competitor about the possibility of a sale. We think it would make a lot of sense. First, there is some management uncertainty as the company is currently undergoing a CEO search. Should a top performer such as ORLY acquire AAP, it would immediately solve this issue and put a proven team in charge of a complex integration effort. Second, we think having an activist investor such as Starboard on board helps further align the company's incentives with shareholders. This makes a sale more likely should it appear to be the most valuable option for shareholders.

**Will AAP's top line growth pick back up?** Our expectations are modest, and we project just 0.5% growth in '16. We believe the retailer will see some continuing integration issues. CQ employees have faced the challenge of selling both DIY and DIFM products at the same time, which is something they haven't had to do in the past. Further, we think sales will likely continue to be held back in the near term as some customers have been disappointed with the retailer's decision to discontinue selling popular DIFM products such as Gates and Wix. Longer term, the picture is brighter. While losing Gates and Wix hurt, AAP has done better in other categories facing product disruption, including brakes and batteries. This suggests that AAP can overcome this challenge. Further, we believe the company will ultimately benefit from its push to add more frequent delivery to more locations, its employment initiatives, and its store closure program.

**Figure 64: AAP's DIY and DIFM comp growth, FY'14-FY'16E**



Source: UBS estimates

- **Can AAP still hit its 12% operating margin target in 2016?** We expect it to fall a little short at 11.7%, though this is still above the consensus of 11.5%. While some doubts emerged after AAP's 3Q earnings, we think that several initiatives will allow it to beat consensus expectations. First, AAP noted its assumptions were based on "modest" sales expectations. Second, the company has begun to implement two new labor initiatives. The first involves altering its store operating model, which would allow more associates to work on both DIY & DIFM sales. Not only will this allow for the better allocation of

labor hours, but it should also enable employees to develop a wider skill set and help them become more motivated and productive. The second initiative involves increasing the variable component of its store compensation model, which should better align incentives with company performance. Taken together, we believe these initiatives should allow the company to come closer to the company's operating margin target than the consensus believes.

## What to do with the stock?

While AAP's integration hurdles were a bit higher than originally expected in CY'15, we believe the company's strong asset base and worthy initiatives should help it find more success in CY'16 and beyond. Adding daily delivery should boost the company's reputation among commercial customers, while its employment initiatives should help encourage both higher store productivity and better expense management. We think these actions will allow for considerable operating margin expansion, and at current levels, we think it's a good time to get involved with the name. Our new \$180 price target (\$190 prior) equates to 17x our new CY'17 EPS estimate of \$10.40 and is based on a DCF/multiple blend analysis.

We think it is useful to examine how our price target would respond to various changes in our assumptions for AAP's earnings outlook over the next few years and the valuation multiple that would be associated with those scenarios. The following figure highlights our base case, a high case, and a low case.

**Figure 65: AAP price target sensitivity analysis**

	Base Case (Published estimates)					High Case			Low Case		
	2013A	2014A	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E
Total Comp Growth	-1.5%	1.9%	0.5%	0.5%	1.3%	1.0%	4.0%	3.5%	-1.0%	-2.0%	-1.0%
Total Growth Contribution from New Stores	6.2%	49.7%	-1.5%	-0.8%	0.8%	-1.5%	-0.8%	0.8%	-1.5%	-0.8%	0.8%
Total Sales Growth	4.7%	51.6%	-1.0%	-0.4%	2.0%	-0.5%	3.2%	4.3%	-2.5%	-2.8%	-0.2%
<b>Total Sales</b>	<b>6,494</b>	<b>9,844</b>	<b>9,745</b>	<b>9,710</b>	<b>9,908</b>	<b>9,796</b>	<b>10,109</b>	<b>10,538</b>	<b>9,599</b>	<b>9,330</b>	<b>9,306</b>
<b>Operating Income</b>	<b>683</b>	<b>977</b>	<b>994</b>	<b>1,138</b>	<b>1,226</b>	<b>1,021</b>	<b>1,230</b>	<b>1,367</b>	<b>962</b>	<b>1,010</b>	<b>1,044</b>
Operating Income Margin	10.5%	9.9%	10.2%	11.7%	12.4%	10.4%	12.2%	13.0%	10.0%	10.8%	11.2%
Operating Income Yr. / Yr. Change	-7	-60	28	152	65	50	175	80	10	80	40
Interest Expense	-32	-70	-71	(54)	(45)	(71)	(54)	(45)	(71)	(54)	(45)
Provision for Income Taxes	240	335	347	409	446	357	444	499	335	361	377
Income Taxes Rate	36.9%	37.0%	37.6%	37.8%	37.8%	37.6%	37.8%	37.8%	37.6%	37.8%	37.8%
<b>Diluted Net Income</b>	<b>411</b>	<b>571</b>	<b>576</b>	<b>675</b>	<b>735</b>	<b>593</b>	<b>732</b>	<b>823</b>	<b>556</b>	<b>595</b>	<b>622</b>
<b>Diluted EPS - reported</b>	<b>\$5.60</b>	<b>\$7.78</b>	<b>\$7.82</b>	<b>\$9.15</b>	<b>\$10.40</b>	<b>\$8.05</b>	<b>\$9.93</b>	<b>\$11.64</b>	<b>\$7.55</b>	<b>\$8.07</b>	<b>\$8.80</b>
Shares outstanding - diluted	73.4	73.4	73.7	73.8	70.7	73.7	73.8	70.7	73.7	73.8	70.7
NTM PE Multiple:			23x	20x	17x	26x	21x	18x	20x	18x	16x
<b>Estimated Value:</b>			<b>\$180</b>	<b>\$180</b>	<b>\$180</b>	<b>\$209</b>	<b>\$209</b>	<b>\$210</b>	<b>\$151</b>	<b>\$145</b>	<b>\$141</b>
Dividend:			\$0.30	\$0.24	\$0.24	\$0.30	\$0.24	\$0.24	\$0.30	\$0.24	\$0.24
<b>Upside / Downside (vs. \$148.83):</b>			<b>21%</b>	<b>21%</b>	<b>21%</b>	<b>41%</b>	<b>40%</b>	<b>41%</b>	<b>2%</b>	<b>-2%</b>	<b>-5%</b>

Source: Company reports, UBS estimates

Figure 66: AAP financial model summary (\$ millions except per share)

	CY	1Q14	2Q14	3Q14	4Q14	2014	1Q15	2Q15	3Q15	4Q15E	2015E	1Q16E	2Q16E	3Q16E	4Q16E	2016E	1Q17E	2Q17E	3Q17E	4Q17E	2017E
<b>Income Statement</b>																					
<b>Total Sales</b>		<b>2,969</b>	<b>2,348</b>	<b>2,289</b>	<b>2,237</b>	<b>9,844</b>	<b>3,038</b>	<b>2,370</b>	<b>2,295</b>	<b>2,041</b>	<b>9,745</b>	<b>3,025</b>	<b>2,357</b>	<b>2,283</b>	<b>2,045</b>	<b>9,710</b>	<b>3,065</b>	<b>2,414</b>	<b>2,337</b>	<b>2,092</b>	<b>9,908</b>
Yr./Yr. Change		47.3%	51.5%	50.6%	58.8%	51.6%	2.3%	1.0%	0.3%	-8.8%	-1.0%	-0.4%	-0.6%	-0.5%	0.2%	-0.4%	1.3%	2.4%	2.4%	2.3%	2.0%
DIY Comp Store Sales		1.0%	0.6%	-1.0%	-1.0%	0.0%	-0.6%	-0.3%	0.0%	0.0%	-0.3%	0.1%	0.1%	0.2%	0.5%	0.2%	0.5%	0.5%	0.5%	0.5%	0.5%
DIFM Comp Store Sales		4.5%	5.5%	5.0%	4.3%	4.8%	1.8%	2.0%	0.9%	-1.0%	1.0%	0.3%	0.4%	0.7%	1.3%	0.6%	1.5%	2.0%	2.0%	1.8%	1.8%
Comp Store Sales		2.4%	2.6%	1.5%	1.1%	1.9%	0.7%	1.0%	0.5%	-0.6%	0.5%	0.2%	0.3%	0.5%	1.0%	0.5%	1.1%	1.4%	1.4%	1.4%	1.3%
Gross Profit		1,353	1,062	1,034	1,004	4,454	1,394	1,087	1,032	916	4,430	1,406	1,095	1,042	931	4,474	1,432	1,128	1,072	958	4,590
% of Sales		45.6%	45.2%	45.2%	44.9%	45.2%	45.9%	45.9%	45.0%	44.9%	45.5%	46.5%	46.5%	45.6%	45.5%	46.1%	46.7%	46.7%	45.9%	45.8%	46.3%
Yr./Yr. Change (bps)		(446)	(505)	(500)	(494)	(484)	31	64	(20)	0	21	60	60	65	65	62	25	25	25	25	25
SG&A Expense		1,069	799	798	811	3,477	1,086	802	789	760	3,436	1,054	776	764	743	3,336	1,055	785	773	751	3,365
% of Sales		36.0%	34.0%	34.8%	36.3%	35.3%	35.7%	33.8%	34.4%	37.2%	35.3%	34.8%	32.9%	33.5%	36.3%	34.4%	34.4%	32.5%	33.1%	35.9%	34.0%
Yr./Yr. Change (bps)		(391)	(367)	(412)	(547)	(424)	(26)	(22)	(48)	95	(6)	(90)	(90)	(22)	(90)	(90)	(40)	(40)	(40)	(40)	(40)
<b>Operating Income</b>		<b>284</b>	<b>263</b>	<b>237</b>	<b>193</b>	<b>977</b>	<b>308</b>	<b>285</b>	<b>244</b>	<b>156</b>	<b>994</b>	<b>352</b>	<b>319</b>	<b>278</b>	<b>188</b>	<b>1,138</b>	<b>377</b>	<b>343</b>	<b>300</b>	<b>206</b>	<b>1,226</b>
% of Sales		9.6%	11.2%	10.3%	8.6%	9.9%	10.1%	12.0%	10.6%	7.7%	10.2%	11.6%	13.5%	12.2%	9.2%	11.7%	12.3%	14.2%	12.8%	9.9%	12.4%
Yr./Yr. Change (bps)		(55)	(137)	(88)	53	(60)	57	85	28	(95)	28	150	150	155	155	152	65	65	65	65	65
Interest, Net		(24)	(17)	(16)	(17)	(73)	(22)	(15)	(14)	(15)	(67)	(17)	(13)	(13)	(12)	(54)	(15)	(10)	(10)	(10)	(45)
Pretax Income		261	246	221	178	906	285	266	231	141	923	335	307	265	176	1,084	362	333	290	196	1,181
Income Taxes		96	93	82	64	335	108	99	86	53	347	127	116	100	67	409	137	126	109	74	446
Tax Rate		36.7%	37.8%	37.0%	36.2%	37.0%	38.0%	37.0%	37.5%	37.8%	37.6%	37.8%	37.8%	37.8%	37.8%	37.8%	37.8%	37.8%	37.8%	37.8%	37.8%
Net Income		165	153	139	113	571	176	168	144	88	576	209	191	165	110	675	225	207	180	122	735
<b>EPS</b>		<b>\$2.26</b>	<b>\$2.09</b>	<b>\$1.90</b>	<b>\$1.54</b>	<b>\$7.78</b>	<b>\$2.40</b>	<b>\$2.27</b>	<b>\$1.95</b>	<b>\$1.19</b>	<b>\$7.82</b>	<b>\$2.83</b>	<b>\$2.59</b>	<b>\$2.24</b>	<b>\$1.49</b>	<b>\$9.15</b>	<b>\$3.11</b>	<b>\$2.91</b>	<b>\$2.57</b>	<b>\$1.77</b>	<b>\$10.40</b>
Yr./Yr. Change		36.7%	31.0%	33.7%	64.3%	38.9%	6.2%	9.0%	3.0%	-22.6%	0.5%	18.1%	13.8%	14.6%	24.8%	17.0%	9.8%	12.2%	14.9%	19.1%	13.6%
Avg Shares Outstanding		73	73	73	73	73	74	74	74	74	74	74	74	74	74	74	73	71	70	69	71
Total Stores, end of period		6,781	6,795	6,764	6,697	6,697	6,650	6,669	6,658	6,608	6,608	6,568	6,528	6,528	6,528	6,528	6,563	6,598	6,633	6,668	6,668
Yr./Yr. Change		70.8%	70.3%	68.3%	65.4%	65.4%	-1.9%	-1.9%	-1.6%	-1.3%	-1.3%	-1.2%	-2.1%	-2.0%	-1.2%	-1.2%	-0.1%	1.1%	1.6%	2.1%	2.1%
Square Footage, end of period		44	44	44	43	43	43	43	43	43	43	43	42	42	42	42	42	43	43	43	43
Yr./Yr. Change		51.6%	50.6%	48.7%	45.9%	45.9%	-1.9%	-1.9%	-1.6%	-1.3%	-1.3%	-1.2%	-2.1%	-2.0%	-1.2%	-1.2%	-0.1%	1.1%	1.6%	2.1%	2.1%
<b>Cash Flow Statement</b>																					
FFO		81	239	220	169	709	102	229	189	41	561	367	273	330	509	1,479	-77	287	354	575	1,139
Yr./Yr. Change		-71%	54%	213%	3%	37%	119%	-12%	-13%	-126%	-31%	477%	11%	75%	-1759%	243%	-177%	0%	4%	12%	-35%
FCF		21	194	164	102	481	45	171	143	(26)	332	261	190	250	438	1,139	(200)	190	261	492	743
Yr./Yr. Change		-71%	54%	213%	3%	37%	119%	-12%	-13%	-126%	-31%	477%	11%	75%	-1759%	243%	-177%	0%	4%	12%	-35%
EBITDA		\$373	\$327	\$303	\$259	\$1,261	\$392	\$348	\$305	\$217	\$1,262	\$442	\$389	\$345	\$249	\$1,424	\$475	\$420	\$374	\$273	\$1,543
Yr./Yr. Change		39%	35%	38%	60%	42%	5%	6%	1%	-16%	0%	13%	12%	13%	15%	13%	8%	8%	8%	10%	8%
<b>Balance Sheet</b>																					
Cash & S/T Investments		\$83	\$67	\$90	\$105	\$105	\$124	\$115	\$105	\$25	\$25	\$81	\$67	\$212	\$546	\$546	\$117	\$28	\$109	\$422	\$422
Cash per Share		\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
Inventory, end of period		3,911	3,935	3,942	3,937	3,937	4,105	4,120	4,142	3,959	3,959	4,042	4,051	3,899	3,919	3,919	4,076	4,130	3,973	3,991	3,991
Yr./Yr. Change		61%	63%	60%	54%	54%	5%	5%	5%	1%	1%	-2%	-2%	-6%	-1%	-1%	1%	2%	2%	2%	2%
Ending Inventory per Sq Ft		89	89	90	91	91	95	95	96	93	93	95	96	92	93	93	96	97	93	92	92
Yr./Yr. Change		6%	9%	8%	6%	6%	7%	7%	7%	2%	2%	0%	0%	-4%	0%	0%	1%	1%	0%	0%	0%
Total Assets		7,913	7,970	7,998	7,962	7,962	8,147	8,168	8,182	7,846	7,846	8,025	8,067	8,063	7,967	7,967	8,165	8,193	8,126	8,001	8,001
Total Liabilities		6,246	6,155	6,072	5,959	5,959	6,000	5,879	5,768	5,466	5,466	5,438	5,288	5,123	4,889	4,889	5,037	5,031	4,963	4,863	4,863
Total shareholders' equity		1,667	1,815	1,925	2,003	2,003	2,147	2,289	2,413	2,380	2,380	2,587	2,780	2,941	3,078	3,078	3,128	3,162	3,163	3,139	3,139
Book Value per Share		\$22.72	\$24.72	\$26.22	\$27.25	\$27.28	\$29.14	\$31.07	\$32.71	\$32.26	\$32.28	\$35.08	\$37.68	\$39.87	\$41.73	\$41.73	\$43.14	\$44.36	\$45.13	\$45.55	\$44.40
Total Debt		2,002	1,798	1,730	1,636	1,636	1,610	1,453	1,293	1,325	1,325	1,125	925	825	725	725	675	575	575	575	575
Total Debt / EBITDA		5.1x	5.3x	5.4x	5.9x	1.2x	3.8x	3.9x	3.9x	6.0x	1.0x	2.4x	2.2x	1.8x	0.7x	0.1x	1.2x	1.2x	1.2x	0.6x	0.1x
Total Adjusted Debt / EBITDAR		-	-	-	-	3.2x	-	-	-	-	3.3x	-	-	-	-	2.7x	-	-	-	-	2.5x

Source: Company reports, UBS estimates

## O'Reilly Automotive (ORLY) – Buy

Topics to watch: For 2016, we believe the following factors will be the critical drivers for how the shares perform:

- **Will ORLY purchase AAP?** While there would be plenty of store overlap, we believe that ORLY would benefit from scale and synergy benefits. Most importantly, an acquisition would allow it to gain a stronger presence in the Northeast and Southeast regions. An AAP acquisition would be its largest to date and would essentially require integrating multiple companies into its fold at once (most notably Advance and Carquest). However, ORLY has a history of successfully tackling complex integrations, with the most notable example being CSK. Should ORLY decide to pursue this route, we conservatively estimate that a deal could add ~14% to its EPS by Year 3. If ORLY elects to pass on AAP, we think it could instead focus on acquiring smaller chains from motivated sellers with 30-80 stores, aging CEOs, and little in the way of succession planning.
- **Can ORLY keep up its comp growth momentum?** Even with AAP and AZO adding more frequent deliveries to a greater percentage of their stores, ORLY's better developed DC and hub store networks allow it to get products to customers quicker than the competition. Further, the company will likely continue to benefit from its well-developed culture of service, which provides its employees with incentives for sales production and opportunities for promotion. It has ramped up its labor hours per store in order to capitalize on any disruption at AAP, which we think was a prudent move. Finally, we believe continued low fuel prices and growth in vehicle miles travelled should support ORLY and the industry as a whole. The biggest challenge for ORLY will be lapping its own impressive comp growth, which we estimate at 6.6% for FY'15. Taking all this into consideration, we model 3.5% comparable store sales growth for 2016, which could prove to be conservative. Still, this equates to 10.1% growth on a 2-year stack, which compares favorably to AAP (at 1.0%) and AZO (at 7.2%), and would help demonstrate the continued strength of ORLY's business model.

Figure 67: ORLY, AAP, and AZO comp growth, CY'14-CY'16E

	1Q'14	2Q'14	3Q'14	4Q'14	FY'14	1Q'15	2Q'15	3Q'15	4Q'15E	FY'15E	1Q'16E	2Q'16E	3Q'16E	4Q'16E	FY'16E
ORLY 1-Yr Comp	6.3%	5.1%	6.2%	6.3%	6.0%	7.2%	7.2%	7.9%	4.0%	6.6%	3.5%	3.5%	3.5%	3.5%	3.5%
ORLY 2-Yr Comp	6.9%	11.6%	10.8%	11.7%	10.3%	13.5%	12.3%	14.1%	10.3%	12.6%	10.7%	10.7%	11.4%	7.5%	10.1%
AAP 1-Yr Comp	2.4%	2.6%	1.5%	1.1%	1.9%	0.7%	1.0%	0.5%	0.0%	0.6%	0.2%	0.3%	0.5%	1.0%	0.5%
AAP 2-Yr Comp	-0.8%	2.3%	-0.5%	1.2%	0.4%	3.2%	3.6%	2.0%	1.1%	2.5%	1.0%	1.3%	1.0%	1.0%	1.0%
AZO 1-Yr Comp	-1.8%	-0.1%	1.0%	0.9%	0.0%	4.3%	4.0%	2.1%	4.5%	3.7%	3.6%	2.3%	4.5%	3.5%	3.5%
AZO 2-Yr Comp	4.1%	3.8%	3.1%	1.1%	3.0%	2.5%	3.9%	3.1%	5.4%	3.7%	7.9%	6.3%	6.6%	8.0%	7.2%

We expect ORLY to considerably outperform AAP and AZO on a 2 year stack basis in FY'16

Source: Company reports, UBS estimates

- **Will ORLY face margin pressure as online competition and commodity prices likely go up?** We think it's unlikely. While ORLY has acknowledged that online retailers have undercut its prices on select items, particularly in the DIY market, the company historically hasn't fully matched such discounts. ORLY continues to have a distinct advantage relative to the competition with its ability to have more products available on a same day basis, as customers have historically valued convenience above price. On the pricing front, some commodity inflation could occur as unemployment tightens and interest rates rise. That said, we think ORLY and its competitors would likely be able to pass through any increases to the end consumer.



## What to do with the stock?

Over the past few years, ORLY has been the standout player in a favorable environment for the auto parts retailers. With some continued merger disruption in the space, its well positioned to gain share again in CY'16. Further gross margin gains and SG&A leverage will likely complement its sales growth. When combined with continued share repurchases, we believe another year of double digit EPS growth is likely. Thus, we continue to believe that ORLY is a good place to invest as we head into 2016. Our new \$285 price target (\$300 previously) equates to 25x our CY'17 EPS estimate of \$11.38 and is based on a DCF/multiple blend analysis.

We think it is useful to examine how our price target would respond to various changes in our assumptions for ORLY's earnings outlook over the next few years and the valuation multiple that would be associated with those scenarios. The following figure highlights our base case, a high case, and a low case.

**Figure 68: ORLY price target sensitivity analysis**

	Base Case (Published estimates)					Upside Case			Downside Case		
	2013A	2014A	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2016E
Comparable Store Sales Growth	4.3%	6.0%	6.6%	3.5%	3.0%	7.5%	5.0%	4.5%	4.0%	1.0%	0.5%
Growth Contribution from New Stores	3.2%	2.6%	2.8%	2.3%	2.4%	2.8%	2.3%	2.4%	2.8%	2.3%	2.4%
Total Sales Growth	7.6%	8.5%	9.5%	5.8%	5.4%	10.3%	7.3%	6.9%	6.8%	3.3%	2.9%
<b>Total Sales</b>	<b>6,649</b>	<b>7,216</b>	<b>7,900</b>	<b>8,356</b>	<b>8,805</b>	<b>7,963</b>	<b>8,542</b>	<b>9,130</b>	<b>7,710</b>	<b>7,963</b>	<b>8,192</b>
<b>Operating Income</b>	<b>1,103</b>	<b>1,270</b>	<b>1,507</b>	<b>1,636</b>	<b>1,768</b>	<b>1,541</b>	<b>1,722</b>	<b>1,913</b>	<b>1,419</b>	<b>1,489</b>	<b>1,557</b>
Operating Income Margin	16.6%	17.6%	19.1%	19.6%	20.1%	19.4%	20.2%	21.0%	18.4%	18.7%	19.0%
Operating Income Yr. / Yr. Change	79	101	147	50	50	175	80	80	80	30	30
Interest Expense	(47)	(51)	(55)	(57)	(54)	(55)	(57)	(54)	(55)	(57)	(54)
Other Income, Net	3	3	1	3	3	1	3	3	1	3	3
Provision for Income Taxes	389	444	526	588	639	538	620	693	494	534	560
Income Taxes Rate	36.7%	36.3%	36.2%	37.2%	37.2%	36.2%	37.2%	37.2%	36.2%	37.2%	37.2%
<b>Diluted Net Income</b>	<b>670</b>	<b>778</b>	<b>927</b>	<b>993</b>	<b>1,078</b>	<b>949</b>	<b>1,047</b>	<b>1,170</b>	<b>871</b>	<b>901</b>	<b>946</b>
<b>Diluted EPS - reported</b>	<b>\$6.03</b>	<b>\$7.34</b>	<b>\$9.13</b>	<b>\$10.12</b>	<b>\$11.38</b>	<b>\$9.34</b>	<b>\$10.67</b>	<b>\$12.34</b>	<b>\$8.58</b>	<b>\$9.18</b>	<b>\$9.98</b>
Shares outstanding - diluted	111.1	106.0	101.6	98.2	94.7	101.6	98.2	94.7	101.6	98.2	94.7
NTM PE Multiple:			31x	28x	25x	39x	34x	30x	28x	26x	24x
Estimated Value:			\$285	\$285	\$285	\$364	\$363	\$370	\$240	\$239	\$240
Dividend:			\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
<b>Upside / Downside (vs. \$240.17):</b>			<b>19%</b>	<b>19%</b>	<b>19%</b>	<b>52%</b>	<b>51%</b>	<b>54%</b>	<b>0%</b>	<b>-1%</b>	<b>0%</b>

Source: Company reports, UBS estimates

Figure 69: ORLY financial model summary (\$ millions except per share)

	1Q14	2Q14	3Q14	4Q14	2014	1Q15	2Q15	3Q15	4Q15E	2015E	1Q16E	2Q16E	3Q16E	4Q16E	2016E	1Q17E	2Q17E	3Q17E	4Q17E	2017E
<b>Income Statement</b>																				
<b>Total Sales</b>	<b>1,728</b>	<b>1,847</b>	<b>1,877</b>	<b>1,764</b>	<b>7,216</b>	<b>1,902</b>	<b>2,036</b>	<b>2,080</b>	<b>1,882</b>	<b>7,900</b>	<b>2,013</b>	<b>2,152</b>	<b>2,200</b>	<b>1,992</b>	<b>8,356</b>	<b>2,123</b>	<b>2,268</b>	<b>2,317</b>	<b>2,098</b>	<b>8,805</b>
Yr./Yr. Change	9.0%	7.7%	8.6%	8.8%	8.5%	10.1%	10.2%	10.8%	6.7%	9.5%	5.8%	5.7%	5.7%	5.8%	5.8%	5.5%	5.4%	5.4%	5.3%	5.4%
Comp Store Sales	6.3%	5.1%	6.2%	6.3%	6.0%	7.2%	7.2%	7.9%	4.0%	6.6%	3.5%	3.5%	3.5%	3.5%	3.5%	3.0%	3.0%	3.0%	3.0%	3.0%
Gross Profit	878	951	968	912	3,709	987	1,059	1,089	979	4,114	1,050	1,126	1,126	1,042	4,376	1,114	1,193	1,193	1,103	4,638
% of Sales	50.8%	51.5%	51.6%	51.7%	51.4%	51.9%	52.0%	52.4%	52.0%	52.1%	52.2%	52.3%	52.3%	52.3%	52.4%	52.5%	52.6%	52.6%	52.6%	52.7%
Yr./Yr. Change (bps)	41	64	71	117	73	110	54	78	30	68	30	30	30	30	30	30	30	30	30	30
SG&A Expense	591	614	624	609	2,439	637	654	674	642	2,607	670	687	687	676	2,741	702	720	720	707	2,871
% of Sales	34.2%	33.3%	33.3%	34.5%	33.8%	33.5%	32.1%	32.4%	34.1%	33.0%	33.3%	31.9%	31.9%	33.9%	32.8%	33.1%	31.7%	31.7%	33.7%	32.6%
Yr./Yr. Change (bps)	(37)	(30)	(22)	(23)	(28)	(71)	(113)	(87)	(40)	(79)	(20)	(20)	(20)	(20)	(20)	(20)	(20)	(20)	(20)	(20)
<b>Operating Income</b>	<b>287</b>	<b>336</b>	<b>344</b>	<b>303</b>	<b>1,270</b>	<b>350</b>	<b>405</b>	<b>415</b>	<b>336</b>	<b>1,507</b>	<b>381</b>	<b>439</b>	<b>439</b>	<b>366</b>	<b>1,636</b>	<b>412</b>	<b>474</b>	<b>474</b>	<b>396</b>	<b>1,768</b>
% of Sales	16.6%	18.2%	18.3%	17.2%	17.6%	18.4%	19.9%	20.0%	17.9%	19.1%	18.9%	20.4%	20.4%	18.4%	19.6%	19.4%	20.9%	20.9%	18.9%	20.1%
Yr./Yr. Change (bps)	78	94	93	140	101	181	167	165	70	147	50	50	50	50	50	50	50	50	50	50
Interest, Net	(13)	(12)	(12)	(13)	(51)	(14)	(14)	(14)	(14)	(55)	(14)	(14)	(14)	(14)	(57)	(14)	(14)	(14)	(14)	(54)
Pretax Income	275	325	332	290	1,222	338	391	401	323	1,453	367	425	425	352	1,581	400	461	461	383	1,717
Income Taxes	101	119	115	108	444	125	146	135	121	526	137	158	158	131	588	149	171	171	143	639
Tax Rate	36.8%	36.7%	34.7%	37.4%	36.3%	37.0%	37.3%	33.6%	37.3%	36.2%	37.2%	37.2%	37.2%	37.2%	37.2%	37.2%	37.2%	37.2%	37.2%	37.2%
Net Income	174	206	217	182	778	213	245	266	203	927	231	267	267	221	993	251	289	289	241	1,078
<b>EPS</b>	<b>\$1.61</b>	<b>\$1.91</b>	<b>\$2.06</b>	<b>\$1.76</b>	<b>\$7.34</b>	<b>\$2.06</b>	<b>\$2.40</b>	<b>\$2.64</b>	<b>\$2.02</b>	<b>\$9.13</b>	<b>\$2.32</b>	<b>\$2.71</b>	<b>\$2.71</b>	<b>\$2.28</b>	<b>\$10.12</b>	<b>\$2.61</b>	<b>\$3.04</b>	<b>\$3.04</b>	<b>\$2.58</b>	<b>\$11.38</b>
Yr./Yr. Change	18.2%	21.0%	21.9%	25.5%	21.6%	28.1%	25.7%	28.1%	15.1%	24.4%	12.6%	12.7%	12.7%	12.8%	10.8%	12.5%	12.3%	12.3%	12.9%	12.5%
Avg Shares Outstanding	108	108	105	103	106	103	102	101	100	102	99	99	99	97	98	96	95	95	93	95
Total Stores, end of period	4,216	4,257	4,311	4,366	4,366	4,433	4,465	4,523	4,571	4,571	4,626	4,681	4,681	4,781	4,781	4,831	4,881	4,881	4,981	4,981
Yr./Yr. Change	4.3%	4.2%	4.3%	4.8%	4.8%	5.1%	4.9%	4.9%	4.7%	4.7%	4.4%	4.8%	4.8%	4.6%	4.6%	4.4%	4.3%	4.3%	4.2%	4.2%
Square Footage, end of period	30	31	31	32	31	32	32	33	33	33	33	34	34	34	34	35	35	35	36	36
Yr./Yr. Change	4.6%	4.5%	4.5%	5.0%	4.8%	5.4%	5.1%	5.2%	4.2%	4.7%	3.8%	4.2%	4.2%	4.6%	4.6%	4.4%	4.3%	4.3%	4.2%	4.2%
<b>Cash Flow Statement</b>																				
CFFO	346	310	327	207	1,190	406	292	364	214	1,289	248	393	393	361	1,435	201	425	425	468	1,559
Yr./Yr. Change	53%	45%	17%	10%	31%	18%	-6%	11%	3%	8%	-39%	35%	35%	68%	11%	-19%	8%	8%	30%	9%
<b>FCF</b>	<b>262</b>	<b>198</b>	<b>205</b>	<b>95</b>	<b>760</b>	<b>315</b>	<b>197</b>	<b>254</b>	<b>107</b>	<b>885</b>	<b>154</b>	<b>292</b>	<b>292</b>	<b>267</b>	<b>1,042</b>	<b>102</b>	<b>319</b>	<b>319</b>	<b>370</b>	<b>1,145</b>
Yr./Yr. Change	72%	80%	30%	3%	48%	20%	-1%	24%	13%	16%	-51%	48%	48%	149%	18%	-34%	9%	9%	38%	10%
EBITDA	\$335	\$383	\$392	\$356	\$1,467	\$406	\$455	\$467	\$384	\$1,712	\$447	\$510	\$510	\$432	\$1,911	\$482	\$548	\$548	\$465	\$2,058
Yr./Yr. Change	13%	12%	13%	17%	14%	21%	19%	19%	8%	17%	10%	12%	12%	13%	12%	8%	8%	8%	8%	8%
<b>Balance Sheet</b>																				
Cash & S/T Investments	\$512	\$453	\$298	\$251	\$251	\$474	\$260	\$277	\$184	\$184	\$413	\$480	\$480	\$626	\$626	\$753	\$797	\$797	\$971	\$971
Cash per Share	\$4.74	\$4.22	\$2.83	\$2.42	\$2.36	\$4.59	\$2.55	\$2.75	\$1.84	\$1.81	\$4.15	\$4.87	\$4.87	\$6.46	\$6.46	\$7.84	\$8.37	\$8.37	\$10.40	\$10.40
Inventory, end of period	2,397	2,463	2,518	2,555	2,555	2,528	2,561	2,607	2,630	2,630	2,658	2,690	2,690	2,683	2,683	2,787	2,817	2,817	2,722	2,722
Yr./Yr. Change	4%	5%	6%	8%	8%	5%	4%	4%	3%	3%	5%	5%	5%	2%	2%	5%	5%	5%	1%	1%
Ending Inventory per Sq Ft	79	80	81	81	81	79	79	80	80	80	80	80	80	76	76	0	0	0	0	0
Yr./Yr. Change	0%	0%	2%	2%	3%	0%	-1%	-2%	-1%	-2%	0%	0%	0%	-3%	-3%	0%	0%	0%	0%	0%
Total Assets	6,430	6,508	6,475	6,540	6,540	6,786	6,668	6,775	6,749	6,749	7,065	7,217	7,217	7,388	7,388	7,668	7,798	7,798	7,910	7,910
Total Liabilities	4,267	4,390	4,499	4,522	4,522	4,642	4,698	4,773	4,664	4,664	4,966	5,068	5,068	5,177	5,177	5,473	5,580	5,580	5,687	5,687
Total shareholders' equity	2,163	2,118	1,976	2,018	2,018	2,144	1,970	2,002	2,085	2,085	2,099	2,149	2,149	2,211	2,211	2,196	2,218	2,218	2,223	2,223
Book Value per Share	\$20.02	\$19.69	\$18.78	\$19.53	\$19.03	\$20.76	\$19.29	\$19.87	\$20.81	\$20.52	\$21.13	\$21.80	\$21.80	\$22.79	\$22.79	\$22.85	\$23.31	\$23.31	\$23.79	\$23.79
Total Debt	1,396	1,396	1,397	1,397	1,397	1,397	1,397	1,397	1,397	1,397	1,697	1,697	1,697	1,697	1,697	1,997	1,997	1,997	1,997	1,997
Total Debt / EBITDA	4.2x	3.6x	3.6x	3.9x	1.0x	3.4x	3.1x	3.0x	3.6x	0.8x	3.8x	3.3x	3.3x	3.9x	3.9x	4.1x	3.6x	3.6x	4.3x	4.3x
Total Adjusted Debt / EBITDAR					2.1x					1.8x					0.0x					0.0x

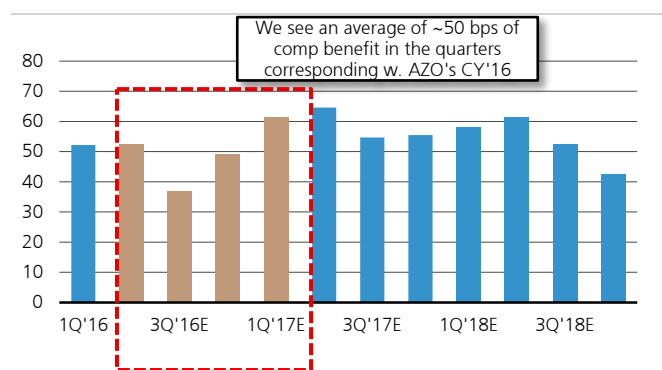
Source: Company reports, UBS estimates

## AutoZone (AZO) – Neutral

Topics to watch: For 2016, we believe the following factors will be the critical drivers for how the shares perform:

- **Would AZO consider purchasing AAP?** In mid December, StreetInsider reported that AAP was considering a possible sale. We can't substantiate if this actually occurred, but it would make sense. While we believe the accretion would likely be lower than what ORLY could expect to see (we est. ~2% Year 3 accretion for AZO vs. ~14% accretion for ORLY), there would still be some benefits. Most importantly, AAP would allow AZO to ramp up its commercial business considerably in a much shorter period of time. Thus, while we believe ORLY would be more likely to pursue a purchase of AAP, we wouldn't rule out the possibility of AZO getting involved either.
- **Can AZO balance the benefits from its inventory investments with its costs?** We believe AZO's move to more frequent deliveries in two-thirds of its stores is a prudent move. With ORLY already offering daily deliveries in nearly all of its stores, and AAP ramping up its own daily delivery expansion, we think AZO needed to undertake a similar initiative if it was truly serious about competing in the commercial space. However, these projects are expensive, and costs came in a bit higher than initial expectations were last quarter. We estimate the initiative will cost the retailer -17 bps in operating margin in CY'16, but will add an incremental \$2 mm in operating income. But, the long-term benefits should outweigh the internal costs.

Figure 70: AZO inventory initiative comp benefit



Source: Company reports, UBS estimates

Figure 71: AZO inventory Op. Income & Margin benefit

	CY'16E	CY'17E
<b>Additional Sales Dollars (\$ mm)</b>	106.1	171.3
Incremental COGS (at 30 bps per qtr)	32	34
Base COGS rate	47.3%	47.4%
Base COGS	50	81
Total COGS	83	115
Gross Profit	23	56
Increased SG&A (at 20% margin)	21	34
<b>Incremental Operating Income</b>	<b>2</b>	<b>22</b>
<b>Incremental Benefit to Overall OM (in bps)</b>	<b>-17</b>	<b>-9</b>
Tax Rate	35.9%	35.9%
<b>EPS Impact</b>	<b>\$0.05</b>	<b>\$0.52</b>
Diluted Shares	29.0	27.4

Source: Company reports, UBS estimates

- **Will AZO continue to buy back shares at a high rate in 2016?** AZO continues to be a free cash flow machine, and we don't expect that to change in CY'16. Because of this, we anticipate it will continue to utilize share repurchases as a lever to reward shareholders in the upcoming year, albeit at a slightly slower rate than it saw in 2015. For CY'16, we estimate that AZO will buyback a total of \$1,125 mm in shares, which is -18% below its rate in CY'15. Still, we see this adding an incremental \$1.20, or ~3% to its EPS. Plus, its shares climbed by 20% YoY, so its repurchases are becoming less powerful.

## What to do with the stock?

AZO has been one of the most consistent names in hardline retail for some time. Still, it recognizes it needs to evolve in order to remain a top player in an evolving auto parts industry. Its inventory replenishment initiatives, new store prototype,

and investments in labor show that it is committed to remaining a top player in DIY while at the same time enhancing its position in DIFM. All the while, we expect it to maintain ~10% EPS growth for the next several years. At current levels, though, we think the stock is fairly valued. Our \$825 price target equates to 18x our CY'17 EPS estimate of \$46.30 and is based on a DCF/multiple blend analysis.

We think it is useful to examine how our price target would respond to various changes in our assumptions for AZO's earnings outlook over the next few years and the valuation multiple that would be associated with those scenarios. The following figure highlights our base case, a high case, and a low case.

**Figure 72: AZO price target sensitivity analysis**

CY	Base Case (Published estimates)					High Case			Low Case		
	2013A	2014A	2015A	2016E	2017E	2015A	2016E	2017E	2015A	2016E	2017E
Comparable Store Sales Growth	0.3%	-0.3%	3.5%	2.9%	2.5%	4.0%	4.0%	4.0%	0.5%	0.0%	0.0%
Growth Contribution from New Stores	6.4%	4.5%	3.4%	2.0%	1.7%	3.4%	2.0%	1.7%	3.4%	2.0%	1.7%
Total Sales Growth	6.7%	4.2%	7.0%	4.9%	4.2%	7.4%	6.0%	5.7%	3.9%	2.0%	1.7%
<b>Total Sales</b>	<b>9,250</b>	<b>9,642</b>	<b>10,313</b>	<b>10,822</b>	<b>11,278</b>	<b>10,357</b>	<b>10,983</b>	<b>11,610</b>	<b>12,777</b>	<b>13,039</b>	<b>13,262</b>
<b>Operating Income</b>	<b>1,794</b>	<b>1,855</b>	<b>1,982</b>	<b>2,059</b>	<b>2,137</b>	<b>1,990</b>	<b>2,100</b>	<b>2,220</b>	<b>2,116</b>	<b>2,127</b>	<b>2,130</b>
Operating Income Margin	19.4%	19.2%	19.2%	19.0%	19.0%	19.2%	19.1%	19.1%	16.6%	16.3%	16.1%
Operating Income Yr. / Yr. Change	5	3	-2	-20	-8	10	-10	0	-25	-25	-25
Interest Expense	-187	-162	-148	-151	-156	-148	-151	-156	-148	-151	-156
Provision for Income Taxes	576	603	654	686	712	657	701	742	702	710	710
Income Taxes Rate	35.8%	35.6%	35.7%	35.9%	35.9%	35.7%	35.9%	35.9%	35.7%	35.9%	35.9%
<b>Diluted Net Income</b>	<b>1,031</b>	<b>1,090</b>	<b>1,180</b>	<b>1,222</b>	<b>1,269</b>	<b>1,185</b>	<b>1,248</b>	<b>1,322</b>	<b>1,266</b>	<b>1,266</b>	<b>1,264</b>
<b>Diluted EPS - reported</b>	<b>\$28.69</b>	<b>\$32.57</b>	<b>\$37.04</b>	<b>\$42.18</b>	<b>\$46.30</b>	<b>\$37.20</b>	<b>\$43.08</b>	<b>\$48.23</b>	<b>\$39.74</b>	<b>\$43.69</b>	<b>\$46.14</b>
Shares outstanding - diluted	35.9	33.5	31.9	29.0	27.4	31.9	29.0	27.4	31.9	29.0	27.4
NTM PE Multiple:	22x					23x	20x	18x	18x	16x	15x
Estimated Value:	\$825					\$856	\$862	\$868	\$695	\$699	\$692
Upside / Downside (vs. \$735.96):	12%					16%	17%	18%	-6%	-5%	-6%

Source: Company reports, UBS estimates

Figure 73: AZO financial model summary (\$ millions except per share)

	1Q15	2Q15	3Q15	4Q15	2015	1Q16	2Q16E	3Q16E	4Q16E	2016E	1Q17E	2Q17E	3Q17E	4Q17E	2017E	1Q18E	2Q18E	3Q18E	4Q18E	2018E
<b>Income Statement</b>																				
<b>Total Sales</b>	<b>2,260</b>	<b>2,144</b>	<b>2,493</b>	<b>3,290</b>	<b>10,187</b>	<b>2,386</b>	<b>2,251</b>	<b>2,631</b>	<b>3,456</b>	<b>10,723</b>	<b>2,485</b>	<b>2,345</b>	<b>2,742</b>	<b>3,605</b>	<b>11,177</b>	<b>2,585</b>	<b>2,440</b>	<b>2,853</b>	<b>3,750</b>	<b>11,629</b>
Yr./Yr. Change	8.0%	7.7%	6.5%	7.9%	7.5%	5.6%	5.0%	5.5%	5.0%	5.3%	4.1%	4.2%	4.2%	4.3%	4.2%	4.1%	4.0%	4.0%	4.0%	4.0%
Comp Store Sales	4.5%	3.6%	2.3%	4.5%	3.8%	3.5%	3.0%	3.0%	3.0%	3.1%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%
Gross Profit	1,177	1,120	1,303	1,728	5,327	1,253	1,176	1,375	1,815	5,618	1,303	1,224	1,432	1,891	5,850	1,356	1,274	1,490	1,967	6,087
% of Sales	52.1%	52.2%	52.3%	52.5%	52.3%	52.5%	52.3%	52.3%	52.5%	52.4%	52.5%	52.2%	52.2%	52.5%	52.3%	52.5%	52.2%	52.2%	52.5%	52.3%
Yr./Yr. Change (bps)	20	15	29	20	21	45	0	0	0	10	(5)	(5)	(5)	(5)	(5)	0	0	0	0	0
SG&A Expense	768	759	789	1,058	3,374	815	802	839	1,118	3,575	850	837	876	1,168	3,731	884	871	911	1,215	3,882
% of Sales	34.0%	35.4%	31.6%	32.2%	33.1%	34.2%	35.6%	31.9%	32.4%	33.3%	34.2%	35.7%	31.9%	32.4%	33.4%	34.2%	35.7%	31.9%	32.4%	33.4%
Yr./Yr. Change (bps)	45	24	12	52	35	17	25	25	20	22	5	5	5	5	5	0	0	0	0	0
<b>Operating Income</b>	<b>409</b>	<b>361</b>	<b>514</b>	<b>669</b>	<b>1,953</b>	<b>438</b>	<b>374</b>	<b>536</b>	<b>696</b>	<b>2,043</b>	<b>454</b>	<b>387</b>	<b>556</b>	<b>722</b>	<b>2,119</b>	<b>472</b>	<b>403</b>	<b>578</b>	<b>751</b>	<b>2,204</b>
% of Sales	18.1%	16.9%	20.6%	20.3%	19.2%	18.4%	16.6%	20.4%	20.1%	19.1%	18.3%	16.5%	20.3%	20.0%	19.0%	18.3%	16.5%	20.3%	20.0%	19.0%
Yr./Yr. Change (bps)	(25)	(9)	16	(32)	(14)	28	(25)	(25)	(20)	(12)	(10)	(10)	(10)	(10)	(10)	(0)	0	0	(0)	(0)
Interest, Net	(37)	(35)	(32)	(47)	(150)	(35)	(35)	(32)	(48)	(150)	(36)	(36)	(34)	(49)	(155)	(37)	(37)	(35)	(50)	(159)
Pretax Income	372	327	482	622	1,803	403	339	503	648	1,894	417	351	522	673	1,963	435	365	544	702	2,045
Income Taxes	133	115	173	221	642	145	122	181	233	681	150	126	188	242	706	156	131	195	252	735
Tax Rate	35.9%	35.2%	35.9%	35.5%	35.6%	35.9%	35.9%	35.9%	35.9%	35.9%	35.9%	35.9%	35.9%	35.9%	35.9%	35.9%	35.9%	35.9%	35.9%	35.9%
Net Income	238	212	309	401	1,160	258	217	322	415	1,213	267	225	334	431	1,257	278	234	348	449	1,310
<b>EPS</b>	<b>\$7.27</b>	<b>\$6.51</b>	<b>\$9.57</b>	<b>\$12.75</b>	<b>\$36.03</b>	<b>\$8.29</b>	<b>\$7.35</b>	<b>\$11.05</b>	<b>\$14.42</b>	<b>\$41.45</b>	<b>\$9.41</b>	<b>\$8.02</b>	<b>\$12.12</b>	<b>\$15.85</b>	<b>\$45.35</b>	<b>\$10.38</b>	<b>\$8.84</b>	<b>\$13.34</b>	<b>\$17.45</b>	<b>\$49.95</b>
Yr./Yr. Change	15.7%	15.6%	13.1%	13.0%	11.2%	14.0%	13.0%	15.5%	13.1%	15.1%	13.5%	9.1%	9.7%	10.0%	9.4%	10.3%	10.2%	10.1%	10.1%	10.1%
Avg Shares Outstanding	33	33	32	31	32	31	29	29	29	29	28	28	28	27	28	27	26	26	26	26
Total Stores, end of period	5,434	5,476	5,512	5,609	5,609	5,635	5,670	5,704	5,737	5,737	5,775	5,813	5,852	5,890	5,890	5,928	5,966	6,005	6,043	6,043
Yr./Yr. Change	3.7%	3.7%	2.2%	4.0%	4.0%	2.9%	2.9%	1.7%	2.3%	1.8%	1.2%	1.3%	2.0%	2.0%	2.0%	0.6%	1.3%	#REF!	#REF!	1.9%
Square Footage, end of period	33	33	33	34	34	34	34	34	34	34	34	35	35	35	35	35	35	36	36	36
Yr./Yr. Change	3.6%	3.7%	3.6%	3.3%	3.3%	3.3%	3.0%	2.9%	1.9%	1.9%	2.0%	2.1%	2.2%	2.3%	2.3%	2.3%	2.3%	2.2%	2.2%	2.2%
<b>Cash Flow Statement</b>																				
FFO	375	101	569	480	1,525	529	111	299	715	1,654	467	115	310	745	1,637	483	120	323	775	1,701
Yr./Yr. Change	5%	-33%	23%	30%	14%	41%	10%	-47%	49%	8%	-12%	3%	4%	4%	-1%	4%	4%	4%	4%	4%
<b>FCF</b>	<b>283</b>	<b>8</b>	<b>462</b>	<b>292</b>	<b>1,045</b>	<b>395</b>	<b>(15)</b>	<b>152</b>	<b>522</b>	<b>1,053</b>	<b>330</b>	<b>(14)</b>	<b>159</b>	<b>546</b>	<b>1,022</b>	<b>372</b>	<b>15</b>	<b>200</b>	<b>614</b>	<b>1,201</b>
Yr./Yr. Change	3%	-90%	28%	51%	16%	40%	-300%	-67%	79%	1%	-16%	-6%	5%	5%	-3%	13%	-203%	26%	12%	18%
EBITDA	\$471	\$423	\$578	\$757	\$2,229	\$502	\$433	\$604	\$786	\$2,326	\$521	\$449	\$627	\$816	\$2,413	\$542	\$467	\$652	\$849	\$2,511
Yr./Yr. Change	7%	6%	7%	6%	7%	7%	3%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%	4%
<b>Balance Sheet</b>																				
Cash & S/T Investments	\$117	\$152	\$153	\$175	\$175	\$165	\$50	\$50	\$272	\$272	\$252	\$50	\$50	\$246	\$246	\$269	\$50	\$50	\$314	\$314
Cash per Share	\$3.58	\$4.66	\$4.75	\$5.57	\$5.44	\$5.31	\$1.70	\$1.71	\$9.44	\$9.29	\$8.88	\$1.79	\$1.81	\$9.06	\$8.89	\$10.02	\$1.89	\$1.92	\$12.20	\$11.98
Inventory, end of period	3,280	3,457	3,468	3,422	3,422	3,516	3,629	3,660	3,594	3,594	3,576	3,786	3,819	3,752	3,752	3,721	3,939	3,973	3,903	3,903
Yr./Yr. Change	11%	12%	11%	9%	9%	7%	5%	6%	5%	5%	2%	4%	4%	4%	4%	4%	4%	4%	4%	4%
Ending Inventory per Sq Ft	90	96	96	93	93	95	98	98	95	95	94	99	99	97	97	96	101	101	98	98
Yr./Yr. Change	5%	7%	6%	5%	5%	5%	1%	2%	3%	3%	-1%	2%	2%	2%	2%	1%	1%	1%	1%	1%
Total Assets	7,717	7,950	8,032	8,102	8,102	8,218	8,256	8,445	8,595	8,595	8,673	8,745	8,939	9,062	9,062	9,140	9,177	9,343	9,488	9,488
Total Liabilities	9,380	9,419	9,639	9,804	9,804	9,995	10,102	10,164	10,265	10,265	10,386	10,568	10,721	10,830	10,830	10,939	11,076	11,187	11,299	11,299
Total shareholders' equity	(1,663)	(1,469)	(1,607)	(1,701)	(1,701)	(1,778)	(1,846)	(1,718)	(1,670)	(1,670)	(1,713)	(1,822)	(1,782)	(1,767)	(1,767)	(1,799)	(1,898)	(1,844)	(1,811)	(1,811)
Book Value per Share	-\$50.76	-\$45.14	-\$49.75	-\$54.07	-\$52.83	-\$57.09	-\$62.60	-\$58.89	-\$57.96	-\$57.07	-\$60.33	-\$65.11	-\$64.60	-\$64.97	-\$63.74	-\$67.06	-\$71.75	-\$70.66	-\$70.33	-\$69.06
Total Debt	4,422	4,448	4,748	4,625	4,625	4,754	4,874	4,972	4,972	4,972	4,972	5,134	5,325	5,325	5,325	5,325	5,442	5,591	5,591	5,591
Total Debt / EBITDA	9.1x	10.2x	7.9x	5.9x	2.0x	9.1x	11.1x	8.1x	6.0x	2.0x	9.1x	11.3x	8.4x	6.2x	2.1x	9.3x	11.5x	8.5x	6.2x	2.1x
Total Adjusted Debt / EBITDAR	-	-	-	-	2.7x	-	-	-	-	2.8x	-	-	-	-	2.0x	-	-	-	-	2.0x

Source: Company reports, UBS estimates

## Best Buy (BBY) - Neutral

Topics to Watch: For 2016, we believe the following factors will be the critical drivers for how the shares perform.

- **How will BBY perform in key categories?** We expect BBY to show mild comp sales growth next year. The company has now shown double digit comp sales in the Appliances category. BBY should likely continue to benefit from increased demand for these products, as well as rising ASPs. Further, it is [well positioned to capture share](#) from Sears as 60% of its stores are within a 10 minute drive of a Sears location. We estimate that BBY could see a ~100 bps comp benefit from the appliances category in '16. In addition, the company should continue to see unit growth of Ultra HD televisions, although the falling ASPs should surely be an offset. Though, the Super Bowl shift should push about 40 bps of sales into 1Q'17 from 4Q'16. The wearables category should continue to be a tailwind. But, with adoption rising rapidly, it's unclear what the replacement cycle will be on these devices. At the same time, demand for computers and tablets has been muted lately and could remain that way. While there is potential for a future beneficial virtual reality cycle, it's probably farther off in the future. For these reasons, we model 0.5% comp sales in '16.
- **What will be the dynamic between reaping the benefits from cost cuttings and further investment?** We expect modest operating margin expansion next year of ~25 bps. The company has noted that for fiscal '17 it should start to see benefits from other initiatives. But, these gains will be used to offset some further growth investments. As a reminder, BBY expects to save \$400 million over three years as part of its Renew Blue phase two cost reduction and gross profit optimization program. As of 3Q'16, it had eliminated \$110 million in total costs, of which \$85 million came in fiscal '16. We believe BBY will manage these offsets carefully to achieve balance, with some upside to margin expansion.
- **Can BBY accelerate its share repurchases in '16?** We model a moderate \$300 million in buybacks in '16, which is less than our '15 forecast. The company brought back repurchases as part of its capital allocation program in 2Q as it repurchased a very respectable \$321 million in total. It followed that quarter up with \$64 million in the next quarter. BBY intends to repurchase \$1 billion in shares over the next three years, implying a little more than \$300 per annum. But, as we have seen with its buyback activity in '15, its repurchasing could be uneven with potential for upside.

## What to do with the stock?

Best Buy has been an up and down story lately. While it has shown some improvement in its comp sales and margins in the early parts of the year, its holiday outlook was rather weak. Going into next year, we would want to see an acceleration of trends to be more encouraged about its investment case. But the constant balance between expense savings and required investment, plus uneven sales trends, keeps our outlook rather muted at current levels. Our \$33 price target equates to 11x our CY'17 EPS estimate of \$3.09 and is based on a DCF/multiple blend analysis.

We think it is useful to examine how our price target would respond to various changes in our assumptions for BBY's earnings outlook over the next few years

and the valuation multiple that would be associated with those scenarios. The following figure highlights our base case, a high case, and a low case.

**Figure 74: BBY price target sensitivity analysis**

Calendar Year	Base Case (Published estimates)					High Case			Low Case		
	2013A	2014A	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E
Comparable Store Sales Growth	-1.0%	0.5%	1.2%	0.6%	0.5%	3.0%	2.0%	2.0%	-1.0%	-1.5%	-1.5%
Growth Contribution from New Stores	-6.8%	-1.2%	-2.7%	0.0%	0.0%	-2.7%	0.0%	0.0%	-2.7%	0.0%	0.0%
Total Sales Growth	-7.8%	-0.7%	-1.5%	0.6%	0.5%	0.3%	2.0%	2.0%	-3.7%	-1.5%	-1.5%
<b>Total Sales</b>	<b>40,611</b>	<b>40,339</b>	<b>39,728</b>	<b>39,977</b>	<b>40,181</b>	<b>40,456</b>	<b>41,260</b>	<b>42,089</b>	<b>38,842</b>	<b>38,255</b>	<b>37,685</b>
<b>Operating Income</b>	<b>1,163</b>	<b>1,497</b>	<b>1,505</b>	<b>1,613</b>	<b>1,661</b>	<b>1,623</b>	<b>1,964</b>	<b>2,193</b>	<b>1,364</b>	<b>1,286</b>	<b>1,229</b>
Operating Income Margin	2.9%	3.7%	3.8%	4.0%	4.1%	4.0%	4.8%	5.2%	3.5%	3.4%	3.3%
Operating Income Yr. / Yr. Change	-49	85	8	24	10	30	75	45	-20	-15	-10
Interest Income (Expense)	(81)	(76)	(62)	(62)	(41)	(62)	(62)	(41)	(62)	(62)	(41)
Provision for Income Taxes	374	536	528	567	593	571	696	787	476	448	435
Income Taxes Rate	34.6%	37.7%	36.6%	36.6%	36.6%	36.6%	36.6%	36.6%	36.6%	36.6%	36.6%
Dilution, Minority Interest, & Other	0	0	0	0	0	0	0	0	0	0	0
<b>Diluted Net Income</b>	<b>708</b>	<b>885</b>	<b>915</b>	<b>984</b>	<b>1,028</b>	<b>990</b>	<b>1,207</b>	<b>1,365</b>	<b>826</b>	<b>776</b>	<b>754</b>
<b>Diluted EPS - reported</b>	<b>\$2.04</b>	<b>\$2.50</b>	<b>\$2.61</b>	<b>\$2.89</b>	<b>\$3.09</b>	<b>\$2.82</b>	<b>\$3.55</b>	<b>\$4.10</b>	<b>\$2.35</b>	<b>\$2.28</b>	<b>\$2.26</b>
Shares outstanding - diluted	347.5	353.6	350.9	340.3	332.9	350.9	340.3	332.9	350.9	340.3	332.9
NTM PE Multiple:			13x	11x	11x	17x	14x	12x	7x	7x	7x
Estimated Value:			\$33	\$33	\$33	\$48	\$50	\$49	\$16	\$16	\$16
Dividend:			\$0.88	\$0.92	\$0.92	\$0.88	\$0.92	\$0.92	\$0.88	\$0.92	\$0.92
<b>Upside / Downside Potential (vs. \$30.23):</b>			<b>12%</b>	<b>12%</b>	<b>12%</b>	<b>62%</b>	<b>67%</b>	<b>66%</b>	<b>-43%</b>	<b>-44%</b>	<b>-45%</b>

Source: Company reports, UBS estimates

Figure 75: BBY financial model summary (\$ millions except per share)

	CY	1Q14	2Q14	3Q14	4Q14	2014	1Q15	2Q15	3Q15	4Q15E	2015E	1Q16E	2Q16E	3Q16E	4Q16E	2016E	1Q17E	2Q17E	3Q17E	4Q17E	2017E
<b>Income Statement</b>																					
<b>Total Sales</b>		<b>8,639</b>	<b>8,459</b>	<b>9,032</b>	<b>14,209</b>	<b>40,339</b>	<b>8,558</b>	<b>8,528</b>	<b>8,819</b>	<b>13,823</b>	<b>39,728</b>	<b>8,639</b>	<b>8,572</b>	<b>8,867</b>	<b>13,899</b>	<b>39,977</b>	<b>8,683</b>	<b>8,616</b>	<b>8,913</b>	<b>13,970</b>	<b>40,181</b>
Yr./Yr. Change		-3.2%	-3.1%	1.2%	1.3%	-0.7%	-0.9%	0.8%	-2.4%	-2.7%	-1.5%	0.9%	0.5%	0.5%	0.5%	0.6%	0.5%	0.5%	0.5%	0.5%	0.5%
Comp Store Sales		-1.8%	-2.2%	2.9%	2.0%	0.5%	0.6%	3.5%	0.7%	0.5%	1.2%	1.0%	0.5%	0.5%	0.5%	0.6%	0.5%	0.5%	0.5%	0.5%	0.5%
Domestic Comp		-1.3%	-2.0%	3.2%	2.8%	1.0%	0.6%	3.8%	0.8%	0.5%	1.3%	1.0%	0.5%	0.5%	0.5%	0.6%	0.5%	0.5%	0.5%	0.5%	0.5%
Intl. Com		-6.6%	-3.8%	0.2%	-4.0%	-3.5%	0.0%	0.0%	0.0%	0.0%	0.0%	1.0%	1.0%	1.0%	1.0%	1.0%	0.5%	0.5%	0.5%	0.5%	0.5%
Gross Profit		1,967	1,978	2,076	3,026	9,047	1,960	2,085	2,111	2,916	9,072	1,983	2,100	2,131	2,953	9,167	1,997	2,115	2,147	2,975	9,234
% of Sales		22.8%	23.4%	23.0%	21.3%	22.4%	22.9%	24.4%	23.9%	21.1%	22.8%	23.0%	24.5%	24.0%	21.2%	22.9%	23.0%	24.5%	24.1%	21.3%	23.0%
Yr./Yr. Change (bps)		(81)	(76)	(47)	113	(7)	13	107	95	(20)	41	5	5	10	15	10	5	5	5	5	5
Domestic Gross Margin		22.7%	23.4%	23.0%	21.2%	22.4%	22.9%	24.6%	24.1%	21.1%	22.9%	23.0%	24.6%	24.2%	21.2%	23.0%	23.0%	24.7%	24.2%	21.3%	23.0%
Yr./Yr. Change (bps)		(74)	(49)	(47)	129	6	26	113	104	(15)	49	5	5	10	15	10	5	5	5	5	5
SG&A Expense		1,746	1,736	1,860	2,208	7,550	1,741	1,793	1,864	2,169	7,567	1,744	1,789	1,861	2,160	7,555	1,749	1,794	1,866	2,164	7,573
% of Sales		20.2%	20.5%	20.6%	15.5%	18.7%	20.3%	21.0%	21.1%	15.7%	19.0%	20.2%	20.9%	21.0%	15.5%	18.9%	20.1%	20.8%	20.9%	15.5%	18.8%
Yr./Yr. Change (bps)		(108)	(139)	(135)	(14)	(91)	13	50	54	15	33	(15)	(15)	(15)	(15)	(15)	(5)	(5)	(5)	(5)	(5)
<b>Operating Income</b>		<b>221</b>	<b>242</b>	<b>216</b>	<b>818</b>	<b>1,497</b>	<b>219</b>	<b>292</b>	<b>247</b>	<b>747</b>	<b>1,505</b>	<b>238</b>	<b>311</b>	<b>271</b>	<b>793</b>	<b>1,613</b>	<b>248</b>	<b>321</b>	<b>281</b>	<b>811</b>	<b>1,661</b>
% of Sales		2.6%	2.9%	2.4%	5.8%	3.7%	2.6%	3.4%	2.8%	5.4%	3.8%	2.8%	3.6%	3.1%	5.7%	4.0%	2.9%	3.7%	3.2%	5.8%	4.1%
Yr./Yr. Change (bps)		27	63	88	127	85	0	56	41	(35)	8	20	20	25	30	24	10	10	10	10	10
Domestic Operating Margin		3.0%	3.5%	2.7%	5.9%	4.1%	3.1%	4.0%	3.2%	5.6%	4.2%	3.3%	4.2%	3.4%	5.9%	4.4%	3.4%	4.3%	3.5%	6.0%	4.5%
Yr./Yr. Change (bps)		18	91	87	146	95	8	43	46	(30)	10	20	20	25	30	24	10	10	10	10	10
Interest, Net		(19)	(17)	(22)	(18)	(76)	(13)	(16)	(17)	(16)	(62)	(12)	(16)	(19)	(15)	(62)	(7)	(11)	(14)	(10)	(41)
Pretax Income		202	227	199	806	1,434	208	276	230	731	1,443	226	295	252	778	1,551	242	310	267	801	1,620
Income Taxes		86	90	83	282	541	77	102	82	267	528	83	108	92	285	567	88	113	98	293	593
Tax Rate		42.6%	39.6%	41.7%	35.0%	37.7%	37.0%	37.0%	35.7%	36.5%	36.6%	36.6%	36.6%	36.6%	36.6%	36.6%	36.6%	36.6%	36.6%	36.6%	36.6%
Net Income		123	148	121	526	918	131	174	144	464	915	144	187	160	494	984	153	197	169	508	1,028
<b>EPS</b>		<b>\$0.35</b>	<b>\$0.42</b>	<b>\$0.34</b>	<b>\$1.48</b>	<b>\$2.60</b>	<b>\$0.37</b>	<b>\$0.49</b>	<b>\$0.41</b>	<b>\$1.34</b>	<b>\$2.61</b>	<b>\$0.42</b>	<b>\$0.55</b>	<b>\$0.47</b>	<b>\$1.46</b>	<b>\$2.89</b>	<b>\$0.46</b>	<b>\$0.59</b>	<b>\$0.51</b>	<b>\$1.54</b>	<b>\$3.09</b>
Yr./Yr. Change		-4.2%	39.2%	75.4%	22.8%	25.1%	4.4%	17.0%	20.7%	-9.1%	0.5%	13.9%	11.2%	13.8%	9.0%	10.8%	9.3%	7.7%	8.6%	5.1%	6.8%
Avg Shares Outstanding		350	352	354	356	354	358	354	349	346	351	344	342	340	338	340	336	334	332	331	333
Total Stores, end of period		1,777	1,759	1,757	1,731	1,731	1,657	1,648	1,646	1,646	1,646	1,649	1,652	1,655	1,658	1,658	1,661	1,664	1,667	1,670	1,670
Yr./Yr. Change		-17	-35	-33	-48	-48	-120	-111	-111	-85	-85	-8	4	9	12	12	12	12	12	12	12
Square Footage, end of period		49	48	48	48	48	46	46	46	46	46	46	46	46	46	46	46	46	46	46	46
Yr./Yr. Change		-0.5%	-1.0%	-0.9%	-1.0%	-1.0%	-4.9%	-4.6%	-4.5%	-4.2%	-4.2%	-0.2%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
<b>Cash Flow Statement</b>																					
CCFO		308	179	287	1,161	1,935	-10	318	155	781	1,244	277	366	231	772	1,646	288	377	242	787	1,694
Yr./Yr. Change		-6260%	646%	-6%	55%	77%	-103%	78%	-46%	-33%	-36%	-2869%	15%	49%	-1%	32%	4%	3%	5%	2%	3%
<b>FCF</b>		<b>197</b>	<b>32</b>	<b>120</b>	<b>1,025</b>	<b>1,374</b>	<b>(134)</b>	<b>149</b>	<b>(45)</b>	<b>511</b>	<b>481</b>	<b>134</b>	<b>225</b>	<b>85</b>	<b>542</b>	<b>986</b>	<b>166</b>	<b>257</b>	<b>117</b>	<b>606</b>	<b>1,145</b>
Yr./Yr. Change		-210%	-131%	-35%	64%	151%	-168%	366%	-138%	-50%	-65%	-200%	51%	-288%	6%	105%	24%	14%	38%	12%	16%
EBITDA		382	400	381	990	2,153	382	455	415	915	2,167	403	474	439	961	2,278	414	486	451	980	2,330
Yr./Yr. Change		-5%	8%	28%	25%	16%	0%	14%	9%	-8%	1%	5%	4%	6%	5%	5%	3%	2%	3%	2%	2%
<b>Balance Sheet</b>																					
Cash & S/T Investments		3,066	3,080	3,138	3,888	3,888	3,739	3,495	3,347	3,503	3,503	1,816	3,520	3,433	3,804	3,804	2,149	3,884	3,830	4,264	4,264
Cash per Share		9	9	9	11	11	10	10	10	10	10	10	10	10	11	11	11	12	12	13	13
Inventory, end of period		5,255	5,583	6,900	5,174	5,174	4,930	4,995	6,651	5,226	5,226	4,973	5,017	6,679	5,245	5,245	4,995	5,040	6,708	5,268	5,268
Yr./Yr. Change		-4%	3%	-1%	-4%	-4%	-6%	-11%	-4%	1%	1%	1%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Ending Inventory per Sq Ft		108	115	143	107	107	107	108	144	113	113	108	109	145	114	114	108	109	145	114	114
Yr./Yr. Change		-3%	4%	0%	-3%	-3%	-1%	-6%	1%	5%	5%	1%	0%	0%	0%	0%	0%	0%	0%	0%	0%
Total Assets		13,911	14,349	15,762	15,256	15,256	13,719	13,566	15,150	14,993	14,993	13,678	13,774	15,308	15,322	15,322	14,014	14,120	15,672	15,699	15,699
Total Liabilities		9,487	9,819	11,189	10,256	10,256	8,851	8,944	10,500	10,194	10,194	8,907	8,987	10,534	10,225	10,225	8,935	9,016	10,569	10,259	10,259
Total shareholders' equity		4,424	4,530	4,573	5,000	5,000	4,868	4,622	4,650	4,798	4,798	4,771	4,786	4,775	5,097	5,097	5,079	5,104	5,103	5,439	5,439
Book Value per Share		\$12.63	\$12.86	\$12.92	\$14.04	\$14.14	\$13.61	\$13.06	\$13.32	\$13.86	\$13.67	\$13.87	\$14.01	\$14.06	\$15.10	\$14.98	\$15.12	\$15.28	\$15.35	\$16.45	\$16.34
Total Debt		1,648	1,635	1,635	1,621	1,621	1,607	1,609	1,615	1,615	1,615	1,615	1,615	1,615	1,615	1,615	1,615	1,615	1,615	1,615	1,615
Total Debt / EBITDA		0.9x	0.9x	0.5x	0.8x	0.8x	0.7x	0.7x	0.4x	0.7x	0.7x	0.7x	0.7x	0.7x	0.7x	0.7x	0.7x	0.7x	0.7x	0.7x	0.7x
Total Adjusted Debt / EBITDAR		-	-	-	-	2.8x	-	-	-	-	2.7x	-	-	-	-	0.5x	-	-	-	-	0.5x

Source: Company reports, UBS estimates



## hhgregg (HGG) - Sell

Topics to Watch: For 2016, we believe the following factors will be the critical drivers for how the shares perform.

- **Will negative comp sales trends reverse course?** While a couple of years of tough top-line results make for easy comparisons, we still don't believe HGG will drive comp sales growth in the next year. Despite HSD appliances industry growth, the company is only seeing a slight uptick in this category at best. This probably means it continues to lose share. In consumer electronics, the company has focused on selling higher margin, large-screen televisions, with 4K expected to represent 60% of its total TV business. But, the company has made price investments in these two categories and still wasn't able to materially drive comp sales higher. While it has seen some decent gains the home products category, it's still a small part of the business. Plus, the larger losses in the computing category more than offsets the gains. As such, while HGG's comp sales could see improvement on a relative basis, we still believe they will remain negative as a whole going forward.
- **Can its cost cutting measures make a meaningful impact?** We think it may improve margins, but there are potential offsets. For example, it has been reducing the labor in the stores and spending less on advertising. While this may help get its cost structure under control, it could lead to further degradation of sales. For example, having fewer employees in the stores, or hiring part-time labor should lead to lower customer satisfaction within the stores. By removing advertising dollars, it may have more difficulty driving incremental customers to the stores. The business model is currently stretched at both ends where it needs to drive traffic and deliver a high-quality differentiated customer experience, but it can't really afford to do so.
- **How much of margin of error does HGG have?** Despite its recent troubles, HGG's balance sheet is relatively clean. It finished 2Q'16 with \$35 million in cash with no long-term debt. Though, we estimate it finishes the year with a 7x-8x adjusted debt/EBITDAR ratio. Thus, unless deteriorating trends accelerate considerably, HGG probably has the financial flexibility to stay afloat for the immediate future. But, its long-term health will be determined by its ability to turn things around and stabilize its comp decline and steady its margin profile.

## What to do with the stock?

HGG is in a precarious position. It needs its sales trends to stabilize and grow so that it can leverage its expenses. But, its cutting employees and spending less on advertising, which could undermine these sales generators. As such, it could continue to bleed on both lines. We recommend proceeding with caution. Our \$3.30 price target equates to 4.8x our CY'17 EBITDA estimate and is based on a DCF/multiple blend analysis.

Figure 76: HGG financial model summary (\$ millions except per share)

	FY	1Q15	2Q15	3Q15	4Q15	2015	1Q16	2Q16	3Q16E	4Q16E	2016E	1Q17E	2Q17E	3Q17E	4Q17E	2017E	1Q18E	2Q18E	3Q18E	4Q18E	2018E
<b>Income Statement</b>																					
Total Sales		\$472	\$506	\$666	\$486	\$2,129	\$441	\$487	\$593	\$461	\$1,982	\$436	\$482	\$587	\$457	\$1,962	\$440	\$487	\$593	\$462	\$1,982
Yr./Yr. Change		-10.0%	-11.0%	-5.9%	-9.8%	-8.9%	-6.6%	-3.8%	-10.9%	-5.0%	-6.9%	-1.2%	-1.0%	-1.0%	-1.0%	-1.0%	1.0%	1.0%	1.0%	1.2%	1.0%
Comp Store Sales		-10.2%	-11.4%	-6.3%	-10.0%	-9.2%	-6.3%	-3.5%	-11.0%	-5.0%	-6.7%	-1.0%	-1.0%	-1.0%	-1.0%	-1.0%	1.0%	1.0%	1.0%	1.0%	1.0%
Gross Profit		\$140	\$147	\$180	\$139	\$606	\$134	\$139	\$158	\$132	\$563	\$133	\$137	\$157	\$131	\$558	\$135	\$139	\$159	\$133	\$565
% of Sales		29.7%	29.1%	27.0%	28.6%	28.5%	30.5%	28.5%	26.7%	28.6%	28.4%	30.5%	28.5%	26.7%	28.7%	28.5%	30.6%	28.6%	26.8%	28.7%	28.5%
Yr./Yr. Change (bps)		23	(48)	20	(5)	(4)	75	(59)	(30)	0	(4)	5	5	5	5	5	5	5	5	5	5
SG&A Expense		\$117	\$119	\$133	\$113	\$481	\$111	\$113	\$118	\$107	\$449	\$109	\$111	\$115	\$105	\$441	\$109	\$112	\$115	\$106	\$441
% of Sales		24.7%	23.5%	19.9%	23.2%	22.6%	25.2%	23.3%	19.8%	23.2%	22.7%	25.0%	23.1%	19.6%	23.0%	22.5%	24.8%	22.9%	19.4%	22.8%	22.3%
Yr./Yr. Change (bps)		196	236	120	95	155	50	(24)	(10)	0	7	(20)	(20)	(20)	(20)	(20)	(20)	(20)	(20)	(20)	(20)
Operating Income		(\$14)	(\$16)	(\$2)	(\$12)	(\$44)	(\$8)	(\$9)	\$1	(\$8)	(\$25)	(\$7)	(\$8)	\$3	(\$6)	(\$18)	(\$5)	(\$6)	\$5	(\$5)	(\$11)
% of Sales		-3.0%	-3.2%	-0.3%	-2.5%	-2.1%	-1.9%	-1.9%	0.1%	-1.7%	-1.3%	-1.5%	-1.6%	0.4%	-1.4%	-0.9%	-1.2%	-1.2%	0.8%	-1.0%	-0.6%
Yr./Yr. Change (bps)		(267)	(432)	(156)	(118)	(236)	110	120	40	80	81	35	35	35	35	35	35	35	35	35	35
Interest, Net		1	1	1	1	1	1	1	1	1	3	1	1	1	1	2	1	1	1	1	2
Pretax Income		(15)	(17)	(3)	(13)	(47)	(9)	(10)	(0)	(9)	(28)	(7)	(8)	2	(7)	(20)	(6)	(7)	4	(5)	(14)
Income Taxes		(4)	(6)	1	0	(9)	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Tax Rate		29.5%	37.5%	-45.8%	-0.2%	19.9%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
Net Income		(10)	(10)	(4)	(13)	(37)	(9)	(10)	(0)	(9)	(28)	(7)	(8)	2	(7)	(20)	(6)	(7)	4	(5)	(14)
EPS		(\$0.36)	(\$0.37)	(\$0.14)	(\$0.47)	(\$1.33)	(\$0.32)	(\$0.37)	(\$0.01)	(\$0.32)	(\$1.00)	(\$0.26)	(\$0.30)	\$0.07	(\$0.25)	(\$0.74)	(\$0.20)	(\$0.24)	\$0.15	(\$0.20)	(\$0.49)
Yr./Yr. Change		828.9%	NM	NM	182.1%	NM	-12.4%	0.1%	-96.2%	-33.1%	-24.8%	-18.4%	-18.1%	NM	-20.3%	-26.5%	-20.6%	-19.6%	104.8%	-22.1%	-33.0%
Avg Shares Outstanding		28	28	28	28	28	28	28	28	28	28	28	28	28	28	28	28	28	28	28	28
Total Stores, end of period		229	228	228	228	228	227	227	227	227	227	227	227	227	227	227	227	227	227	228	228
Yr./Yr. Change		1	0	0	0	0	-2	-1	-1	-1	-1	0	0	0	0	0	0	0	0	1	1
Square Footage, end of period		8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8	8
Yr./Yr. Change		0.4%	0.0%	0.0%	0.0%	0.0%	-0.9%	-0.4%	-0.4%	-0.4%	-0.4%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.4%	0.4%
<b>Cash Flow Statement</b>																					
FFFO		-41	32	11	11	13	-16	26	-16	-4	-11	-31	31	13	3	16	-42	34	14	4	10
Yr./Yr. Change		137%	-34%	-159%	-84%	-85%	-60%	-18%	-252%	-136%	-183%	89%	19%	-182%	-166%	-253%	38%	12%	6%	36%	-39%
FCF		(45)	25	5	6	(10)	(21)	22	(21)	(8)	(27)	(35)	26	7	(2)	(3)	(49)	27	5	(3)	(20)
Yr./Yr. Change		100%	-36%	-121%	-92%	-116%	-55%	-12%	-525%	-240%	177%	70%	18%	-136%	-76%	-88%	40%	4%	-29%	74%	489%
EBITDA		-3	-5	8	-4	-4	0	-1	7	-2	5	2	1	9	0	12	3	2	11	2	19
Yr./Yr. Change		-136%	-130%	-59%	-199%	-108%	-106%	-79%	-11%	-57%	-216%	766%	-156%	28%	-107%	143%	90%	280%	24%	1446%	61%
<b>Balance Sheet</b>																					
Cash & S/T Investments		\$3	\$41	\$27	\$30	\$30	\$10	\$35	\$14	\$6	\$6	\$2	\$28	\$35	\$33	\$33	(\$11)	\$17	\$22	\$19	\$19
Cash per Share		\$0	\$1	\$1	\$1	\$1	\$0	\$1	\$1	\$0	\$0	\$0	\$1	\$1	\$1	\$1	(\$0)	\$1	\$1	\$1	\$1
Inventory, end of period		364	336	382	257	257	325	289	341	237	237	321	286	338	235	235	324	288	341	237	237
Yr./Yr. Change		4%	3%	-1%	-14%	-14%	-11%	-14%	-11%	-8%	-8%	-1%	-1%	-1%	-1%	-1%	1%	1%	1%	1%	1%
Ending Inventory per Sq Ft		46	43	49	33	33	42	37	44	30	30	41	37	43	30	30	41	37	44	30	30
Yr./Yr. Change		4%	3%	-1%	-14%	-14%	-10%	-14%	-10%	-7%	-7%	-1%	-1%	-1%	-1%	-1%	1%	1%	1%	1%	1%
Total Assets		656	659	624	468	468	520	486	603	472	472	549	527	609	486	486	533	514	597	474	474
Total Liabilities		359	371	426	294	294	354	330	386	263	263	317	302	381	264	264	311	298	375	257	257
Total shareholders' equity		297	288	198	174	174	166	156	217	209	209	233	225	228	222	222	222	216	221	217	217
Book Value per Share		\$10.45	\$10.14	\$7.05	\$6.27	\$6.17	\$5.99	\$5.64	\$7.83	\$7.54	\$7.55	\$8.40	\$8.13	\$8.24	\$8.01	\$8.01	\$8.01	\$7.80	\$7.99	\$7.82	\$7.82
Total Debt		0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Total Debt / EBITDA		0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x
Total Adjusted Debt / EBITDAR						8.8x					7.6x					7.2x					6.8x

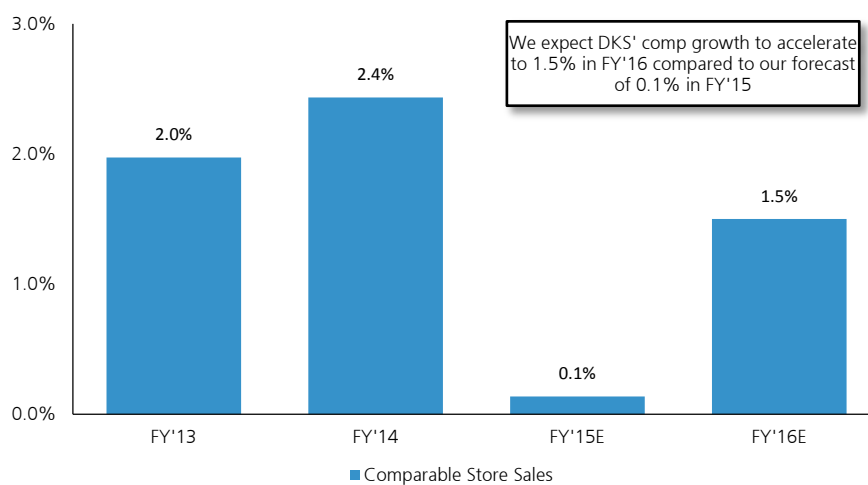
Source: Company reports, UBS estimates

## Dick's Sporting Goods (DKS) - Buy

Topics to Watch: For 2016, we believe the following factors will be the critical drivers for how the shares perform.

- **Will DKS' comp growth re-accelerate in 2016?** DKS' comp performance has been inconsistent lately due to pressure from its golf and hunting businesses. While golf is finally showing some signs of stability, its hunting business continues to be a bit of a drag. Going forward, we think hunting will continue to pressure its comp (outside of gun sales), especially in the first half of 2016. However, golf will likely show some positive performance next year. All in, we forecast a 1.5% comp for FY'16 which is higher than our 0.1% forecast for FY'15.

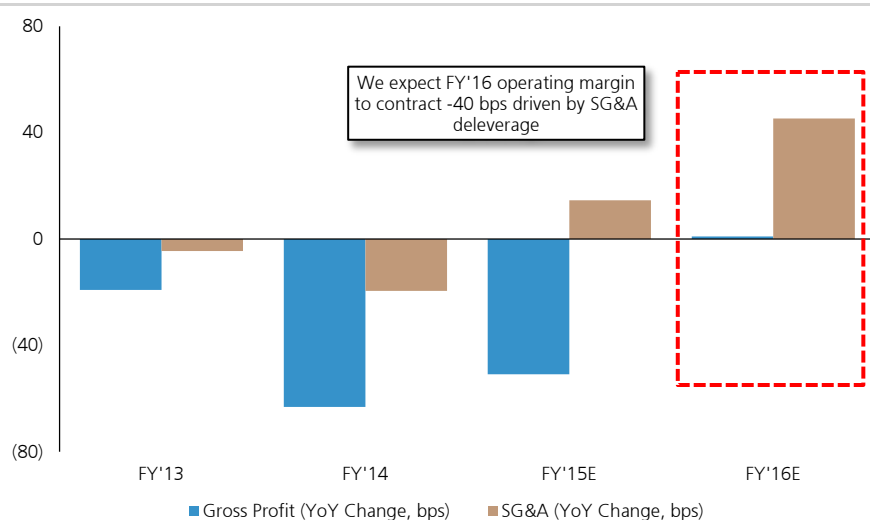
**Figure 77: We expect DKS' comp to accelerate 120 bps in FY'16**



Source: Company Reports, UBS Estimates

- **Will DKS buyback shares aggressively in 2016?** DKS forward multiple contracted from 17x in the beginning of 2015 to 11x by year end. We think this provides an attractive opportunity for the company to accelerate its share repurchase program in 2016. DKS has highlighted in the past that it would look at repurchases strategically. We think it would make sense for the company to pursue that path given that its shares are currently trading at ~\$35 compared to ~\$50 in the beginning of 2015. We conservatively model only \$200 mm in share repurchases for 2016, but we believe that there could be upside to our estimate.
- **How will DKS' margin picture look like in 2016?** It is unlikely that DKS will see operating margin expansion in 2016. We forecast a flat gross margin for the year as 1H declines should be more or less compensated by improvements in 2H (helped by higher promotions in the year ago comparable period). However, its SG&A should deleverage throughout the year as the company invests to bring its eCommerce operations in house by January, 2017. All in, we forecast its operating margin will contract by -40 bps to 7.2% in FY'16.

**Figure 78: DKS Margin performance (in bps)**



Source: Company Reports, UBS Estimates

## What to do with the stock?

We think the risk reward is favorable for DKS at current levels. In FY'16, the company's comp growth should accelerate as compares get easier and golf begins to comp positively. Although, its margin should remain under pressure, we think there is a good chance that the company might accelerate its share repurchase program. This should provide a nice cushion to its EPS growth. Further, with the stock currently trading at 10x our CY'17 EPS estimate of \$3.50, we think there is limited downside from current levels. Our new \$42 PT (was \$43) equates to 12x our CY'17 EPS estimate of \$3.50 and is based on a DCF/multiple blend analysis.

We think it is useful to examine how our price target would respond to various changes in our assumptions for DKS's earnings outlook over the next few years and the valuation multiple that would be associated with those scenarios. The following figure highlights our base case, a high case, and a low case.

**Figure 79: DKS price target sensitivity analysis**

	Base Case (Published estimates)					High Case			Low Case		
	2013A	2014A	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E
Comparable Store Sales Growth	2.0%	2.4%	0.1%	1.5%	1.5%	1.0%	3.0%	3.0%	-1.5%	-1.0%	-1.0%
Growth Contribution from New Stores	4.5%	7.2%	7.1%	6.5%	4.6%	7.1%	6.5%	4.6%	7.1%	6.5%	4.6%
Total Sales Growth	6.5%	9.7%	7.2%	8.0%	6.1%	8.1%	9.5%	7.6%	5.6%	5.5%	3.6%
<b>Total Sales</b>	<b>6,213</b>	<b>6,814</b>	<b>7,305</b>	<b>7,887</b>	<b>8,368</b>	<b>7,364</b>	<b>8,061</b>	<b>8,674</b>	<b>7,194</b>	<b>7,587</b>	<b>7,860</b>
<b>Operating Income</b>	<b>545</b>	<b>560</b>	<b>551</b>	<b>564</b>	<b>607</b>	<b>568</b>	<b>650</b>	<b>734</b>	<b>526</b>	<b>479</b>	<b>493</b>
Operating Income Margin	8.8%	8.2%	7.5%	7.2%	7.3%	7.7%	8.1%	8.5%	7.3%	6.3%	6.3%
Operating Income Yr. / Yr. Change	-21	-55	-67	-39	10	-50	35	40	-90	-100	-5
Interest Expense	5	2	(0)	2	4	(0)	2	4	(0)	2	4
Provision for Income Taxes	212	214	211	218	235	217	251	284	201	185	191
Income Taxes Rate	38.5%	38.1%	38.3%	38.5%	38.5%	38.3%	38.5%	38.5%	38.3%	38.5%	38.5%
<b>Diluted Net Income</b>	<b>338</b>	<b>348</b>	<b>340</b>	<b>348</b>	<b>376</b>	<b>350</b>	<b>401</b>	<b>454</b>	<b>325</b>	<b>296</b>	<b>305</b>
<b>Diluted EPS - reported</b>	<b>\$2.69</b>	<b>\$2.87</b>	<b>\$2.90</b>	<b>\$3.10</b>	<b>\$3.50</b>	<b>\$2.99</b>	<b>\$3.57</b>	<b>\$4.22</b>	<b>\$2.77</b>	<b>\$2.63</b>	<b>\$2.84</b>
Shares outstanding - diluted	125.6	121.2	117.2	112.4	107.5	117.2	112.4	107.5	117.2	112.4	107.5
NTM PE Multiple:			14x	14x	12x	18x	15x	13x	11x	11x	10x
Estimated Value:			\$42	\$42	\$42	\$54	\$54	\$55	\$30	\$29	\$28
Dividend:			\$0.55	\$0.55	\$0.55	\$0.55	\$0.55	\$0.55	\$0.55	\$0.55	\$0.55
<b>Potential Upside / Downside (vs. \$35.83):</b>			<b>19%</b>	<b>19%</b>	<b>19%</b>	<b>52%</b>	<b>51%</b>	<b>55%</b>	<b>-13%</b>	<b>-18%</b>	<b>-19%</b>

Source: Company reports, UBS estimates

Figure 80: DKS financial model summary (\$ millions except per share)

	1Q14	2Q14	3Q14	4Q14	2014	1Q15	2Q15	3Q15	4Q15E	2015E	1Q16E	2Q16E	3Q16E	4Q16E	2016E	1Q17E	2Q17E	3Q17E	4Q17E	2017E
<b>Income Statement</b>																				
<b>Total Sales</b>	<b>\$1,439</b>	<b>\$1,689</b>	<b>\$1,527</b>	<b>\$2,160</b>	<b>\$6,814</b>	<b>\$1,565</b>	<b>\$1,823</b>	<b>\$1,643</b>	<b>\$2,274</b>	<b>\$7,305</b>	<b>\$1,696</b>	<b>\$1,986</b>	<b>\$1,773</b>	<b>\$2,432</b>	<b>\$7,887</b>	<b>\$1,809</b>	<b>\$2,110</b>	<b>\$1,878</b>	<b>\$2,571</b>	<b>\$8,368</b>
Yr./Yr. Change	7.9%	10.3%	9.0%	10.9%	9.7%	8.8%	7.9%	7.6%	5.3%	7.2%	8.3%	9.0%	8.0%	6.9%	8.0%	6.7%	6.2%	5.9%	5.7%	6.1%
Comp Store Sales	1.5%	3.2%	1.1%	3.4%	2.4%	1.0%	1.2%	0.4%	-1.5%	0.1%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%
Gross Profit	441	505	452	691	\$2,089	469	554	488	691	\$2,202	495	601	528	754	\$2,379	531	642	562	801	\$2,536
% of Sales	30.6%	29.9%	29.6%	32.0%	30.7%	30.0%	30.4%	29.7%	30.4%	30.1%	29.2%	30.3%	29.8%	31.0%	30.2%	29.4%	30.4%	29.9%	31.2%	30.3%
Yr./Yr. Change (bps)	(23)	(140)	(73)	(25)	(63)	(68)	47	13	(160)	(51)	(75)	(10)	5	60	1	15	15	15	15	15
SG&A Expense	337	365	358	439	1,499	361	396	387	473	1,617	398	440	426	517	1,782	427	470	453	549	1,899
% of Sales	23.4%	21.6%	23.4%	20.3%	22.0%	23.0%	21.7%	23.6%	20.8%	22.1%	23.5%	22.2%	24.0%	21.3%	22.6%	23.6%	22.3%	24.1%	21.4%	22.7%
Yr./Yr. Change (bps)	(2)	13	(40)	(38)	(19)	(38)	10	14	50	15	45	45	45	45	45	10	10	10	10	10
<b>Operating Income</b>	<b>98</b>	<b>132</b>	<b>80</b>	<b>250</b>	<b>560</b>	<b>102</b>	<b>148</b>	<b>85</b>	<b>216</b>	<b>551</b>	<b>90</b>	<b>152</b>	<b>88</b>	<b>234</b>	<b>564</b>	<b>99</b>	<b>164</b>	<b>96</b>	<b>249</b>	<b>607</b>
% of Sales	6.8%	7.8%	5.2%	11.6%	8.2%	6.5%	8.1%	5.2%	9.5%	7.5%	5.3%	7.6%	5.0%	9.6%	7.2%	5.4%	7.8%	5.1%	9.7%	7.3%
Yr./Yr. Change (bps)	(53)	(166)	(41)	14	(55)	(28)	33	(6)	(209)	(67)	(118)	(50)	(20)	11	(39)	12	11	13	8	10
Interest, Net	2	1	(0)	(1)	2	2	(1)	(2)	1	(0)	2	1	(2)	1	2	1	1	1	1	4
Pretax Income	99	133	80	250	562	103	148	83	217	551	92	153	86	235	566	100	165	97	250	611
Income Taxes	38	51	30	94	214	40	57	31	84	211	36	59	33	91	218	38	63	37	96	235
Tax Rate	38.3%	38.7%	38.1%	37.7%	38.1%	38.8%	38.3%	37.2%	38.5%	38.3%	38.5%	38.5%	38.5%	38.5%	38.5%	38.5%	38.5%	38.5%	38.5%	38.5%
Net Income	61	82	49	156	348	63	91	52	134	340	57	94	53	145	348	61	101	60	154	376
<b>EPS</b>	<b>\$0.50</b>	<b>\$0.67</b>	<b>\$0.41</b>	<b>\$1.30</b>	<b>\$2.87</b>	<b>\$0.53</b>	<b>\$0.77</b>	<b>\$0.45</b>	<b>\$1.15</b>	<b>\$2.90</b>	<b>\$0.50</b>	<b>\$0.83</b>	<b>\$0.47</b>	<b>\$1.31</b>	<b>\$3.10</b>	<b>\$0.56</b>	<b>\$0.94</b>	<b>\$0.56</b>	<b>\$1.46</b>	<b>\$3.50</b>
Yr./Yr. Change	3.5%	-5.3%	3.3%	17.3%	6.6%	7.2%	15.4%	8.7%	-11.1%	1.1%	-6.9%	7.5%	6.4%	13.4%	6.9%	12.9%	12.7%	17.5%	11.2%	12.9%
Avg Shares Outstanding	123	122	120	120	121	119	118	117	116	117	114	113	112	111	112	109	108	107	106	108
Total Stores, end of period	650	653	690	694	694	704	709	744	745	745	760	775	789	795	795	807	819	831	837	837
Yr./Yr. Change	8%	7%	8%	8%	8%	8%	9%	8%	7%	7%	8%	9%	6%	7%	7%	6%	6%	5%	5%	5%
Square Footage, end of period	32	33	34	34	34	35	35	37	37	37	38	38	39	39	39	40	41	41	41	41
Yr./Yr. Change	8.1%	8.0%	8.3%	8.2%	8.2%	8.1%	8.0%	8.2%	7.7%	7.7%	8.3%	9.2%	6.0%	6.7%	6.7%	6.2%	5.7%	5.3%	5.3%	5.3%
<b>Cash Flow Statement</b>																				
FFFO	14	138	-49	503	606	36	168	-87	503	624	-31	195	-143	591	611	-71	212	-145	626	623
Yr./Yr. Change	-118%	71%	-22%	9%	50%	155%	21%	76%	0%	3%	-188%	16%	64%	18%	-2%	126%	9%	2%	6%	2%
<b>FCF</b>	<b>(50)</b>	<b>52</b>	<b>(170)</b>	<b>425</b>	<b>257</b>	<b>(30)</b>	<b>78</b>	<b>(206)</b>	<b>430</b>	<b>277</b>	<b>(109)</b>	<b>103</b>	<b>(224)</b>	<b>479</b>	<b>249</b>	<b>(152)</b>	<b>118</b>	<b>(229)</b>	<b>512</b>	<b>250</b>
Yr./Yr. Change	-54%	169%	4%	14%	117%	-40%	51%	21%	1%	8%	262%	32%	9%	11%	-10%	38%	14%	2%	7%	1%
EBITDA	135	185	121	299	739	144	196	131	267	739	138	205	138	288	770	151	221	149	307	828
Yr./Yr. Change	3%	-2%	4%	13%	6%	7%	6%	8%	-11%	0%	-4%	4%	5%	8%	4%	9%	8%	8%	6%	8%
<b>Balance Sheet</b>																				
Cash & S/T Investments	139	100	78	222	222	81	123	74	488	488	368	456	216	680	680	513	617	373	871	871
Cash per Share	1	1	1	2	2	1	1	1	4	4	3	4	2	6	6	5	6	3	8	8
Inventory, end of period	1,481	1,419	1,765	1,391	1,391	1,624	1,616	1,997	1,516	1,516	1,778	1,763	2,154	1,607	1,607	1,892	1,869	2,277	1,696	1,696
Yr./Yr. Change	13%	11%	12%	13%	13%	10%	14%	13%	9%	9%	9%	10%	8%	6%	6%	6%	6%	6%	6%	6%
Ending Inventory per Sq Ft	46	44	52	41	41	47	46	54	41	41	47	46	55	41	41	47	46	55	41	41
Yr./Yr. Change	4%	3%	4%	4%	4%	1%	5%	5%	1%	1%	1%	0%	2%	-1%	-1%	0%	0%	0%	0%	0%
Total Assets	3,269	3,255	3,656	3,436	3,436	3,535	3,676	4,058	4,031	4,031	4,167	4,316	4,500	4,491	4,491	4,598	4,754	4,949	4,939	4,939
Total Liabilities	1,534	1,559	1,991	1,604	1,604	1,792	1,842	2,335	2,125	2,125	2,227	2,291	2,447	2,238	2,238	2,312	2,375	2,535	2,312	2,312
Total shareholders' equity	1,735	1,697	1,664	1,832	1,832	1,743	1,833	1,723	1,906	1,906	1,941	2,025	2,054	2,253	2,253	2,286	2,379	2,414	2,627	2,627
Book Value per Share	\$14.07	\$13.93	\$13.87	\$15.30	\$18.63	\$14.66	\$15.56	\$14.79	\$16.48	\$16.26	\$16.97	\$17.92	\$18.38	\$20.38	\$20.04	\$20.92	\$22.01	\$22.58	\$24.84	\$24.43
Total Debt	7	7	287	6	6	58	6	348	348	348	348	348	348	348	348	348	348	348	348	348
Total Debt / EBITDA	0.1x	0.0x	2.4x	0.0x	0.0x	0.4x	0.0x	2.7x	1.3x	0.5x	2.5x	1.7x	2.5x	1.2x	0.5x	2.3x	1.6x	2.3x	1.1x	0.4x
Total Adjusted Debt / EBITDAR	-	-	-	-	3.0x	-	-	-	-	3.4x	-	-	-	-	3.4x	-	-	-	-	3.4x

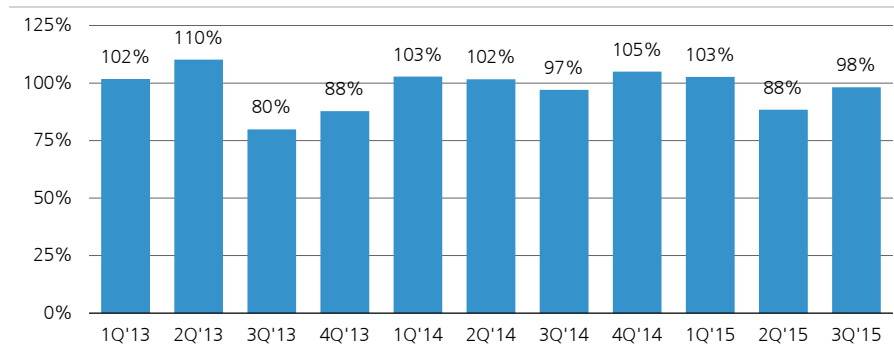
Source: Company reports, UBS estimates

## Five Below (FIVE) - Buy

Topics to Watch: For 2016, we believe the following factors will be the critical drivers for how the shares perform.

- **Will new store productivity remain high as it expands into new territories and fills in existing markets?** As FIVE continues to grow its square footage at a ~20% clip, we expect its new stores will be highly productive. After seeing a lower productivity in 2Q, by our calculation the company had 98% new space productivity in 3Q. Its recent commentary about new stores gives us confidence that it can continue to see strong returns from its upcoming openings. Specifically, the company noted that its opening in Mississippi was among its strongest initial performers this year despite little brand recognition in the market. Continued strength in this metric would support the company's march to 2,000 domestic stores.

**Figure 81: FIVE's new space productivity has averaged ~100% the last 3 years**



Source: Company reports, UBS

- **Can FIVE find another hot product or category to drive sales growth?** The company rode the Rainbow loom craze to a 9.0% comp in 3Q'13 and saw sales of Frozen licensed merchandise in 4Q'14. Looking forward, FIVE is likely to benefit from sales of Star Wars products in 4Q'15 and into '16. The company has historically seen the most benefit after movie releases, so this could be a tailwind next year. Further, FIVE has carried Teenage Mutant Ninja Turtles products in the past, and this franchise is releasing a new film in Summer 2016.
- **Will FIVE return to operating margin expansion in '16?** We believe it will. The company made a number of investments that hit its SG&A in 2015 that it couldn't offset with gross margin expansion. In particular, the company continued to roll out television advertising with by adding a large scale test in 2Q'15. Further, FIVE replaced its distribution center in the Northeast with a larger facility. In 2016, it will lap the incremental television advertisement and continue to leverage its new facility. This, combined with gross margin expansion leads to our expected ~50 bps of operating margin growth in 2016.

## What to do with the stock?

FIVE's unique product assortment supports its earnings algorithm. The company should continue to increase its store base by 20% each year at near full productivity, while its existing locations show solid improvement. At the same time, its margins should continue to show improvement as it gains scale. While its results have been lumpy recently, we attribute that to growing pains as opposed to

fundamental problems with the business. Our \$40 price target equates to 24x our CY'17 EPS estimate of \$1.66 and is based on a DCF/multiple blend.

We think it is useful to examine how our price target would respond to various changes in our assumptions for FIVE's earnings outlook over the next few years and the valuation multiple that would be associated with those scenarios. The following figure highlights our base case, a high case, and a low case.

**Figure 82: FIVE price target sensitivity analysis**

	Base Case (Published estimates)					High Case			Low Case		
	2013A	2014A	2015E	2016E	2017E	2015E	2016E	2016E	2015E	2016E	2017E
Comparable Store Sales Growth	4.2%	3.4%	3.6%	3.0%	3.0%	4.0%	5.5%	5.5%	1.5%	1.5%	1.5%
Growth Contribution from New Stores	23.7%	23.6%	18.4%	18.2%	17.6%	18.4%	18.2%	17.6%	18.4%	18.2%	17.6%
Total Sales Growth	27.8%	27.0%	22.0%	21.2%	20.6%	22.4%	23.7%	23.1%	19.9%	19.7%	19.1%
<b>Total Sales</b>	<b>535</b>	<b>680</b>	<b>830</b>	<b>1,006</b>	<b>1,213</b>	<b>833</b>	<b>1,030</b>	<b>1,268</b>	<b>816</b>	<b>976</b>	<b>1,163</b>
<b>Operating Income</b>	<b>61</b>	<b>78</b>	<b>94</b>	<b>118</b>	<b>148</b>	<b>95</b>	<b>126</b>	<b>164</b>	<b>91</b>	<b>111</b>	<b>134</b>
Operating Income Margin	11.4%	11.4%	11.3%	11.8%	12.2%	11.4%	12.2%	12.9%	11.1%	11.3%	11.5%
Operating Income Yr. / Yr. Change	-53	9	-17	47	45	0	75	75	-35	25	20
Interest Expense	2	0	0	0	0	0	0	0	0	0	0
Provision for Income Taxes	22.6	29.0	35.6	45.2	56.5	36	48	63	34	42	51
Income Taxes Rate	38.2%	37.4%	38.1%	38.2%	38.2%	38.1%	38.2%	38.2%	38.1%	38.2%	38.2%
<b>Diluted Net Income</b>	<b>37</b>	<b>49</b>	<b>58</b>	<b>73</b>	<b>91</b>	<b>59</b>	<b>78</b>	<b>101</b>	<b>56</b>	<b>68</b>	<b>83</b>
<b>Diluted EPS - reported</b>	<b>\$0.68</b>	<b>\$0.89</b>	<b>\$1.05</b>	<b>\$1.33</b>	<b>\$1.66</b>	<b>\$1.07</b>	<b>\$1.41</b>	<b>\$1.84</b>	<b>\$1.02</b>	<b>\$1.24</b>	<b>\$1.51</b>
Shares outstanding - diluted	54.2	54.6	54.8	55.0	55.0	54.8	55.0	55.0	54.8	55.0	55.0
NTMPE Multiple:			38x	30x	24x	44x	33x	26x	25x	20x	17x
Estimated Value:			\$40	\$40	\$40	\$47	\$47	\$48	\$25	\$25	\$26
Dividend:			\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
<b>Potential Upside / Downside (vs. \$33.72):</b>			19%	19%	19%	40%	38%	42%	-25%	-26%	-24%

Source: Company reports, UBS estimates

Figure 83: FIVE financial model summary (\$ millions except per share)

FY	1Q14	2Q14	3Q14	4Q14	2014	1Q15	2Q15	3Q15	4Q15E	2015E	1Q16E	2Q16E	3Q16E	4Q16E	2016E	1Q17E	2Q17E	3Q17E	4Q17E	2017E
<b>Income Statement</b>																				
<b>Total Sales</b>	<b>\$126</b>	<b>\$152</b>	<b>\$138</b>	<b>\$264</b>	<b>\$680</b>	<b>\$154</b>	<b>\$182</b>	<b>\$170</b>	<b>\$324</b>	<b>\$830</b>	<b>\$187</b>	<b>\$220</b>	<b>\$205</b>	<b>\$394</b>	<b>\$1,006</b>	<b>\$225</b>	<b>\$265</b>	<b>\$247</b>	<b>\$476</b>	<b>\$1,213</b>
Yr./Yr. Change	31.8%	30.2%	24.6%	24.4%	27.0%	22.0%	19.5%	23.0%	22.9%	22.0%	21.3%	20.5%	20.7%	21.7%	21.2%	20.6%	20.6%	20.6%	20.6%	20.6%
Comp Store Sales	6.2%	3.2%	1.5%	3.2%	3.4%	1.7%	3.0%	4.8%	4.1%	3.6%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%	3.0%
<b>Gross Profit</b>	<b>\$39</b>	<b>\$51</b>	<b>\$42</b>	<b>\$106</b>	<b>\$238</b>	<b>\$47</b>	<b>\$60</b>	<b>\$53</b>	<b>\$132</b>	<b>\$292</b>	<b>\$58</b>	<b>\$73</b>	<b>\$64</b>	<b>\$162</b>	<b>\$357</b>	<b>\$70</b>	<b>\$88</b>	<b>\$78</b>	<b>\$197</b>	<b>\$433</b>
% of Sales	30.9%	33.4%	30.2%	40.3%	35.0%	30.7%	32.8%	31.1%	40.9%	35.2%	30.9%	33.1%	31.3%	41.1%	35.5%	31.2%	33.3%	31.6%	41.4%	35.7%
Yr./Yr. Change (bps)	(70)	(27)	(75)	60	(16)	(22)	(55)	93	55	26	25	25	25	25	26	25	25	25	25	25
<b>SG&amp;A Expense</b>	<b>\$33</b>	<b>\$38</b>	<b>\$36</b>	<b>\$53</b>	<b>\$160</b>	<b>\$40</b>	<b>\$48</b>	<b>\$46</b>	<b>\$64</b>	<b>\$199</b>	<b>\$48</b>	<b>\$58</b>	<b>\$55</b>	<b>\$78</b>	<b>\$239</b>	<b>\$58</b>	<b>\$69</b>	<b>\$66</b>	<b>\$93</b>	<b>\$285</b>
% of Sales	26.0%	24.6%	26.2%	20.2%	23.5%	26.1%	26.5%	27.0%	19.9%	23.9%	25.9%	26.3%	26.8%	19.7%	23.7%	25.7%	26.1%	26.6%	19.5%	23.5%
Yr./Yr. Change (bps)	(64)	(73)	(62)	28	(25)	7	185	78	(35)	43	(20)	(20)	(20)	(20)	(21)	(20)	(20)	(20)	(20)	(20)
<b>Operating Income</b>	<b>\$6</b>	<b>\$13</b>	<b>\$5</b>	<b>\$53</b>	<b>\$78</b>	<b>\$7</b>	<b>\$12</b>	<b>\$7</b>	<b>\$68</b>	<b>\$94</b>	<b>\$9</b>	<b>\$15</b>	<b>\$9</b>	<b>\$85</b>	<b>\$118</b>	<b>\$12</b>	<b>\$19</b>	<b>\$12</b>	<b>\$104</b>	<b>\$148</b>
% of Sales	4.9%	8.7%	4.0%	20.1%	11.4%	4.6%	6.3%	4.1%	21.0%	11.3%	5.0%	6.8%	4.6%	21.4%	11.8%	5.5%	7.2%	5.0%	21.9%	12.2%
Yr./Yr. Change (bps)	(6)	46	(12)	32	9	(29)	(240)	15	90	(17)	45	45	45	45	47	45	45	45	45	45
Interest, Net	0	0	0	0	0	0	0	(0)	(0)	0	0	0	0	0	0	0	0	0	0	0
Pretax Income	6	13	5	53	78	7	11	7	68	93	9	15	9	85	118	12	19	12	104	148
Income Taxes	2	5	2	20	29	3	4	3	26	36	4	6	4	32	45	5	7	5	40	57
Tax Rate	37.7%	37.6%	39.5%	37.0%	37.4%	39.0%	37.1%	38.2%	38.2%	38.1%	38.2%	38.2%	38.2%	38.2%	38.2%	38.2%	38.2%	38.2%	38.2%	38.2%
Net Income	4	8	3	33	49	4	7	4	42	58	6	9	6	52	73	8	12	8	64	91
					33%					39%										
<b>EPS</b>	<b>\$0.07</b>	<b>\$0.15</b>	<b>\$0.06</b>	<b>\$0.61</b>	<b>\$0.89</b>	<b>\$0.08</b>	<b>\$0.13</b>	<b>\$0.08</b>	<b>\$0.76</b>	<b>\$1.05</b>	<b>\$0.11</b>	<b>\$0.17</b>	<b>\$0.11</b>	<b>\$0.95</b>	<b>\$1.33</b>	<b>\$0.14</b>	<b>\$0.22</b>	<b>\$0.14</b>	<b>\$1.17</b>	<b>\$1.66</b>
Yr./Yr. Change	47.5%	41.1%	24.5%	29.2%	31.5%	17.4%	-15.3%	30.6%	25.4%	18.2%	34.5%	30.0%	33.1%	24.2%	26.1%	31.4%	28.6%	32.5%	23.2%	25.2%
Avg Shares Outstanding	54	55	55	55	55	55	55	55	55	55	55	55	55	55	55	55	55	55	55	55
Total Stores, end of period	323	353	365	366	366	385	417	434	436	436	460	490	520	521	521	550	586	622	623	623
Yr./Yr. Change	65	77	61	62	62	62	64	69	70	70	75	73	86	85	85	90	96	102	102	102
Square Footage, end of period	2	3	3	3	3	3	3	3	3	3	3	4	4	4	4	4	4	5	5	5
Yr./Yr. Change	25.2%	27.9%	20.1%	20.4%	20.4%	19.2%	18.1%	18.9%	19.1%	19.1%	19.5%	17.5%	19.8%	19.5%	19.5%	19.5%	19.6%	19.6%	19.6%	19.6%
<b>Cash Flow Statement</b>																				
FFFO	-4	17	-16	65	61	-1	27	-28	26	24	26	7	67	33	133	31	9	82	41	163
Yr./Yr. Change	-65%	175%	40%	34%	97%	-81%	62%	71%	-61%	-61%	-3430%	-75%	-343%	30%	454%	20%	33%	21%	25%	22%
<b>FCF</b>	<b>(14)</b>	<b>7</b>	<b>(21)</b>	<b>58</b>	<b>29</b>	<b>(12)</b>	<b>8</b>	<b>(43)</b>	<b>8</b>	<b>(38)</b>	<b>12</b>	<b>(10)</b>	<b>52</b>	<b>4</b>	<b>58</b>	<b>14</b>	<b>(11)</b>	<b>63</b>	<b>6</b>	<b>72</b>
Yr./Yr. Change	-28%	-891%	17%	30%	454%	-19%	9%	100%	-86%	-231%	-205%	-224%	-222%	-56%	-252%	19%	12%	22%	57%	25%
EBITDA	10	18	10	58	95	12	17	13	74	115	15	22	16	91	145	19	27	21	112	180
Yr./Yr. Change	31%	35%	22%	27%	28%	18%	-3%	28%	28%	21%	28%	26%	28%	24%	25%	27%	26%	27%	23%	24%
<b>Balance Sheet</b>																				
Cash & S/T Investments	\$18	\$26	\$5	\$63	\$63	\$52	\$61	\$18	\$26	\$26	\$38	\$28	\$80	\$84	\$84	\$98	\$87	\$151	\$156	\$156
Cash per Share	\$0	\$0	\$0	\$1	\$1	\$1	\$1	\$0	\$0	\$0	\$1	\$1	\$1	\$2	\$2	\$2	\$2	\$3	\$3	\$3
Inventory, end of period	99	107	167	116	116	120	124	214	141	141	145	149	257	171	171	174	179	309	205	205
Yr./Yr. Change	31%	28%	45%	29%	29%	22%	16%	28%	22%	21%	21%	20%	20%	21%	21%	20%	20%	20%	20%	20%
Ending Inventory per Sq Ft	41	40	61	42	42	41	40	66	43	43	42	40	66	44	44	42	41	66	44	44
Yr./Yr. Change	5%	0%	21%	7%	7%	2%	-2%	7%	2%	2%	1%	2%	0%	1%	1%	1%	0%	0%	0%	0%
Total Assets	223	244	290	295	295	303	339	397	375	375	346	350	519	527	527	490	496	700	712	712
Total Liabilities	99	111	152	121	121	121	147	198	253	253	141	166	229	297	297	160	191	266	348	348
Total shareholders' equity	123	133	139	174	174	182	192	199	122	122	205	184	290	231	231	330	306	434	364	364
Book Value per Share	\$2.27	\$2.43	\$2.54	\$3.19	\$3.19	\$3.32	\$3.51	\$3.64	\$2.21	\$2.22	\$3.73	\$3.34	\$5.28	\$4.20	\$4.20	\$6.01	\$5.56	\$7.90	\$6.62	\$6.62
Total Debt	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Total Debt / EBITDA	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x	0.0x
Total Adjusted Debt / EBITDAR					2.9x					2.9x					2.8x					2.7x

Source: Company reports, UBS estimates

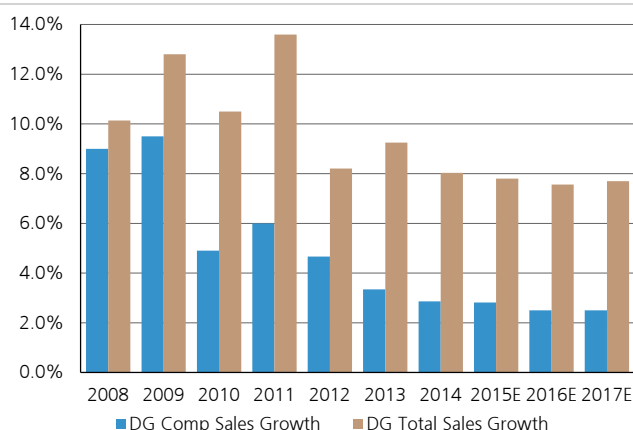


## Dollar General (DG) - Buy

Topics to Watch: For 2016, we believe the following factors will be the critical drivers for how the shares perform.

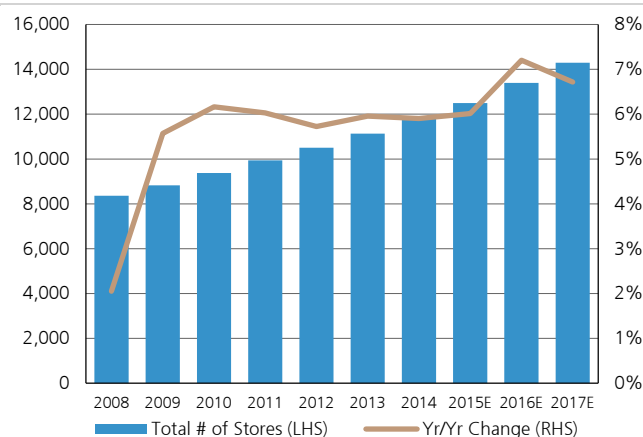
- **Will DG see comp sales accelerate in '16?** It probably won't be returning to consistent mid-single digital comp sales growth for the foreseeable future. But, we think its earnings algorithm can continue to work if it continues to see same store sales grow in the LSD-MSD range, which is reasonably conservative. The company has seen strong comp growth the last few years on the heels of big initiatives such as ramping up the number of coolers in its stores, selling tobacco in its locations, or adding alcohol to its mix. Going forward, it will continue to add coolers, which should support the sales of fast turning consumables. It will also add labor to its stores, which combined with its inventory initiatives, should increase its in-stock levels. This should lead to more converted sales and a better customer experience. At the same time, the company is expected to grow square footage by 7% in '16 and '17. This should help it take advantage of any disruption from the Dollar Tree/Family Dollar integration. As such, we think it should see HSD sales growth over the next few years, a pretty remarkable feat for a retailer of its size.

**Figure 84: DG's earnings algorithm can still work even if its comp sales slow to the LSD-MSD range**



Source: Company reports, UBS estimates

**Figure 85: DG is increasing the number of store openings in 2016 and 2017**



Source: Company reports, UBS estimates

- **What will be the impact of its store labor investment?** By adding more associates or employee hours to its stores, we think DG should see an improvement in the customer experience, offset by expense deleverage. Our [UBS Evidence Lab study](#) where we checked 50 DG stores found that in-stock levels were lower in July 2015 than in the previous year and that there were fewer employees working in the store. Adding more labor hours should help move products from the back room or elsewhere to the shelves. Further, it should improve the customer experience through cleaner stores and faster checkout. We expect DG to add labor to 40% of its chain, as this is the percentage of its locations that are within 2.5 miles of a FDO. This should help it better compete directly with its chief peer. But the increased labor will come with incremental expense. But, we think the sales benefit from the initiative should make it a net benefit.
- **At what comp level will DG see SG&A leverage?** Previously, the company has it its able to leverage costs with 3.5% comp sales. But, with its recent

rationalization of positions at its headquarters, we think it could help push this level much lower, probably in the 2.5% to 3% range. Further, the introduction of zero based budgeting for fiscal 2016 should help keep its costs under control. This should be helpful for its earnings algorithm should it not be able to consistently comp in the mid-single digits. Still, we model 15 bps of SG&A deleverage next year.

## What to do with the stock?

We think DG's earnings algorithm remains very much intact. Even if its comp sales are a little bit slower than in the past, the company should see a boost from its accelerated new store expansion. Further, puts and takes on the margin line should keep them relatively stable. It will continue to repurchase which should amplify returns. Our new \$82 price target (previously \$78) equates to 16x our CY'17 EPS estimate of \$5.00 and is based on a DCF/multiple blend analysis.

We think it is useful to examine how our price target would respond to various changes in our assumptions for DG's earnings outlook over the next few years and the valuation multiple that would be associated with those scenarios. The following figure highlights our base case, a high case, and a low case.

**Figure 86: DG price target sensitivity analysis**

	Base Case (Published estimates)					High Case			Low Case		
	2013A	2014A	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E
Comparable Store Sales Growth	3.3%	2.9%	2.8%	2.5%	2.5%	3.0%	4.0%	4.0%	2.5%	2.0%	1.0%
Growth Contribution from New Stores	5.9%	5.2%	5.0%	5.1%	5.2%	5.0%	5.1%	5.2%	5.0%	5.1%	5.2%
Total Sales Growth	9.2%	8.0%	7.8%	7.6%	7.7%	8.0%	9.1%	9.2%	7.5%	7.1%	6.2%
<b>Total Sales</b>	<b>17,504</b>	<b>18,910</b>	<b>20,385</b>	<b>21,926</b>	<b>23,615</b>	<b>20,420</b>	<b>22,270</b>	<b>24,319</b>	<b>20,325</b>	<b>21,761</b>	<b>23,110</b>
<b>Operating Income</b>	<b>1,746</b>	<b>1,783</b>	<b>1,930</b>	<b>2,055</b>	<b>2,201</b>	<b>1,956</b>	<b>2,223</b>	<b>2,525</b>	<b>1,907</b>	<b>2,041</b>	<b>2,122</b>
Operating Income Margin	10.0%	9.4%	9.5%	9.4%	9.3%	9.6%	10.0%	10.4%	9.4%	9.4%	9.2%
Operating Income Yr. / Yr. Change	-37	-54	4	-10	-5	15	40	40	-5	0	-20
Interest Income (Expense)	(89)	(88)	(85)	(83)	(81)	(85)	(83)	(81)	(85)	(83)	(81)
Other Income, Net	0	0	0	0	0	0	0	0	0	0	0
Provision for Income Taxes	620	626	685	730	785	694	792	904	676	725	755
Income Taxes Rate	37.4%	36.9%	37.1%	37.0%	37.0%	37.1%	37.0%	37.0%	37.1%	37.0%	37.0%
<b>Diluted Net Income</b>	<b>1,037</b>	<b>1,069</b>	<b>1,161</b>	<b>1,242</b>	<b>1,336</b>	<b>1,177</b>	<b>1,348</b>	<b>1,540</b>	<b>1,146</b>	<b>1,234</b>	<b>1,286</b>
<b>Diluted EPS - reported</b>	<b>\$3.20</b>	<b>\$3.50</b>	<b>\$3.93</b>	<b>\$4.43</b>	<b>\$5.00</b>	<b>\$3.99</b>	<b>\$4.81</b>	<b>\$5.77</b>	<b>\$3.88</b>	<b>\$4.40</b>	<b>\$4.81</b>
Shares outstanding - diluted	323.6	305.7	295.2	280.4	267.1	295.2	280.4	267.1	295.2	280.4	267.1
NTM PE Multiple:			21x	19x	16x	24x	20x	17x	15x	13x	12x
Estimated Value:			\$82	\$82	\$82	\$96	\$96	\$98	\$58	\$57	\$58
			\$0.00	\$0.88	\$0.88	\$0.00	\$0.88	\$0.88	\$0.00	\$0.88	\$0.88
<b>Upside / Downside Potential (vs. \$71.84):</b>			<b>14%</b>	<b>15%</b>	<b>15%</b>	<b>33%</b>	<b>35%</b>	<b>38%</b>	<b>-19%</b>	<b>-19%</b>	<b>-18%</b>

Source: Company reports, UBS estimates

Figure 87: DG financial model summary (\$ millions except per share)

	1Q14	2Q14	3Q14	4Q14	2014	1Q15	2Q15	3Q15	4Q15E	2015E	1Q16E	2Q16E	3Q16E	4Q16E	2016E	1Q17E	2Q17E	3Q17E	4Q17E	2017E
<b>Income Statement</b>																				
<b>Total Sales</b>	<b>\$4,522</b>	<b>\$4,724</b>	<b>\$4,724</b>	<b>\$4,939</b>	<b>\$18,910</b>	<b>\$4,919</b>	<b>\$5,096</b>	<b>\$5,067</b>	<b>\$5,303</b>	<b>\$20,385</b>	<b>\$5,278</b>	<b>\$5,475</b>	<b>\$5,453</b>	<b>\$5,721</b>	<b>\$21,926</b>	<b>\$5,692</b>	<b>\$5,899</b>	<b>\$5,870</b>	<b>\$6,154</b>	<b>\$23,615</b>
Yr./Yr. Change	6.8%	7.5%	7.8%	9.9%	8.0%	8.8%	7.9%	7.3%	7.4%	7.8%	7.3%	7.4%	7.6%	7.9%	7.6%	7.8%	7.7%	7.6%	7.6%	7.7%
Comp Store Sales	1.5%	2.1%	2.8%	4.9%	2.9%	3.7%	2.8%	2.3%	2.5%	2.8%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%	2.5%
Gross Profit	1,358	1,456	1,424	1,565	\$5,803	1,499	1,588	1,537	1,686	\$6,310	1,611	1,709	1,657	1,822	\$6,798	1,740	1,844	1,786	1,963	\$7,333
% of Sales	30.0%	30.8%	30.1%	31.7%	30.7%	30.5%	31.2%	30.3%	31.8%	31.0%	30.5%	31.2%	30.4%	31.8%	31.0%	30.6%	31.3%	30.4%	31.9%	31.1%
Yr./Yr. Change (bps)	(57)	(53)	(18)	(23)	(37)	44	35	20	10	27	5	5	5	5	5	5	5	5	5	5
SG&A Expense	978	1,027	1,021	993	4,019	1,071	1,112	1,107	1,090	4,379	1,157	1,203	1,199	1,184	4,743	1,253	1,302	1,297	1,280	5,132
% of Sales	21.6%	21.7%	21.6%	20.1%	21.3%	21.8%	21.8%	21.8%	20.5%	21.5%	21.9%	22.0%	22.0%	20.7%	21.6%	22.0%	22.1%	22.1%	20.8%	21.7%
Yr./Yr. Change (bps)	39	(1)	21	14	17	14	9	23	45	23	15	15	15	15	15	10	10	10	10	10
<b>Operating Income</b>	<b>380</b>	<b>429</b>	<b>402</b>	<b>573</b>	<b>1,783</b>	<b>428</b>	<b>476</b>	<b>430</b>	<b>596</b>	<b>1,930</b>	<b>454</b>	<b>506</b>	<b>457</b>	<b>638</b>	<b>2,055</b>	<b>487</b>	<b>542</b>	<b>489</b>	<b>683</b>	<b>2,201</b>
% of Sales	8.4%	9.1%	8.5%	11.6%	9.4%	8.7%	9.3%	8.5%	11.2%	9.5%	8.6%	9.2%	8.4%	11.1%	9.4%	8.6%	9.2%	8.3%	11.1%	9.3%
Yr./Yr. Change (bps)	(96)	(52)	(39)	(38)	(54)	31	27	(3)	(35)	4	(10)	(10)	(10)	(10)	(10)	(5)	(5)	(5)	(5)	(5)
Interest, Net	22	23	22	22	88	22	21	21	21	85	21	20	21	21	83	21	20	20	20	81
Pretax Income	357	406	381	551	1,695	407	455	409	575	1,846	433	486	436	617	1,972	466	522	469	663	2,120
Income Taxes	135	155	141	195	626	153	173	151	207	685	160	180	161	228	730	173	193	173	245	785
Tax Rate	37.8%	38.1%	37.2%	35.3%	36.9%	37.7%	38.0%	37.0%	36.0%	37.1%	37.0%	37.0%	37.0%	37.0%	37.0%	37.0%	37.0%	37.0%	37.0%	37.0%
Net Income	222	251	239	357	1,069	253	282	257	368	1,161	273	306	275	389	1,242	294	329	295	418	1,336
<b>EPS</b>	<b>\$0.72</b>	<b>\$0.83</b>	<b>\$0.79</b>	<b>\$1.17</b>	<b>\$3.50</b>	<b>\$0.84</b>	<b>\$0.95</b>	<b>\$0.88</b>	<b>\$1.27</b>	<b>\$3.93</b>	<b>\$0.96</b>	<b>\$1.08</b>	<b>\$0.99</b>	<b>\$1.41</b>	<b>\$4.43</b>	<b>\$1.08</b>	<b>\$1.22</b>	<b>\$1.11</b>	<b>\$1.59</b>	<b>\$5.00</b>
Yr./Yr. Change	1.2%	7.4%	9.6%	15.7%	9.2%	17.0%	15.2%	11.7%	8.7%	12.4%	14.0%	13.9%	12.3%	10.9%	12.7%	13.1%	13.0%	12.8%	12.7%	12.9%
Avg Shares Outstanding	310	304	304	304	306	302	297	293	289	295	286	282	279	275	280	272	269	265	262	267
Total Stores, end of period	11,338	11,535	11,715	11,789	11,789	11,999	12,198	12,396	12,498	12,498	12,743	12,988	13,233	13,398	13,398	13,643	13,888	14,133	14,298	14,298
Yr./Yr. Change	4.3%	4.3%	5.2%	5.9%	4.0%	4.0%	4.1%	5.1%	6.0%	4.2%	4.5%	4.8%	5.9%	7.2%	5.1%	3.1%	3.7%	5.5%	4.8%	4.8%
Square Footage, end of period	84	85	87	87	87	89	90	92	93	93	94	96	98	99	99	101	103	105	106	106
Yr./Yr. Change	6.9%	6.6%	6.4%	6.3%	6.3%	6.2%	6.0%	6.0%	6.2%	6.2%	6.3%	6.5%	6.8%	7.2%	7.2%	7.1%	6.9%	6.8%	6.7%	6.7%
<b>Cash Flow Statement</b>																				
<b>FFO</b>	<b>251</b>	<b>235</b>	<b>354</b>	<b>474</b>	<b>1,315</b>	<b>344</b>	<b>213</b>	<b>223</b>	<b>175</b>	<b>955</b>	<b>468</b>	<b>555</b>	<b>507</b>	<b>243</b>	<b>1,772</b>	<b>445</b>	<b>596</b>	<b>544</b>	<b>180</b>	<b>1,765</b>
Yr./Yr. Change	71%	-30%	28%	5%	8%	37%	-9%	-37%	-63%	-27%	36%	160%	127%	39%	86%	-5%	7%	7%	-26%	0%
<b>FCF</b>	<b>167</b>	<b>128</b>	<b>257</b>	<b>389</b>	<b>941</b>	<b>244</b>	<b>66</b>	<b>84</b>	<b>74</b>	<b>468</b>	<b>361</b>	<b>397</b>	<b>356</b>	<b>134</b>	<b>1,248</b>	<b>329</b>	<b>426</b>	<b>382</b>	<b>63</b>	<b>1,200</b>
Yr./Yr. Change	-6999%	-28%	82%	9%	39%	46%	-48%	-67%	-81%	-50%	48%	501%	326%	81%	167%	-9%	7%	7%	-53%	-4%
<b>EBITDA</b>	<b>464</b>	<b>514</b>	<b>489</b>	<b>659</b>	<b>2,126</b>	<b>515</b>	<b>563</b>	<b>519</b>	<b>697</b>	<b>2,294</b>	<b>548</b>	<b>600</b>	<b>553</b>	<b>746</b>	<b>2,446</b>	<b>588</b>	<b>643</b>	<b>592</b>	<b>800</b>	<b>2,623</b>
Yr./Yr. Change	-3%	2%	3%	6%	2%	11%	10%	6%	6%	8%	6%	6%	7%	7%	7%	7%	7%	7%	7%	7%
<b>Balance Sheet</b>																				
<b>Cash &amp; S/T Investments</b>	<b>166</b>	<b>172</b>	<b>216</b>	<b>580</b>	<b>580</b>	<b>225</b>	<b>181</b>	<b>183</b>	<b>43</b>	<b>43</b>	<b>203</b>	<b>287</b>	<b>332</b>	<b>156</b>	<b>156</b>	<b>175</b>	<b>292</b>	<b>365</b>	<b>120</b>	<b>120</b>
Cash per Share	1	1	1	2	2	1	1	1	0	0	1	1	1	1	1	1	1	1	0	0
<b>Inventory, end of period</b>	<b>2,605</b>	<b>2,789</b>	<b>2,789</b>	<b>2,783</b>	<b>2,783</b>	<b>2,839</b>	<b>3,030</b>	<b>3,102</b>	<b>2,983</b>	<b>2,983</b>	<b>3,044</b>	<b>3,253</b>	<b>3,336</b>	<b>3,216</b>	<b>3,216</b>	<b>3,281</b>	<b>3,502</b>	<b>3,588</b>	<b>3,457</b>	<b>3,457</b>
Yr./Yr. Change	8%	10%	8%	9%	9%	9%	9%	11%	7%	7%	7%	7%	8%	8%	8%	8%	8%	8%	7%	7%
<b>Ending Inventory per Sq Ft</b>	<b>31</b>	<b>33</b>	<b>32</b>	<b>32</b>	<b>32</b>	<b>32</b>	<b>34</b>	<b>34</b>	<b>32</b>	<b>32</b>	<b>32</b>	<b>34</b>	<b>34</b>	<b>32</b>	<b>32</b>	<b>32</b>	<b>34</b>	<b>34</b>	<b>33</b>	<b>33</b>
Yr./Yr. Change	1%	3%	1%	3%	3%	3%	2%	5%	1%	1%	1%	1%	1%	1%	1%	1%	1%	1%	1%	1%
<b>Total Assets</b>	<b>10,602</b>	<b>10,826</b>	<b>10,877</b>	<b>11,224</b>	<b>11,224</b>	<b>10,957</b>	<b>11,195</b>	<b>11,288</b>	<b>11,009</b>	<b>11,009</b>	<b>11,254</b>	<b>11,648</b>	<b>11,821</b>	<b>11,635</b>	<b>11,635</b>	<b>11,613</b>	<b>12,059</b>	<b>12,266</b>	<b>12,009</b>	<b>12,009</b>
<b>Total Liabilities</b>	<b>5,770</b>	<b>5,730</b>	<b>5,534</b>	<b>5,514</b>	<b>5,514</b>	<b>5,571</b>	<b>5,776</b>	<b>5,945</b>	<b>6,197</b>	<b>6,197</b>	<b>6,668</b>	<b>6,758</b>	<b>6,694</b>	<b>6,938</b>	<b>6,938</b>	<b>6,832</b>	<b>6,928</b>	<b>6,856</b>	<b>7,197</b>	<b>7,197</b>
<b>Total shareholders' equity</b>	<b>4,832</b>	<b>5,096</b>	<b>5,344</b>	<b>5,710</b>	<b>5,710</b>	<b>5,386</b>	<b>5,419</b>	<b>5,344</b>	<b>4,812</b>	<b>4,812</b>	<b>4,587</b>	<b>4,890</b>	<b>5,127</b>	<b>4,696</b>	<b>4,696</b>	<b>4,780</b>	<b>5,132</b>	<b>5,410</b>	<b>4,812</b>	<b>4,812</b>
Book Value per Share	\$15.57	\$16.77	\$17.57	\$18.76	\$18.68	\$17.83	\$18.27	\$18.24	\$16.64	\$16.30	\$16.06	\$17.34	\$18.40	\$17.06	\$16.75	\$17.58	\$19.10	\$20.38	\$18.35	\$18.02
<b>Total Debt</b>	<b>3,030</b>	<b>2,903</b>	<b>2,705</b>	<b>2,665</b>	<b>2,665</b>	<b>2,648</b>	<b>2,794</b>	<b>3,121</b>	<b>3,296</b>	<b>3,296</b>	<b>3,859</b>	<b>3,784</b>	<b>3,755</b>	<b>3,803</b>	<b>3,803</b>	<b>3,871</b>	<b>3,791</b>	<b>3,759</b>	<b>3,811</b>	<b>3,811</b>
Total Debt / EBITDA	6.5x	5.6x	5.5x	4.0x	4.0x	5.1x	5.0x	6.0x	4.7x	4.7x	7.0x	6.3x	6.8x	5.1x	5.1x	6.6x	5.9x	6.4x	4.8x	4.8x
Total Adjusted Debt / EBITDAR	-	-	-	-	3.1x	-	-	-	-	3.2x	-	-	-	-	3.3x	-	-	-	-	3.2x

Source: Company reports, UBS estimates

## Dollar Tree (DLTR) - Buy

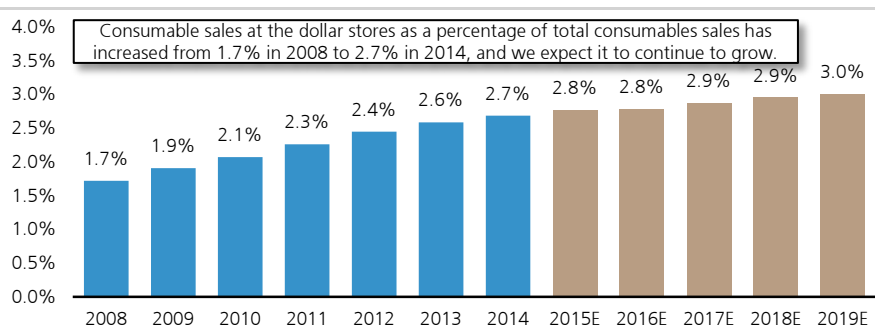
Topics to Watch: For 2016, we believe the following factors will be the critical drivers for how the shares perform.

- **How much progress will DLTR make in its integration efforts with FDO?**

We think DLTR has been doing the right things in late 2015 in order to set itself up for a smoother integration in 2016. Family Dollar has been selling legacy products that are not part of its go-forward product assortment on clearance to make room for new merchandise that is expected to be higher turning. This has definitely helped sales trends, but we estimate that in 3Q it still [generated positive comp sales](#) excluding clearance. Further, it has initiated its rebanner program, converting Family Dollar and most Deal\$ stores to Dollar Tree banners. In addition, it has been progressing well on its plan to capture sourcing and procurement synergies. Early gains should come from paying the lowest price for like products across the company, before working to better align the assortment for similar products. DLTR has targeted at least \$75 million in synergies in the first year, and we think there is an opportunity to generate over [\\$800 million in total synergies](#) over the course of the integration. We believe the initial synergy benefits will be immediately noticeable in the FDO segment's operating margin.

- **Does the Dollar Store sector still have room to grow?** With an expected 2.8% share of the consumables market, we think the Dollar Stores can continue to increase their penetration. This subsector has taken share over time, increasing its penetration by ~100 bps since 2008. We expect the subsector to experience 4% annual growth of consumables sales through 2019. Further, we forecast that core DLTR can see ~6% sales growth. In addition, it should see a sales increase from improving the productivity of Family Dollar stores, converting underperforming Family Dollar locations to Dollar Tree banners, continued Dollar Tree comp increases, and new store growth

**Figure 88: Dollar Stores consumables sales as a % of overall consumables sales**



Source: Kantar Retail, UBS

- **Will the company's financials become clearer in 2016?** DLTR has been more forthcoming with its disclosure of one-time charges stemming from the transaction and we expect the greater transparency to continue into 2016. This has revealed the underlying margin trends for the company are in good shape. According to our numbers, the Dollar Tree segment saw 15 bps of adjusted operating margin expansion in 3Q, while the Family Dollar segment generated 40 bps of adjusted operating margin gains in 3Q. It is encouraging to see gains from FDO under DLTR's ownership as it hadn't seen quarterly margin expansion

since 2011. As DLTR laps the introduction of FDO to its financials in the back half of the year, we think it will clearly display improvement in both segments, highlighting the margin upside from the combined company.

## What to do with the stock?

DLTR is showing early signs of progress with its integration, and its benefits should accelerate over the course of the year. We expect the Family Dollar banner to experience an improvement in sales productivity, while also seeing its margin improve. At the same time, we anticipate a consistent performance from the Dollar Tree segment. Taken together, and with loads of upside to its estimated \$300 million in total synergies, we think the risk/reward is highly favorable. Our new \$92 price target (\$88 previously) equates to 19x our CY'17 estimate of \$4.90 and is based on a DCF/multiple blend analysis.

We think it is useful to examine how our price target would respond to various changes in our assumptions for DLTR's earnings outlook over the next few years and the valuation multiple that would be associated with those scenarios. The following figure highlights our base case, a high case, and a low case.

**Figure 89: DLTR price target sensitivity analysis**

	Base Case (Published estimates)					High Case			Low Case		
	2013A	2014A	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E
Comparable Store Sales Growth	2.5%	4.6%	2.6%	2.5%	3.5%	3.0%	4.0%	5.0%	2.0%	1.5%	1.5%
Growth Contribution from New Stores	3.5%	5.1%	78.1%	31.4%	3.1%	78.1%	31.4%	3.1%	78.1%	31.4%	3.1%
Total Sales Growth	6.0%	9.7%	80.7%	33.9%	6.6%	81.1%	35.4%	8.1%	80.1%	32.9%	4.6%
<b>Total Sales</b>	<b>7,840</b>	<b>8,602</b>	<b>15,544</b>	<b>20,816</b>	<b>22,187</b>	<b>15,578</b>	<b>21,092</b>	<b>22,797</b>	<b>15,720</b>	<b>20,892</b>	<b>21,849</b>
<b>Operating Income</b>	<b>970</b>	<b>1,069</b>	<b>1,121</b>	<b>1,834</b>	<b>2,210</b>	<b>1,338</b>	<b>2,339</b>	<b>2,870</b>	<b>1,088</b>	<b>1,655</b>	<b>1,895</b>
Operating Income Margin	12.4%	12.4%	7.2%	8.8%	10.0%	8.6%	11.1%	12.6%	6.9%	7.9%	8.7%
Operating Income Yr. / Yr. Change	-7	5	-521	160	115	-450	250	150	-550	100	75
Interest Income (Expense)	(15)	(33)	(241)	(384)	(362)	(241)	(384)	(362)	(241)	(384)	(362)
Other Income, Net	(1)	(6)	0	0	0	0	0	0	0	0	0
Provision for Income Taxes	358	384	339	544	693	423	733	941	327	477	575
Income Taxes Rate	37.5%	37.3%	38.6%	37.5%	37.5%	38.6%	37.5%	37.5%	38.6%	37.5%	37.5%
<b>Diluted Net Income</b>	<b>597</b>	<b>646</b>	<b>541</b>	<b>906</b>	<b>1,155</b>	<b>674</b>	<b>1,222</b>	<b>1,568</b>	<b>521</b>	<b>795</b>	<b>958</b>
<b>Diluted EPS - reported</b>	<b>\$2.72</b>	<b>\$3.12</b>	<b>\$2.42</b>	<b>\$3.85</b>	<b>\$4.90</b>	<b>\$3.02</b>	<b>\$5.19</b>	<b>\$6.65</b>	<b>\$2.33</b>	<b>\$3.37</b>	<b>\$4.07</b>
Shares outstanding - diluted	219.1	206.7	223.5	235.7	235.7	223.5	235.7	235.7	223.5	235.7	235.7
NTMPE Multiple:			38x	24x	19x	44x	26x	20x	26x	18x	15x
Estimated Value:			\$92	\$92	\$92	\$133	\$135	\$133	\$61	\$61	\$61
Dividend:			\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00	\$0.00
<b>Upside / Downside Potential (vs. \$78.45):</b>			<b>17%</b>	<b>17%</b>	<b>17%</b>	<b>69%</b>	<b>72%</b>	<b>70%</b>	<b>-23%</b>	<b>-23%</b>	<b>-22%</b>

Source: Company reports, UBS estimates

Figure 90: DLTR financial model summary (\$ millions except per share)

	1Q14	2Q14	3Q14	4Q14	2014	1Q15	2Q15	3Q15	4Q15E	2015E	1Q16E	2Q16E	3Q16E	4Q16E	2016E	1Q17E	2Q17E	3Q17E	4Q17E	2017E
<b>Income Statement</b>																				
<b>Total Sales</b>	<b>\$2,000</b>	<b>\$2,031</b>	<b>\$2,095</b>	<b>\$2,476</b>	<b>\$8,602</b>	<b>\$2,177</b>	<b>\$3,011</b>	<b>\$4,945</b>	<b>\$5,411</b>	<b>\$15,544</b>	<b>\$5,094</b>	<b>\$4,834</b>	<b>\$5,169</b>	<b>\$5,719</b>	<b>\$20,816</b>	<b>\$5,433</b>	<b>\$5,157</b>	<b>\$5,507</b>	<b>\$6,090</b>	<b>\$22,187</b>
Yr./Yr. Change	7.2%	9.5%	11.2%	10.8%	9.7%	8.8%	48.3%	136.0%	118.6%	80.7%	134.0%	60.5%	4.5%	5.7%	33.9%	6.7%	6.7%	6.5%	6.5%	6.6%
Comp Store Sales	2.1%	4.5%	5.9%	5.6%	4.6%	3.4%	2.1%	3.1%	1.8%	2.6%	2.0%	2.3%	2.8%	3.0%	2.5%	3.5%	3.5%	3.5%	3.5%	3.5%
Gross Profit	697	694	725	918	\$3,034	749	855	1,400	1,677	\$4,681	1,444	1,414	1,541	1,829	\$6,228	1,568	1,534	1,669	1,978	\$6,750
% of Sales	34.8%	34.2%	34.6%	37.1%	35.3%	34.4%	28.4%	28.3%	31.0%	30.1%	28.4%	29.3%	29.8%	32.0%	29.9%	28.9%	29.8%	30.3%	32.5%	30.4%
Yr./Yr. Change (bps)	(33)	(80)	(40)	16	(31)	(42)	(577)	(631)	(610)	(516)	(605)	85	150	100	(19)	50	50	50	50	50
SG&A Expense	465	482	491	528	1,965	506	714	1,165	1,175	3,560	1,031	1,013	1,166	1,185	4,395	1,064	1,048	1,206	1,222	4,540
% of Sales	23.2%	23.7%	23.4%	21.3%	22.8%	23.2%	23.7%	23.5%	21.7%	22.9%	20.2%	21.0%	22.5%	20.7%	21.1%	19.6%	20.3%	21.9%	20.1%	20.5%
Yr./Yr. Change (bps)	(32)	(41)	(72)	(2)	(36)	0	0	10	40	5	(300)	(275)	(100)	(100)	(179)	(65)	(65)	(65)	(65)	(65)
<b>Operating Income</b>	<b>232</b>	<b>213</b>	<b>234</b>	<b>390</b>	<b>1,069</b>	<b>243</b>	<b>141</b>	<b>236</b>	<b>501</b>	<b>1,121</b>	<b>414</b>	<b>401</b>	<b>375</b>	<b>644</b>	<b>1,834</b>	<b>504</b>	<b>487</b>	<b>463</b>	<b>756</b>	<b>2,210</b>
% of Sales	11.6%	10.5%	11.2%	15.8%	12.4%	11.2%	4.7%	4.8%	9.3%	7.2%	8.1%	8.3%	7.3%	11.3%	8.8%	9.3%	9.4%	8.4%	12.4%	10.0%
Yr./Yr. Change (bps)	(2)	(39)	33	19	5	(42)	(578)	(641)	(650)	(521)	(305)	360	250	200	160	115	115	115	115	115
Interest, Net	8	8	8	9	33	8	36	98	98	241	98	98	93	93	384	92	92	88	88	362
Pretax Income	224	204	225	377	1,030	238	103	137	403	880	315	302	282	551	1,450	411	394	375	668	1,848
Income Taxes	86	78	82	138	384	91	50	47	151	339	118	113	106	207	544	154	148	141	250	693
Tax Rate	38.2%	38.2%	36.6%	36.6%	37.3%	38.4%	48.1%	34.7%	37.5%	38.6%	37.5%	37.5%	37.5%	37.5%	37.5%	37.5%	37.5%	37.5%	37.5%	37.5%
Net Income	138	126	142	239	646	146	53	89	252	541	197	189	176	344	906	257	246	234	417	1,155
<b>EPS</b>	<b>\$0.67</b>	<b>\$0.61</b>	<b>\$0.69</b>	<b>\$1.16</b>	<b>\$3.12</b>	<b>\$0.71</b>	<b>\$0.25</b>	<b>\$0.38</b>	<b>\$1.07</b>	<b>\$2.42</b>	<b>\$0.84</b>	<b>\$0.80</b>	<b>\$0.75</b>	<b>\$1.46</b>	<b>\$3.85</b>	<b>\$1.09</b>	<b>\$1.05</b>	<b>\$0.99</b>	<b>\$1.77</b>	<b>\$4.90</b>
Yr./Yr. Change	12.8%	9.8%	19.6%	13.6%	14.7%	5.6%	-59.3%	-45.1%	-7.5%	-22.5%	18.4%	222.4%	97.6%	36.7%	58.9%	30.4%	30.5%	32.9%	21.2%	27.4%
Avg Shares Outstanding	207	207	207	207	207	207	215	236	236	223	236	236	236	236	236	236	236	236	236	236
Total Stores, end of period	5,080	5,166	5,282	5,367	5,367	5,454	13,864	14,038	13,868	13,845	14,018	14,168	14,318	14,468	14,468	14,618	14,768	14,918	15,068	15,068
Yr./Yr. Change	317	324	329	375	375	374	8698	8756	8501	8478	8564	304	280	600	623	600	600	600	600	600
Square Footage, end of period	44	45	46	47	46	47	108	110	109	108	110	111	112	113	113	114	116	117	118	118
Yr./Yr. Change	6.8%	6.9%	6.8%	7.6%	7.5%	7.3%	141.5%	139.3%	133.4%	133.4%	132.2%	2.5%	2.3%	4.5%	4.5%	4.3%	4.2%	4.1%	4.0%	4.0%
<b>Cash Flow Statement</b>																				
<b>FFO</b>	<b>198</b>	<b>167</b>	<b>23</b>	<b>538</b>	<b>927</b>	<b>130</b>	<b>-176</b>	<b>-5</b>	<b>403</b>	<b>353</b>	<b>350</b>	<b>334</b>	<b>344</b>	<b>504</b>	<b>1,532</b>	<b>420</b>	<b>401</b>	<b>413</b>	<b>588</b>	<b>1,822</b>
Yr./Yr. Change	53%	-2%	-65%	26%	17%	-35%	-205%	-121%	-25%	-62%	170%	-290%	-7263%	25%	334%	20%	20%	20%	17%	19%
<b>FCF</b>	<b>126</b>	<b>79</b>	<b>(71)</b>	<b>467</b>	<b>601</b>	<b>63</b>	<b>(276)</b>	<b>(174)</b>	<b>214</b>	<b>(173)</b>	<b>197</b>	<b>189</b>	<b>189</b>	<b>333</b>	<b>908</b>	<b>257</b>	<b>246</b>	<b>248</b>	<b>405</b>	<b>1,156</b>
Yr./Yr. Change	384%	6%	292%	23%	30%	-50%	-450%	145%	-54%	-129%	213%	-169%	-208%	56%	-625%	30%	30%	31%	22%	27%
<b>EBITDA</b>	<b>283</b>	<b>262</b>	<b>285</b>	<b>445</b>	<b>1,275</b>	<b>296</b>	<b>231</b>	<b>406</b>	<b>664</b>	<b>1,596</b>	<b>577</b>	<b>555</b>	<b>553</b>	<b>816</b>	<b>2,501</b>	<b>678</b>	<b>652</b>	<b>653</b>	<b>939</b>	<b>2,921</b>
Yr./Yr. Change	8%	6%	13%	12%	10%	5%	-12%	42%	49%	25%	95%	141%	36%	23%	57%	17%	17%	18%	15%	17%
<b>Balance Sheet</b>																				
<b>Cash &amp; S/T Investments</b>	<b>387</b>	<b>468</b>	<b>408</b>	<b>864</b>	<b>864</b>	<b>870</b>	<b>1,303</b>	<b>1,107</b>	<b>1,321</b>	<b>1,321</b>	<b>1,518</b>	<b>1,707</b>	<b>1,896</b>	<b>2,228</b>	<b>2,228</b>	<b>2,486</b>	<b>2,732</b>	<b>2,980</b>	<b>3,385</b>	<b>3,385</b>
Cash per Share	2	2	2	4	4	4	6	5	6	6	6	7	8	9	9	11	12	13	14	14
Inventory, end of period	1,043	1,084	1,305	1,036	1,036	1,094	2,825	3,185	2,483	2,483	2,795	4,482	3,260	2,586	2,586	2,960	4,747	3,448	2,734	2,734
Yr./Yr. Change	3%	6%	5%	0%	0%	5%	161%	144%	140%	140%	156%	59%	2%	4%	4%	6%	6%	6%	6%	6%
Ending Inventory per Sq Ft	24	24	28	22	22	23	58	63	48	48	54	84	60	47	47	53	83	60	47	47
Yr./Yr. Change	-3%	0%	-1%	-7%	-7%	-2%	142%	122%	118%	117%	131%	44%	-5%	-4%	-3%	-2%	-1%	-1%	0%	0%
Total Assets	2,958	3,147	3,368	3,567	3,567	10,869	16,565	16,699	16,048	16,048	16,653	18,760	17,457	17,042	17,042	17,759	20,040	18,700	18,311	18,311
Total Liabilities	1,640	1,699	1,783	1,782	1,782	8,998	12,518	12,557	12,796	12,796	13,575	14,496	12,931	12,940	12,940	13,805	14,784	13,114	13,124	13,124
Total shareholders' equity	1,318	1,448	1,585	1,785	1,785	1,871	4,047	4,142	3,252	3,252	3,078	4,264	4,526	4,102	4,102	3,955	5,256	5,586	5,188	5,188
Book Value per Share	\$6.37	\$7.01	\$7.67	\$8.63	\$7.57	\$9.03	\$18.80	\$17.57	\$13.80	\$14.55	\$13.06	\$18.09	\$19.20	\$17.40	\$17.40	\$16.78	\$22.30	\$23.70	\$22.01	\$22.01
Total Debt	757	757	757	757	757	7,820	8,349	8,344	8,344	8,344	8,344	8,344	8,344	8,344	8,344	8,344	8,344	8,344	8,344	8,344
Total Debt / EBITDA	2.7x	2.9x	2.7x	1.7x	0.6x	26.4x	36.2x	20.6x	12.6x	5.2x	14.5x	15.0x	15.1x	10.2x	3.3x	12.3x	12.8x	12.8x	8.9x	2.9x
Total Adjusted Debt / EBITDAR	-	-	-	-	1.9x	-	-	-	-	6.4x	-	-	-	-	4.9x	-	-	-	-	4.5x

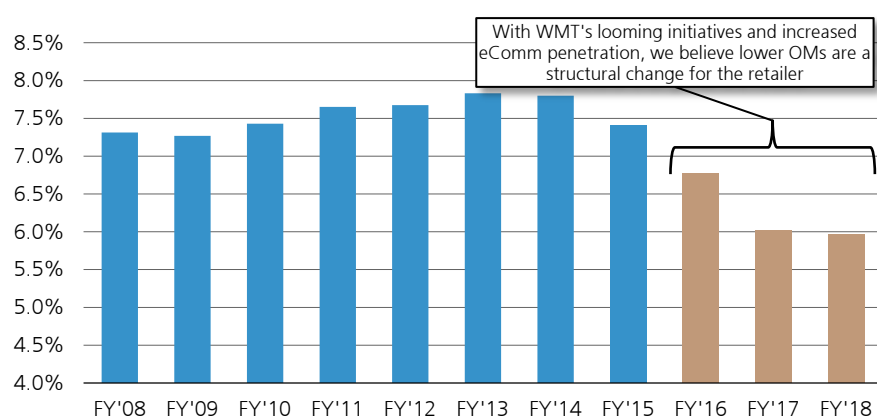
Source: Company Reports, UBS Estimates

## Walmart (WMT) – Neutral

Topics to watch: For CY'16 (FY'17), we believe the following factors will be the critical drivers for how the shares perform:

**Will Walmart ever see a full recovery to its US operating margin?** It won't be easy. In FY'17, WMT plans on investing an additional \$1.5 billion on labor, which comes on top of its \$1.2 billion investment last year. Further, the company is facing continued mix challenges, as Walmart's eCommerce sales continue to grow faster than its brick and mortar revenue. Walmart doesn't expect its eCommerce operations to be profitable until after FY'19, and it's hard to see the retailer collecting a higher digital operating margin than Amazon currently enjoys (~3% in the US) any time soon.

**Figure 91: WMT US operating margin, FY'08-FY'18E**

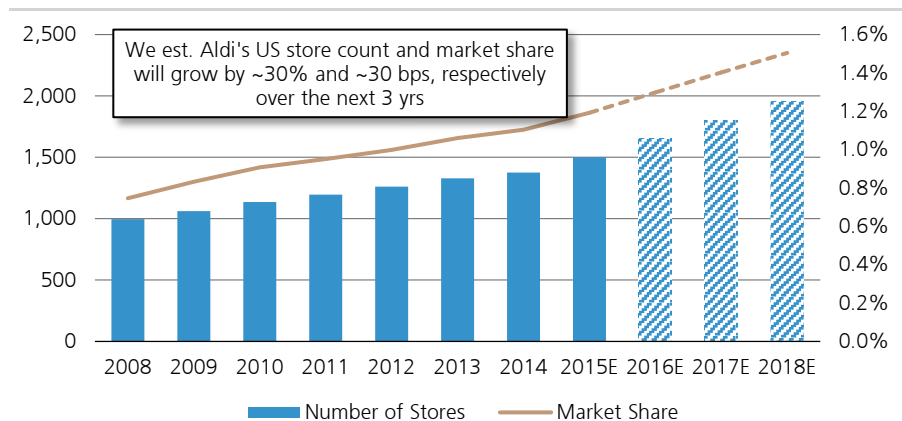


Source: Company reports, UBS estimates

- Will Walmart look to prune back its international operations?** At its 2015 Analyst Day, Walmart left the door open to simplifying its Walmart International business. We think this would be a wise move by the retailer. As it currently stands, Walmart operates ~72 banners worldwide, with ~65 of them operating internationally. Further, Walmart International has eCommerce operations in 10 countries outside the US. At the same time, we estimate the retailer generated just 26% of its net sales from International in FY'16. We believe the added complexity of operating so many formats in 27 countries outside the US outweighs any scale benefits that the retailer may gain from this operation. There is some precedent for Walmart shedding non-core assets, such as its moves to divest its Mexican bank and Vips restaurant business over the past few years. We think further moves to streamline its International business would be viewed favorably by investors.
- Can Walmart successfully fend off ALDI and Lidl in the United States?** The two hard discounters have been causing headaches for WMT's Asda division in the UK, which saw its lowest market share in 9+ years in December 2015 (at 16.2%), according to Kantar. Both retailers are planning to expand considerably in the US over the next few years. ALDI already has ~1,500 US stores, with plans to reach ~2,000 by Walmart's FY'19. Further, Lidl has broken ground on an American headquarters and distribution center in Virginia, and is looking to start opening stores in the US in the near future. With consumables making up two thirds of Walmart US' sales, it will be critical for the retailer to

adapt to the evolving competitive landscape as it looks to maintain its share in the US. Ultimately, we think Walmart will need to show considerable progress with improving its private label offering in order to compete on price while maintaining its margins. CEO Greg Foran has previously competed against both retailers relatively successfully during his tenure with Woolworth's in Australia, which should bode well for Walmart.

**Figure 92: A growing threat to Walmart's US grocery business**



Source: Kantar, US Census Retail, Company reports, UBS estimates

## What to do with the stock?

With another \$1.5 bn in incremental labor expenses expected, CY'16 is set to be an investment year for WMT. We think these steps are necessary to ensure that Walmart continues to be a force to be reckoned with in retail. However, with rising wages, increasing eCommerce penetration, and an increasingly competitive retail landscape in play, we think it will be tougher for WMT to return to its historical 2%+ comp growth and 7-8% operating margins in the US. We think the company's risk and reward are balanced right now, and thus remain on the sidelines. Our \$64 price target equates to 15x our CY'17 EPS estimate of \$4.24 and is based on a DCF/multiple blend analysis.

We think it is useful to examine how our price target would respond to various changes in our assumptions for WMT's earnings outlook over the next few years and the valuation multiple that would be associated with those scenarios. The following figure highlights our base case, a high case, and a low case.



Figure 93: WMT price target sensitivity analysis

Calendar year	Base Case (Published estimates)					High Case			Low Case		
	2013A	2014A	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E
US Comparable Store Sales Growth	-0.6%	0.5%	1.3%	1.5%	2.0%	1.8%	3.0%	3.0%	0.8%	0.0%	1.0%
Growth Contribution from New Stores and Other	2.1%	1.5%	-1.5%	1.4%	0.9%	-1.5%	1.4%	0.9%	-1.5%	1.4%	0.9%
Total Sales Growth	1.5%	2.0%	-0.3%	2.9%	2.9%	0.3%	4.4%	3.9%	-0.7%	1.4%	1.9%
<b>Total Sales</b>	<b>476,294</b>	<b>485,651</b>	<b>484,317</b>	<b>498,465</b>	<b>512,759</b>	<b>486,895</b>	<b>508,421</b>	<b>528,085</b>	<b>482,038</b>	<b>488,888</b>	<b>498,019</b>
<b>Operating Income</b>	<b>26,872</b>	<b>27,147</b>	<b>24,949</b>	<b>22,253</b>	<b>22,707</b>	<b>25,512</b>	<b>23,590</b>	<b>24,766</b>	<b>24,053</b>	<b>19,995</b>	<b>19,870</b>
Operating Income Margin	5.6%	5.6%	5.2%	4.5%	4.4%	5.2%	4.6%	4.7%	5.0%	4.1%	4.0%
Operating Income Yr. / Yr. Change	-28	-5	-44	-69	-4	-35	-60	5	-60	-90	-10
Interest Income (Expense)	(2,216)	(2,348)	(2,519)	(2,299)	(2,379)	(2,519)	(2,299)	(2,379)	(2,519)	(2,299)	(2,379)
Provision for Income Taxes	8,105	7,985	7,236	6,784	6,912	7,418	7,239	7,612	6,947	6,016	5,947
Income Taxes Rate	32.9%	32.2%	32.3%	34.0%	34.0%	32.3%	34.0%	34.0%	32.3%	34.0%	34.0%
Income attributable to noncontrolling interests and others	258	(373)	(445)	(467)	(491)	(445)	(467)	(491)	(445)	(467)	(491)
<b>Diluted Net Income</b>	<b>16,809</b>	<b>16,441</b>	<b>14,748</b>	<b>12,702</b>	<b>12,926</b>	<b>15,130</b>	<b>13,584</b>	<b>14,285</b>	<b>14,141</b>	<b>11,212</b>	<b>11,053</b>
<b>Diluted EPS - reported</b>	<b>\$5.12</b>	<b>\$5.07</b>	<b>\$4.57</b>	<b>\$4.05</b>	<b>\$4.24</b>	<b>\$4.69</b>	<b>\$4.33</b>	<b>\$4.68</b>	<b>\$4.38</b>	<b>\$3.58</b>	<b>\$3.62</b>
Shares outstanding - diluted	3,283.0	3,245.8	3,228.0	3,134.4	3,051.3	3,228.0	3,134.4	3,051.3	3,228.0	3,134.4	3,051.3
NTM PE Multiple:			14x	16x	15x	18x	19x	18x	11x	13x	13x
Estimated Value:			\$64	\$64	\$64	\$84	\$82	\$84	\$48	\$46	\$47
Dividend:			\$1.96	\$2.00	\$2.04	\$1.96	\$2.00	\$2.04	\$1.96	\$2.00	\$2.04
<b>Upside / Downside Potential (vs. \$65.03):</b>			1%	1%	2%	33%	30%	33%	-23%	-25%	-24%

Source: Company reports, UBS estimates

Figure 94: WMT financial model summary (\$ millions except per share)

FY	1Q15	2Q15	3Q15	4Q15	2015	1Q16	2Q16	3Q16	4Q16E	2016E	1Q17E	2Q17E	3Q17E	4Q17E	2017E	1Q18E	2Q18E	3Q18E	4Q18E	2018E
<b>Income Statement</b>																				
Revenue	114,960	120,125	119,001	131,565	485,651	114,826	120,229	117,408	131,854	484,317	118,773	123,350	120,859	135,482	498,465	121,390	127,133	124,580	139,656	512,759
Yr./Yr. Change	0.8%	2.8%	2.9%	1.4%	2.0%	-0.1%	0.1%	-1.3%	0.2%	-0.3%	3.4%	2.6%	2.9%	2.8%	2.9%	2.2%	3.1%	3.1%	3.1%	2.9%
WMT US Comp Store Sales ex fuel	-0.1%	0.0%	0.5%	1.5%	0.5%	1.1%	1.5%	1.5%	1.0%	1.3%	1.5%	1.5%	1.5%	1.5%	1.5%	2.0%	2.0%	2.0%	2.0%	2.0%
Comp Store Sales ex Fuel	-0.5%	0.0%	0.4%	2.0%	0.5%	0.4%	1.3%	0.4%	0.5%	0.6%	2.0%	2.0%	2.0%	2.0%	2.0%	2.5%	2.5%	2.5%	2.5%	2.5%
Gross Profit	28,246	30,115	29,754	32,450	120,565	28,343	30,173	29,962	32,521	120,999	29,080	30,710	30,601	33,213	123,603	29,599	31,524	31,418	34,096	126,638
% of Net Sales	24.0%	24.6%	24.4%	24.1%	24.3%	24.1%	24.5%	25.0%	24.1%	24.4%	23.9%	24.3%	24.7%	24.0%	24.2%	23.8%	24.2%	24.6%	23.9%	24.1%
Yr./Yr. Change (bps)	(7)	(13)	(12)	21	(2)	9	(4)	59	(2)	15	(20)	(21)	(26)	(16)	(21)	(11)	(10)	(10)	(10)	(10)
% of Revenue	24.6%	25.1%	25.0%	24.7%	24.8%	24.7%	25.1%	25.5%	24.7%	25.0%	24.5%	24.9%	25.3%	24.5%	24.8%	24.4%	24.8%	25.2%	24.4%	24.7%
Yr./Yr. Change (bps)	(5)	(10)	(7)	20	0	11	3	52	0	16	(20)	(20)	(20)	(15)	(19)	(10)	(10)	(10)	(10)	(10)
SG&A Expense	22,053	23,375	23,489	24,501	93,418	22,663	24,104	24,399	24,884	96,051	24,036	25,346	25,721	26,247	101,350	24,505	26,060	26,450	26,915	103,931
% of Revenue	19.2%	19.5%	19.7%	18.6%	19.2%	19.7%	20.0%	20.8%	18.9%	19.8%	20.2%	20.5%	21.3%	19.4%	20.3%	20.2%	20.5%	21.2%	19.3%	20.3%
Yr./Yr. Change (bps)	21	9	12	(18)	6	55	59	104	25	60	50	50	50	50	50	(5)	(5)	(5)	(10)	(6)
Operating Income	6,193	6,740	6,265	7,949	27,147	5,680	6,069	5,563	7,637	24,949	5,044	5,363	4,880	6,966	22,253	5,094	5,464	4,968	7,181	22,707
% of Revenue	5.4%	5.6%	5.3%	6.0%	5.6%	4.9%	5.0%	4.7%	5.8%	5.2%	4.2%	4.3%	4.0%	5.1%	4.5%	4.2%	4.3%	4.0%	5.1%	4.4%
Yr./Yr. Change (bps)	(26)	(19)	(19)	38	(5)	(44)	(56)	(53)	(25)	(44)	(70)	(70)	(70)	(65)	(69)	(5)	(5)	(5)	0	(4)
Interest, Net	568	538	656	586	2,348	824	543	552	600	2,519	568	555	564	612	2,299	588	575	584	632	2,379
Pretax Income	5,625	6,202	5,609	7,363	24,799	4,856	5,526	5,011	7,036	22,429	4,476	4,808	4,316	6,354	19,954	4,506	4,889	4,384	6,549	20,328
Income Taxes	1,914	2,113	1,783	2,175	7,985	1,573	1,891	1,697	2,076	7,236	1,522	1,635	1,468	2,160	6,784	1,532	1,662	1,491	2,227	6,912
Tax Rate	34.0%	34.1%	31.8%	29.5%	32.2%	32.4%	34.2%	33.9%	29.5%	32.3%	34.0%	34.0%	34.0%	34.0%	34.0%	34.0%	34.0%	34.0%	34.0%	34.0%
Noncontrolling interests	(129)	(166)	(115)	(222)	(632)	58	(160)	(110)	(233)	(445)	61	(168)	(116)	(245)	(467)	64	(176)	(121)	(257)	(491)
Non Recurring Items A/T	0	0	0	259	259	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Net Income available for common	3,582	3,923	3,711	5,225	16,441	3,341	3,475	3,204	4,728	14,748	3,015	3,005	2,733	3,949	12,702	3,038	3,050	2,772	4,065	12,926
EPS	\$1.10	\$1.21	\$1.15	\$1.61	\$5.07	\$1.03	\$1.08	\$1.00	\$1.47	\$4.57	\$0.95	\$0.95	\$0.88	\$1.28	\$4.05	\$0.98	\$0.99	\$0.91	\$1.35	\$4.24
Yr./Yr. Change	-3.0%	-3.1%	0.5%	0.9%	-1.1%	-6.6%	-11.1%	-13.1%	-8.8%	-9.8%	-8.2%	-11.3%	-11.9%	-12.8%	-11.3%	3.7%	4.3%	4.1%	5.6%	4.5%
Avg Shares Outstanding	3,248	3,241	3,240	3,242	3,246	3,243	3,231	3,219	3,217	3,228	3,189	3,152	3,116	3,080	3,134	3,100	3,067	3,035	3,003	3,051
Total Stores, end of period	10,994	11,053	11,156	11,453	11,453	11,489	11,532	11,554	11,715	11,715	11,792	11,869	11,951	12,029	12,029	12,116	12,203	12,290	12,373	12,373
Yr./Yr. Change	1.3%	0.9%	0.5%	4.7%	4.7%	4.5%	4.3%	3.6%	2.3%	2.3%	2.6%	2.9%	3.4%	2.7%	2.7%	2.1%	2.1%	2.2%	2.9%	#REF!
Square Footage, end of period	1,106	1,112	1,121	1,134	1,134	1,138	1,140	1,145	1,153	1,153	1,159	1,164	1,170	1,175	1,175	1,181	1,187	1,193	1,198	1,198
Yr./Yr. Change	2.7%	2.7%	2.4%	3.0%	3.0%	2.9%	2.5%	2.2%	1.7%	1.7%	1.8%	2.1%	2.2%	1.9%	1.9%	1.9%	1.9%	1.9%	2.0%	2.0%
<b>Cash Flow Statement</b>																				
FFO	5,939	5,961	3,570	13,094	28,564	4,446	5,656	4,903	4,577	19,582	8,515	5,000	5,980	3,797	23,292	8,450	5,367	6,118	3,918	23,853
Yr./Yr. Change	21%	-6%	71%	32%	23%	-25%	-5%	37%	-65%	-31%	92%	-12%	22%	-17%	19%	-1%	7%	2%	3%	2%
FCF	3,782	3,005	440	9,163	16,390	2,243	2,815	1,724	1,281	8,063	5,902	2,287	3,321	816	12,325	5,779	2,697	3,502	985	12,964
Yr./Yr. Change	96%	-7%	-132%	45%	62%	-41%	-6%	292%	-86%	-51%	163%	-19%	93%	-36%	53%	-2%	18%	5%	21%	5%
EBITDA	8,443	9,017	8,619	10,241	36,320	7,999	8,408	7,928	10,274	34,609	7,419	7,830	7,297	9,676	32,223	7,522	8,007	7,460	9,974	32,963
Yr./Yr. Change	-2%	0%	1%	6%	2%	-5%	-7%	-8%	0%	-5%	-7%	-7%	-8%	-6%	-7%	1%	2%	2%	3%	2%
<b>Balance Sheet</b>																				
Cash & ST Investments	6,012	6,184	6,718	9,135	9,135	7,759	5,751	6,990	6,330	6,330	8,142	6,358	5,627	2,408	2,408	5,112	3,750	3,211	170	170
Cash per share	1.9	1.9	2.1	2.8	2.8	2.4	1.8	2.2	2.0	2.0	2.6	2.0	1.8	0.8	0.8	1.6	1.2	1.1	0.1	0.1
Inventory, end of period	45,315	45,451	51,501	45,141	45,141	46,310	45,007	50,706	45,240	45,240	47,496	46,299	52,337	46,578	46,578	49,152	47,782	54,020	48,076	48,076
Yr./Yr. Change	5%	6%	4%	1%	1%	2%	-1%	-2%	0%	0%	3%	3%	3%	3%	3%	3%	3%	3%	3%	3%
Ending Inventory per Sq Ft	41	41	46	40	40	41	39	44	39	39	41	40	45	40	40	42	40	45	40	40
Yr./Yr. Change	2%	3%	1%	-2%	-2%	-1%	-3%	-4%	-1%	-1%	1%	1%	1%	1%	1%	2%	1%	1%	1%	1%
Total Assets	202,746	203,985	207,889	203,706	203,706	200,747	198,620	205,144	201,283	201,283	204,841	201,398	207,015	199,944	199,944	204,720	201,388	207,282	200,124	200,124
Total Liabilities	124,547	121,162	123,836	117,769	117,769	120,757	116,496	122,514	115,633	115,633	120,326	117,781	124,601	117,371	117,371	122,249	119,749	126,791	119,337	119,337
Total Shareholders' Equity	78,199	82,823	84,053	85,937	85,937	79,990	82,124	82,630	85,650	85,650	84,515	83,617	82,414	82,573	82,573	82,471	81,640	80,491	80,787	80,787
Book Value per Share	\$22.50	\$23.99	\$24.42	\$25.11	\$25.08	\$23.61	\$24.41	\$24.72	\$25.67	\$25.59	\$25.54	\$25.56	\$25.47	\$25.81	\$25.37	\$25.62	\$25.62	\$25.52	\$25.88	\$25.47
Total Debt	52,028	50,659	49,663	48,789	48,789	49,432	47,330	47,502	47,502	47,502	47,502	47,502	47,502	47,502	47,502	47,502	47,502	47,502	47,502	47,502
Total Debt / EBITDA	1.5x	1.4x	1.4x	1.3x	1.3x	1.4x	1.3x	1.4x	1.4x	1.4x	1.4x	1.4x	1.4x	1.5x	1.5x	1.5x	1.5x	1.5x	1.4x	1.4x
Total Adjusted Debt / EBITDAR	2.0x	1.9x	1.9x	1.8x	1.8x	1.9x	1.8x	1.9x	1.9x	1.9x	1.9x	2.0x	2.0x	2.0x	2.0x	2.0x	2.0x	2.0x	2.0x	2.0x

Source: Company Reports, UBS Estimates

## Costco (COST) – Buy

Topics to watch: For 2016, we believe the following factors will be the critical drivers for how the shares perform:

- **What kind of benefit will Costco see from the Visa transition?** We see two considerable opportunities for COST to generate a benefit from its switch from Amex to Visa. First, if we conservatively assume that the retailer can save 30 bps in interchange fees after the April 1 transition, it implies that COST could see \$0.14 in savings in CY'16 and \$0.16 in CY'17. We think much of this would be reinvested into card rewards, which in turn could be used to attract new members.

**Figure 95: Visa switch interchange fee savings, CY'16E & CY'17E**

	CY'16E	CY'17E
<b>Costco U.S. Revenue</b>	<b>84,462</b>	<b>87,574</b>
% of sales through Credit Card	42%	42%
Costco U.S. Credit Card Sales	35,474	36,781
Interchange Fee bps savings	27	30
<b>Incremental Impact to EBIT</b>	<b>94</b>	<b>110</b>
Tax Rate	35%	35%
<b>Incremental Impact to EPS</b>	<b>\$0.14</b>	<b>\$0.16</b>
Shares Outstanding	439	436

Source: Company reports, UBS estimates

Second, we believe that by simply accepting Visa, it will likely appeal to a broader audience. In Visa's most recent 10-K, it noted that there were 2.4 bn Visa cards in circulation, compared to just 112 mm Amex cards. Further, our [UBS Evidence Lab Survey](#) of 5,000 shoppers found that for 10% of non-members, not being able to use a Visa or MasterCard was a key reason as to why they were not members of Costco. 1% said it was the only reason. If we assume that 5% of non-members living within a 15 minute radius of a COST warehouse join, it implies ~2 million new US members could join the club (~4.3% growth vs. CY'15) and ~\$4 bn in incremental sales (or a ~440 bps lift to its US comp).

- **Will a looming membership fee increase support COST's shares?** Historically, COST has taken up the price of its membership every ~5-6 years. With the last increase occurring in November 2011, we believe COST could raise its fee as soon as November 2016. This has historically been a good time for investors to accumulate COST shares. In the 12 months leading up to its last two fee hike announcements, COST outperformed the S&P by an average of 16%. Looking beyond this year, we see a membership fee hike being a considerable benefit to shares. In our base case, we estimate that COST can take up its fees by \$10, which would add an incremental \$0.24 per share in CY'17.
- **Will COST be able to sustain its gross margin momentum in 2016?** We believe it can maintain its recent 11% level throughout 2016 for several reasons. First, EIA forecasts suggest that fuel prices will remain suppressed throughout the year. With fuel being a very low margin business for COST, it should benefit from favorable mix effects. Second, COST continues to grow its sales in higher margin Ancillary categories such as its optical and hearing aid businesses. Further, it has also shown momentum in categories such as apparel

and organic food, both of which carry above average margins for the retailer. Altogether, we see these factors helping to drive 3 bps of GM expansion to 11.2% in CY'16.

## What to do with the stock?

COST's very loyal membership base and attractive value proposition have helped it generate a sustainable competitive advantage versus the competition, which is something that is very difficult to do in retail. The retailer has now reported 19 straight quarters of 5% core same store sales growth or better, and appears poised to continue this trend in CY'16. While the stock is priced at a premium, we believe the market is underestimating the impacts of its switch to Visa and its looming membership fee increase. As a result, we think it is an attractive time to buy. Our \$180 price target equates to 27x our CY'17 EPS estimate of \$6.78 and is based on a DCF/multiple blend analysis.

We think it is useful to examine how our price target would respond to various changes in our assumptions for COST's earnings outlook over the next few years and the valuation multiple that would be associated with those scenarios. The following figure highlights our base case, a high case, and a low case.

**Figure 96: COST price target sensitivity analysis**

CY	Base Case (Published estimates)					High Case			Low Case		
	2013A	2014A	2015A	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E
Comparable Store Sales Growth	4.5%	4.3%	-0.3%	3.3%	5.4%	0.0%	6.0%	7.0%	-0.5%	1.0%	1.0%
Growth Contribution from New Stores	0.1%	2.9%	2.1%	4.4%	3.3%	2.1%	4.4%	3.3%	2.1%	4.4%	3.3%
Total Sales Growth	4.6%	7.2%	1.9%	7.7%	8.7%	2.1%	10.4%	10.3%	1.6%	5.4%	4.3%
<b>Total Sales</b>	<b>107,893</b>	<b>115,637</b>	<b>117,860</b>	<b>126,940</b>	<b>138,133</b>	<b>118,122</b>	<b>130,412</b>	<b>143,867</b>	<b>117,544</b>	<b>123,897</b>	<b>129,245</b>
<b>Operating Income</b>	<b>3,068</b>	<b>3,475</b>	<b>3,683</b>	<b>4,102</b>	<b>4,628</b>	<b>3,786</b>	<b>4,571</b>	<b>5,330</b>	<b>3,532</b>	<b>3,661</b>	<b>3,755</b>
Operating Income Margin	2.8%	3.0%	3.1%	3.2%	3.4%	3.2%	3.5%	3.7%	3.0%	3.0%	2.9%
Operating Income Yr. / Yr. Change	4	16	12	11	12	20	30	20	0	-5	-5
Interest Income (Expense)	(15)	(16)	(39)	(39)	(39)	(39)	(39)	(39)	(39)	(39)	(39)
Provision for Income Taxes	1,063	1,206	1,257	1,422	1,606	1,293	1,586	1,852	1,205	1,268	1,300
Income Taxes Rate	34.8%	34.9%	34.5%	35.0%	35.0%	34.5%	35.0%	35.0%	34.5%	35.0%	35.0%
Income attributable to noncontrolling interests and others	(26)	(32)	(30)	(30)	(30)	(57)	(26)	(32)	(57)	(26)	(32)
<b>Diluted Net Income</b>	<b>1,964</b>	<b>2,221</b>	<b>2,357</b>	<b>2,611</b>	<b>2,953</b>	<b>2,397</b>	<b>2,920</b>	<b>3,407</b>	<b>2,231</b>	<b>2,328</b>	<b>2,383</b>
<b>Diluted EPS - reported</b>	<b>\$4.44</b>	<b>\$5.02</b>	<b>\$5.33</b>	<b>\$5.95</b>	<b>\$6.78</b>	<b>\$5.42</b>	<b>\$6.66</b>	<b>\$7.82</b>	<b>\$5.05</b>	<b>\$5.31</b>	<b>\$5.47</b>
Shares outstanding - diluted	442.0	442.4	441.9	438.7	435.8	441.9	438.7	435.8	441.9	438.7	435.8
NTM PE Multiple:					34x	30x	27x	40x	33x	28x	26x
Estimated Value:					\$180	\$180	\$180	\$217	\$220	\$219	\$131
Dividend:					\$6.51	\$1.68	\$1.93	\$6.51	\$1.68	\$1.93	\$6.51
<b>Upside / Downside Potential (vs. \$154.82):</b>					<b>20%</b>	<b>17%</b>	<b>18%</b>	<b>44%</b>	<b>43%</b>	<b>43%</b>	<b>-11%</b>

Source: Company reports, UBS estimates

Figure 97: COST financial model summary (\$ millions except per share)

	FY	1Q14	2Q14	3Q14	4Q14	2014	1Q15	2Q15	3Q15	4Q15	2015	1Q16	2Q16E	3Q16E	4Q16E	2016E	1Q17E	2Q17E	3Q17E	4Q17E	2017E
Income Statement																					
Net Sales		\$24,468	\$25,756	\$25,233	\$34,755	\$110,212	\$26,284	\$26,872	\$25,517	\$34,993	\$113,666	\$26,627	\$28,155	\$27,216	\$37,437	\$119,435	\$28,836	\$30,725	\$29,718	\$40,862	\$130,140
Membership Fee Income		549	550	561	768	2,428	582	582	584	785	2,533	593	605	612	830	2,640	628	657	678	938	2,902
Revenue		25,017	26,306	25,794	35,523	112,640	26,866	27,454	26,101	35,778	116,199	27,220	28,761	27,828	38,266	122,075	29,464	31,382	30,396	41,800	133,042
Yr./Yr. Change		5.5%	5.8%	7.1%	9.3%	7.1%	7.4%	4.4%	1.2%	0.7%	3.2%	1.3%	4.8%	6.6%	7.0%	5.1%	8.2%	9.1%	9.2%	9.2%	9.0%
Comp Store Sales		3.0%	3.0%	4.0%	6.0%	4.0%	4.0%	2.0%	-1.0%	-1.0%	1.0%	-1.0%	2.2%	2.9%	3.4%	2.1%	4.8%	5.4%	5.4%	5.4%	5.3%
Comp Store Sales ex Fuel		5.0%	5.0%	6.0%	7.0%	6.0%	7.0%	8.0%	6.0%	6.0%	7.0%	6.0%	5.5%	5.8%	5.8%	5.9%	5.8%	5.6%	5.5%	5.5%	5.6%
Gross Profit		3,193	3,263	3,240	4,486	14,182	3,481	3,557	3,414	4,682	15,134	3,599	3,735	3,640	5,006	15,980	3,892	4,088	3,999	5,517	17,496
% of Net Sales		10.8%	10.5%	10.6%	10.7%	10.7%	11.0%	11.1%	11.1%	11.1%	11.1%	11.3%	11.1%	11.1%	11.2%	11.2%	11.3%	11.2%	11.2%	11.2%	11.2%
Yr./Yr. Change (bps)		13	(5)	(6)	14	5	22	54	47	44	42	26	5	3	2	8	3	5	5	5	5
% of Revenue		12.8%	12.4%	12.6%	12.6%	12.6%	13.0%	13.0%	13.1%	13.1%	13.0%	13.2%	13.0%	13.1%	13.1%	13.1%	13.2%	13.0%	13.2%	13.2%	13.2%
Yr./Yr. Change (bps)		16	(8)	(8)	10	3	19	55	52	46	43	26	3	(0)	(0)	7	(1)	4	8	12	6
SG&A Expense		2,501	2,531	2,487	3,380	10,899	2,696	2,671	2,579	3,499	11,445	2,806	2,787	2,722	3,708	12,022	2,990	3,022	2,958	4,029	12,999
% of Revenue		10.0%	9.6%	9.6%	9.5%	9.7%	10.0%	9.7%	9.9%	9.8%	9.8%	10.3%	9.7%	9.8%	9.7%	9.8%	10.1%	9.6%	9.7%	9.6%	9.8%
Yr./Yr. Change (bps)		16	13	4	(2)	7	4	11	24	26	17	27	(4)	(10)	(9)	(0)	(16)	(6)	(5)	(5)	(8)
Pre Opening Expense		24	8	16	15	63	15	9	14	27	65	26	9	15	29	79	28	10	16	32	86
% of Revenue		0.1%	0.0%	0.1%	0.0%	0.1%	0.1%	0.0%	0.1%	0.1%	0.1%	0.1%	0.0%	0.1%	0.1%	0.1%	0.1%	0.0%	0.1%	0.1%	0.1%
Yr./Yr. Change (bps)		2	1	2	(1)	1	(4)	0	(1)	3	0	4	0	0	0	1	0	0	0	0	(0)
Impaired Assets & Closing Costs		0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Operating Income		668	724	737	1,091	3,220	770	877	821	1,156	3,624	767	939	903	1,269	3,878	874	1,056	1,025	1,456	4,411
% of Revenue		2.7%	2.8%	2.9%	3.1%	2.9%	2.9%	3.2%	3.1%	3.2%	3.1%	2.8%	3.3%	3.2%	3.3%	3.2%	3.0%	3.4%	3.4%	3.5%	3.3%
Yr./Yr. Change (bps)		(2)	(22)	(14)	13	(4)	20	44	29	16	26	(5)	7	10	9	6	15	10	13	17	14
Interest, Net		(9)	4	(13)	(5)	(23)	9	(7)	(22)	0	(20)	(5)	(12)	(22)	0	(39)	(5)	(12)	(22)	0	(39)
Pretax Income		659	728	724	1,086	3,197	779	870	799	1,156	3,604	762	927	881	1,269	3,839	869	1,044	1,003	1,456	4,372
Income Taxes		228	255	245	381	1,109	274	306	280	378	1,238	275	324	308	444	1,352	304	365	351	510	1,530
Tax Rate		34.6%	35.0%	33.8%	35.1%	34.7%	35.2%	35.2%	35.0%	32.7%	34.4%	36.1%	35.0%	35.0%	35.0%	35.2%	35.0%	35.0%	35.0%	35.0%	35.0%
Noncontrolling interests		(6)	(10)	(6)	(8)	(30)	(9)	(9)	(3)	(11)	(32)	(7)	(9)	(3)	(11)	(30)	(7)	(9)	(3)	(11)	(30)
After-tax Interest Add-back		0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Net income available for common		425	463	473	697	2,058	496	555	516	767	2,334	480	594	570	814	2,458	558	670	649	936	2,812
EPS		\$0.96	\$1.05	\$1.07	\$1.58	\$4.65	\$1.12	\$1.25	\$1.17	\$1.73	\$5.27	\$1.09	\$1.35	\$1.30	\$1.85	\$5.58	\$1.27	\$1.53	\$1.49	\$2.15	\$6.43
Yr./Yr. Change		1.3%	-15.9%	2.6%	13.0%	0.5%	16.8%	19.9%	9.0%	9.9%	13.4%	-3.0%	7.5%	11.2%	7.0%	5.9%	17.1%	13.6%	14.7%	15.7%	15.2%
Avg Shares Outstanding		442	443	443	442	442	442	443	443	442	443	441	441	440	439	440	438	438	437	436	437
Total Stores, end of period		646	649	653	663	663	671	671	673	686	686	697	705	711	718	718	734	743	751	756	756
Yr./Yr. Change		4.7%	4.3%	4.1%	4.6%	4.6%	3.9%	3.4%	3.1%	3.5%	3.5%	3.9%	5.1%	5.6%	4.7%	4.7%	5.3%	5.4%	5.6%	5.3%	5.3%
Square Footage, end of period		92	93	94	95	95	96	96	96	98	98	100	101	102	103	103	105	106	107	108	108
Yr./Yr. Change		4.5%	4.6%	4.4%	5.0%	5.0%	4.1%	3.2%	2.8%	3.0%	3.0%	3.8%	5.0%	5.6%	4.7%	4.7%	5.2%	5.3%	5.5%	5.2%	5.2%
Cash Flow Statement																					
CCFO		939	713	1,490	842	3,984	1,128	900	1,229	1,028	4,285	811	4,561	(791)	(315)	4,266	1,181	4,989	(844)	(319)	5,007
Yr./Yr. Change		-15%	69%	10%	50%	16%	20%	26%	-18%	22%	8%	-28%	407%	-164%	-131%	0%	46%	9%	7%	1%	17%
FCF		365	266	1,085	275	1,991	573	288	808	461	1,892	96	3,899	(1,431)	(1,195)	1,369	562	4,330	(1,482)	(1,197)	2,213
Yr./Yr. Change		-41%	-931%	19%	-295%	47%	57%	8%	-26%	68%	-5%	-83%	1254%	-277%	-359%	-28%	486%	11%	4%	0%	62%
EBITDA		899	964	974	1,412	4,249	1,024	1,137	1,083	1,507	4,751	1,038	1,225	1,180	1,650	5,094	1,167	1,368	1,327	1,872	5,736
Yr./Yr. Change		6%	1%	3%	13%	6%	14%	18%	11%	7%	12%	1%	8%	9%	10%	7%	12%	12%	12%	13%	13%
Balance Sheet																					
Cash & ST Investments		6,439	6,482	7,275	7,315	7,315	7,619	7,453	6,805	6,419	6,419	6,283	9,881	8,131	6,442	6,442	6,688	10,702	8,868	7,311	7,311
Cash per share		15	15	16	17	17	17	17	15	15	15	14	22	18	15	15	15	24	20	17	17
Inventory, end of period		9,337	8,267	8,483	8,456	8,456	9,644	8,558	8,869	8,908	8,908	10,382	8,962	9,456	9,528	9,528	11,239	9,775	10,319	10,394	10,394
Yr./Yr. Change		15%	9%	11%	7%	7%	3%	4%	5%	5%	5%	8%	5%	7%	7%	7%	8%	9%	9%	9%	9%
Ending Inventory per Sq Ft		101	89	91	89	89	100	89	92	91	91	104	89	93	93	93	107	92	96	96	96
Yr./Yr. Change		10%	4%	6%	2%	2%	-1%	0%	2%	2%	2%	4%	0%	1%	2%	2%	3%	4%	3%	4%	4%
Total Assets		32,319	31,566	32,701	33,024	33,024	34,613	33,600	33,491	33,440	33,440	35,451	37,956	37,008	35,909	35,909	38,457	41,319	40,308	39,308	39,308
Total Liabilities		20,910	19,857	20,680	20,509	20,509	22,043	23,175	22,677	22,597	22,597	24,371	26,474	25,203	23,677	23,677	25,775	28,211	26,840	25,170	25,170
Total Shareholders Equity		11,409	11,709	12,021	12,515	12,515	12,570	10,425	10,814	10,843	10,843	11,080	11,482	11,806	12,232	12,232	12,682	13,107	13,468	14,138	14,138
Book Value per Share		\$25.36	\$26.00	\$26.70	\$27.84	\$27.80	\$27.95	\$23.04	\$23.89	\$24.00	\$23.98	\$24.57	\$25.53	\$26.31	\$27.33	\$27.25	\$28.40	\$29.43	\$30.30	\$31.89	\$31.81
Total Debt		4,987	4,985	4,985	5,093	5,093	5,034	3,830	4,826	6,147	6,147	6,126	6,126	6,126	6,126	6,126	6,126	6,126	6,126	6,126	6,126
Total Debt / EBITDA		5.5x	5.2x	5.1x	3.6x	1.2x	4.9x	3.4x	4.5x	4.1x	1.3x	5.9x	5.0x	5.2x	3.7x	1.2x	5.2x	4.5x	4.6x	3.3x	1.1x
Total Adjusted Debt / EBITDAR					1.5x						1.6x					1.5x					1.4x

Source: Company Reports, UBS Estimates

## Target (TGT) – Neutral

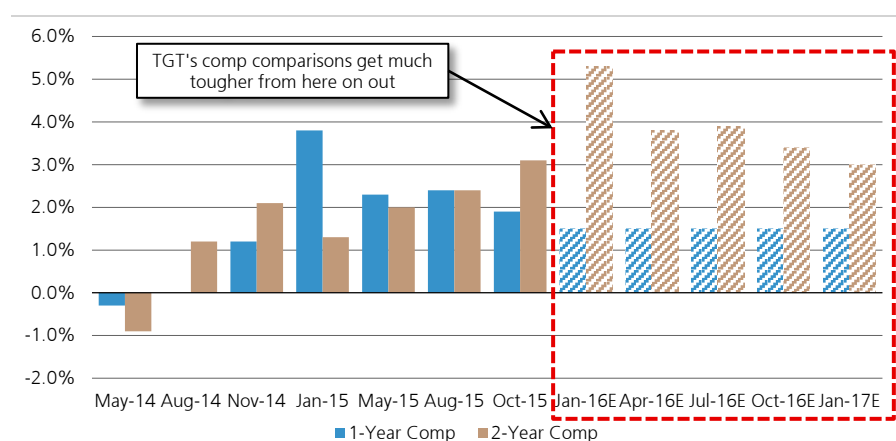
Topics to watch: For 2016, we believe the following factors will be the critical drivers for how the shares perform:

- **Can TGT maintain its comp growth after lapping its easy compares?**

Thus far in 2015, the company has managed to post a considerable improvement to its same store sales growth. Much of this was due to several key factors. First, the company was lapping the prior year's data-breach impacted lower comps, which made more optically pleasing numbers achievable in 1H'16. Second, the company pushed improvements to its "signature categories," where it improved newness and presentation in Style, Wellness, Baby, and Kids. Finally, macro tailwinds such as lower fuel prices and an improving economic environment helped place more discretionary spending power in consumers' hands.

- While the backdrop was favorable in 2015, it will be more challenging in 2016. Its comp compares will be difficult, particularly in its signature categories, where it grew comps 3% in 1Q & 2Q, and 4.5% in 3Q. We believe more of its growth will have to come from grocery and digital, both of which we see being key focuses for the company in FY'16.

**Figure 98: TGT's 1 and 2 year stack comp growth**



Source: Company reports, UBS estimates

- **Will TGT provide more clarity on its grocery strategy?** We expect TGT to start giving us more details on its redesigned grocery concept this year. With its Food & Pet category representing ~22% of its post pharmacy divestiture sales, we believe getting this traffic driving category right will be key. Thus far, the company has primarily focused on updating its assortment, including bringing in more natural and organic products. In '16, we expect to see more movement toward more local products as well as new fixtures. We believe its localization effort holds promise. In its test Chicago market, where TGT has introduced a higher percentage of localized products (e.g. craft beer), the company has seen a 100-200 bps increase in its grocery comps. Assuming it experiences similar lifts throughout the chain, it implies the retailer could see a 20-50 bps company-wide comp tailwind from this initiative should it be implemented nationwide.
- **Will TGT's eCommerce sales reaccelerate?** While still impressive, TGT's eCommerce growth slowed down as FY'15 progressed, decelerating from

~38% in 1Q to ~20% in 3Q. We believe the company's moves to increase newness, enhance its digital fulfillment network, and add ship-from-store capabilities to more stores should allow it to bring this rate back up in FY'16. While reaching its LT 40% growth target may be a stretch, we think ~30% growth in digital would be realistic for TGT next year. This would still represent a considerable comp lift for the company. Using TGT's disclosed digital comp contributions and growth rates, we estimate its digital business will see ~\$2 bn in revenue in FY'15. Should TGT be able to grow eCommerce at 30%, we estimate it would provide ~80 bps to its comp growth in FY'16. If it could reach its 40% target, it implies a ~110 bps contribution, on our estimates.

**Figure 99: UBSe TGT digital comp lift, 30% growth in 2016**

	2014					2015E					2016E				
	May-14	Aug-14	Nov-14	Jan-15	FY'14	May-15	Aug-15	Oct-15	Jan-16E	FY'15E	Apr-16E	Jul-16E	Oct-16E	Jan-17E	FY'16E
	91	91	91	91	364	91	91	91	91	364	91	91	91	91	364
Total Sales	16,657	16,957	17,254	21,751	72,618	17,119	17,427	17,613	21,622	73,781	16,646	16,977	16,444	21,248	71,316
Est Total Sales ex Pharmacy	15,694	15,976	16,256	20,493	68,419	16,136	16,427	16,595	20,981	70,139	16,646	16,977	16,444	21,248	71,316
<b>Digital Comp %</b>	<b>0.7%</b>	<b>0.6%</b>	<b>0.6%</b>	<b>0.9%</b>	<b>0.7%</b>	<b>0.8%</b>	<b>0.6%</b>	<b>0.4%</b>	<b>0.5%</b>	<b>0.6%</b>	<b>0.9%</b>	<b>0.8%</b>	<b>0.7%</b>	<b>0.9%</b>	<b>0.8%</b>
Total Digital Sales	353	339	345	544	1,581	486	441	414	653	1,993	632	573	538	848	2,591
Digital Sales Growth	30%	30%	30%	36%		38%	30%	20%	20%		30%	30%	30%	30%	

Source: Company reports, UBS estimates

**Figure 100: UBSe TGT digital comp lift, 40% growth in 2016**

	2014					2015E					2016E				
	May-14	Aug-14	Nov-14	Jan-15	FY'14	May-15	Aug-15	Oct-15	Jan-16E	FY'15E	Apr-16E	Jul-16E	Oct-16E	Jan-17E	FY'16E
	91	91	91	91	364	91	91	91	91	364	91	91	91	91	364
Total Sales	16,657	16,957	17,254	21,751	72,618	17,119	17,427	17,613	21,622	73,781	16,646	16,977	16,444	21,248	71,316
Est Total Sales ex Pharmacy	15,694	15,976	16,256	20,493	68,419	16,136	16,427	16,595	20,981	70,139	16,646	16,977	16,444	21,248	71,316
<b>Digital Comp %</b>	<b>0.7%</b>	<b>0.6%</b>	<b>0.6%</b>	<b>0.9%</b>	<b>0.7%</b>	<b>0.8%</b>	<b>0.6%</b>	<b>0.4%</b>	<b>0.5%</b>	<b>0.6%</b>	<b>1.2%</b>	<b>1.1%</b>	<b>1.0%</b>	<b>1.2%</b>	<b>1.1%</b>
Total Digital Sales	353	339	345	544	1,581	486	441	414	653	1,993	680	617	580	914	2,791
Digital Sales Growth	30%	30%	30%	36%		38%	30%	20%	20%		40%	40%	40%	40%	

Source: Company reports, UBS estimates

## What to do with the stock?

Under new leadership, Target has looked to simplify its business structure to focus on the products that matter most to its core consumer. Its pharmacy divestiture deal showed outside the box thinking, and its move to add dedicated labor to support its omni-channel operations are moves in the right direction. That said, the company still needs to prove it can generate decent comp gains now that it lapped its easy compares. Thus, we think there are more attractive opportunities for investment elsewhere. Our \$75 price target equates to 13x our CY'17 EPS estimate of \$5.92 and is based on a DCF/multiple blend analysis.

We think it is useful to examine how our price target would respond to various changes in our assumptions for TGT's earnings outlook over the next few years and the valuation multiple that would be associated with those scenarios. The following figure highlights our base case, a high case, and a low case.

Figure 101: TGT price target sensitivity analysis

	Base Case (Published estimates)					High Case			Low Case		
	2013A	2014A	2015E	2016E	2017E	2015E	2016E	2017E	2015E	2016E	2017E
Comparable Store Sales Growth	-0.4%	1.3%	2.0%	1.5%	1.5%	2.5%	3.0%	3.0%	1.0%	0.0%	0.0%
Growth Contribution from New Stores	-2.9%	1.1%	0.4%	0.8%	0.9%	0.4%	0.8%	0.9%	0.4%	0.8%	0.9%
Total Sales Growth	-3.3%	2.4%	2.3%	2.3%	2.4%	2.9%	3.8%	3.9%	1.4%	0.8%	0.9%
<b>Total Sales</b>	<b>71,279</b>	<b>72,618</b>	<b>73,781</b>	<b>71,316</b>	<b>73,022</b>	<b>71,010</b>	<b>73,732</b>	<b>76,574</b>	<b>73,973</b>	<b>74,589</b>	<b>75,227</b>
<b>Operating Income</b>	<b>4,958</b>	<b>4,709</b>	<b>5,169</b>	<b>5,446</b>	<b>5,627</b>	<b>5,117</b>	<b>5,903</b>	<b>6,360</b>	<b>5,093</b>	<b>5,135</b>	<b>5,179</b>
Operating Income Margin	7.0%	6.5%	7.0%	7.6%	7.7%	7.2%	8.0%	8.3%	6.9%	6.9%	6.9%
Operating Income Yr. / Yr. Change	-81	-47	52	63	7	65	80	30	40	0	0
Interest Income (Expense)	(604)	(597)	(608)	(620)	(636)	(608)	(620)	(636)	(608)	(620)	(636)
Provision for Income Taxes	1,545	1,413	1,576	1,703	1,762	1,558	1,865	2,021	1,549	1,594	1,604
Income Taxes Rate	35.5%	34.4%	34.5%	35.3%	35.3%	34.5%	35.3%	35.3%	34.5%	35.3%	35.3%
<b>Diluted Net Income</b>	<b>2,809</b>	<b>2,699</b>	<b>2,985</b>	<b>3,122</b>	<b>3,229</b>	<b>2,951</b>	<b>3,418</b>	<b>3,703</b>	<b>2,935</b>	<b>2,921</b>	<b>2,939</b>
<b>Diluted EPS - adjusted</b>	<b>\$4.38</b>	<b>\$4.22</b>	<b>\$4.70</b>	<b>\$5.31</b>	<b>\$5.92</b>	<b>\$4.65</b>	<b>\$5.82</b>	<b>\$6.78</b>	<b>\$4.63</b>	<b>\$4.97</b>	<b>\$5.39</b>
Shares outstanding - diluted	641.8	640.1	634.5	587.5	545.8	634.5	587.5	545.8	634.5	587.5	545.8
NTM PE Multiple:			16x	14x	13x	20x	16x	14x	14x	13x	12x
Estimated Value:			\$75	\$75	\$75	\$93	\$93	\$95	\$65	\$65	\$65
Dividend:			\$2.16	\$2.32	\$2.50	\$2.16	\$2.32	\$2.50	\$2.16	\$2.32	\$2.50
<b>Upside / Downside Potential (vs. \$73.88):</b>			<b>4%</b>	<b>5%</b>	<b>5%</b>	<b>29%</b>	<b>29%</b>	<b>32%</b>	<b>-9%</b>	<b>-9%</b>	<b>-9%</b>

Source: Company reports, UBS estimates



Figure 102: TGT financial model summary (\$ millions except per share)

	1Q14	2Q14	3Q14	4Q14	2014	1Q15E	2Q15	3Q15	4Q15E	2015E	1Q16E	2Q16E	3Q16E	4Q16E	2016E	1Q17E	2Q17E	3Q17E	4Q17E	2017E
<b>Income Statement</b>																				
<b>Net Sales</b>	<b>16,657</b>	<b>16,957</b>	<b>17,254</b>	<b>21,751</b>	<b>72,618</b>	<b>17,119</b>	<b>17,427</b>	<b>17,613</b>	<b>21,622</b>	<b>73,781</b>	<b>16,646</b>	<b>16,977</b>	<b>16,444</b>	<b>21,248</b>	<b>71,316</b>	<b>17,027</b>	<b>17,396</b>	<b>16,842</b>	<b>21,758</b>	<b>73,022</b>
Yr./Yr. Change	0.2%	0.7%	1.9%	4.1%	1.9%	2.8%	2.8%	2.1%	-0.6%	1.6%	-2.8%	-2.6%	-6.6%	-1.7%	-3.3%	2.3%	2.5%	2.4%	2.4%	2.4%
Comp Store Sales	-0.3%	0.0%	1.2%	3.8%	1.3%	2.3%	2.4%	1.9%	1.5%	2.0%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%	1.5%
Gross Profit	4,909	5,159	5,083	6,188	21,340	5,208	5,376	5,173	6,141	21,898	5,156	5,331	4,904	6,115	21,505	5,274	5,462	5,022	6,262	22,020
% of Net Sales	29.5%	30.4%	29.5%	28.4%	29.4%	30.4%	30.8%	29.4%	28.4%	29.7%	31.0%	31.4%	29.8%	28.8%	30.2%	31.0%	31.4%	29.8%	28.8%	30.2%
Yr./Yr. Change (bps)	(128)	(96)	(53)	84	(41)	95	42	(9)	(5)	29	55	55	45	38	48	0	0	0	0	(0)
SG&A Expense	3,345	3,472	3,632	4,054	14,502	3,408	3,475	3,650	3,991	14,524	3,256	3,343	3,350	3,858	13,807	3,322	3,417	3,423	3,940	14,101
% of Net Sales	20.1%	20.5%	21.1%	18.6%	20.0%	19.9%	19.9%	20.7%	18.5%	19.7%	19.6%	19.7%	20.4%	18.2%	19.4%	19.5%	19.6%	20.3%	18.1%	19.3%
Yr./Yr. Change (bps)	(26)	(8)	(20)	22	(7)	(17)	(53)	(33)	(18)	(28)	(35)	(25)	(35)	(30)	(32)	(5)	(5)	(5)	(5)	(5)
Depreciation Expense	511	537	535	545	2,129	540	551	561	553	2,205	558	571	548	575	2,252	568	581	558	584	2,292
% of Net Sales	3.1%	3.2%	3.1%	2.5%	2.9%	3.2%	3.2%	3.2%	2.6%	3.0%	3.4%	3.4%	3.3%	2.7%	3.2%	3.3%	3.3%	3.3%	2.7%	3.1%
Yr./Yr. Change (bps)	11	24	12	7	13	9	(1)	8	5	6	20	20	15	15	17	(2)	(2)	(2)	(2)	(2)
<b>Operating Income</b>	<b>0</b>	<b>1,053</b>	<b>1,150</b>	<b>916</b>	<b>1,589</b>	<b>4,709</b>	<b>0</b>	<b>1,260</b>	<b>1,350</b>	<b>962</b>	<b>1,597</b>	<b>5,169</b>	<b>0</b>	<b>1,342</b>	<b>1,417</b>	<b>1,682</b>	<b>5,446</b>	<b>0</b>	<b>1,384</b>	<b>1,464</b>
% of Net Sales	6.3%	6.8%	5.3%	7.3%	6.5%	7.4%	7.7%	5.5%	7.4%	7.0%	8.1%	8.3%	6.1%	7.9%	7.6%	8.1%	8.4%	6.2%	8.0%	7.7%
Yr./Yr. Change (bps)	(114)	(112)	(46)	55	(47)	104	96	15	8	52	70	60	65	53	63	7	7	7	7	7
Interest, Net	0	152	148	146	151	597	0	155	148	151	154	608	0	158	151	157	620	0	162	155
Pretax Income	901	1,002	770	1,438	4,112	1,105	1,202	811	1,443	4,561	1,184	1,266	851	1,525	4,826	1,222	1,309	883	1,576	4,991
Income Taxes	312	357	267	479	1,413	391	421	273	491	1,576	418	447	300	538	1,703	431	462	312	556	1,762
Tax Rate	35.5%	34.6%	35.6%	34.7%	33.3%	34.4%	35.4%	35.0%	33.7%	34.0%	34.5%	35.3%	35.3%	35.3%	35.3%	35.3%	35.3%	35.3%	35.3%	35.3%
Net Income	589	645	503	959	2,699	714	781	538	952	2,985	766	819	551	987	3,122	791	847	571	1,020	3,229
<b>EPS</b>	<b>\$0.92</b>	<b>\$1.01</b>	<b>\$0.79</b>	<b>\$1.49</b>	<b>\$4.22</b>	<b>\$1.10</b>	<b>\$1.22</b>	<b>\$0.86</b>	<b>\$1.53</b>	<b>\$4.70</b>	<b>\$1.26</b>	<b>\$1.38</b>	<b>\$0.95</b>	<b>\$1.74</b>	<b>\$5.31</b>	<b>\$1.42</b>	<b>\$1.54</b>	<b>\$1.06</b>	<b>\$1.91</b>	<b>\$5.92</b>
Yr./Yr. Change	-12.2%	-14.9%	-5.8%	14.3%	-3.6%	19.7%	20.6%	8.8%	2.8%	11.6%	14.1%	13.2%	10.8%	13.5%	13.0%	12.3%	11.7%	11.3%	10.0%	11.3%
Avg Shares Outstanding	638	638	640	644	640	646	641	629	622	635	608	594	581	568	587	559	550	541	533	546
Total Stores, end of period	1,789	1,795	1,801	1,790	1,790	1,795	1,799	1,805	1,805	1,805	1,803	1,812	1,821	1,821	1,821	1,829	1,837	1,845	1,845	1,845
Yr./Yr. Change	0.3%	0.4%	0.2%	-0.2%	-0.2%	0.3%	0.2%	0.2%	0.8%	0.8%	0.4%	0.7%	0.9%	0.9%	0.9%	1.4%	1.4%	1.3%	1.3%	1.3%
Square Footage, end of period	240	240	241	240	240	240	241	241	241	241	241	242	243	243	243	244	245	246	246	246
Yr./Yr. Change	0.4%	0.5%	0.3%	0.0%	0.0%	0.4%	0.2%	0.0%	0.5%	0.5%	0.1%	0.4%	0.7%	0.7%	0.7%	1.2%	1.2%	1.1%	1.1%	1.1%
<b>Cash Flow Statement</b>																				
<b>FFO</b>	<b>520</b>	<b>994</b>	<b>536</b>	<b>3,081</b>	<b>5,131</b>	<b>1,551</b>	<b>1,238</b>	<b>971</b>	<b>768</b>	<b>4,528</b>	<b>2,411</b>	<b>1,452</b>	<b>781</b>	<b>824</b>	<b>5,468</b>	<b>2,426</b>	<b>1,492</b>	<b>804</b>	<b>849</b>	<b>5,572</b>
Yr./Yr. Change	-84%	13%	-17%	74%	-21%	198%	25%	81%	-75%	-12%	55%	17%	-20%	7%	21%	1%	3%	3%	3%	2%
<b>FCF</b>	<b>(41)</b>	<b>503</b>	<b>18</b>	<b>2,865</b>	<b>3,345</b>	<b>1,199</b>	<b>880</b>	<b>552</b>	<b>162</b>	<b>2,793</b>	<b>1,911</b>	<b>943</b>	<b>288</b>	<b>187</b>	<b>3,328</b>	<b>1,916</b>	<b>970</b>	<b>299</b>	<b>196</b>	<b>3,381</b>
Yr./Yr. Change	-102%	-467%	-106%	148%	9%	-3024%	75%	2967%	-94%	-16%	59%	7%	-48%	15%	19%	0%	3%	4%	5%	2%
<b>EBITDA</b>	<b>1,564</b>	<b>1,687</b>	<b>1,451</b>	<b>2,134</b>	<b>6,836</b>	<b>1,800</b>	<b>1,901</b>	<b>1,523</b>	<b>2,149</b>	<b>7,373</b>	<b>1,900</b>	<b>1,988</b>	<b>1,553</b>	<b>2,257</b>	<b>7,698</b>	<b>1,952</b>	<b>2,045</b>	<b>1,599</b>	<b>2,322</b>	<b>7,919</b>
Yr./Yr. Change	-10%	-7%	-2%	11%	-2%	15%	13%	5%	1%	8%	6%	5%	2%	5%	4%	3%	3%	3%	3%	3%
<b>Balance Sheet</b>																				
<b>Cash &amp; ST Investments</b>	<b>715</b>	<b>803</b>	<b>718</b>	<b>2,210</b>	<b>2,210</b>	<b>2,768</b>	<b>2,742</b>	<b>1,977</b>	<b>2,393</b>	<b>2,393</b>	<b>4,367</b>	<b>3,929</b>	<b>2,821</b>	<b>1,619</b>	<b>1,619</b>	<b>2,452</b>	<b>2,345</b>	<b>1,544</b>	<b>646</b>	<b>646</b>
Cash per share	1	1	1	3	3	4	4	3	4	4	7	7	5	3	3	4	4	3	1	1
Inventory, end of period	8,450	8,918	10,463	8,790	8,790	8,610	8,269	10,374	8,404	8,404	8,306	7,991	9,624	8,215	8,215	8,496	8,188	9,857	8,412	8,412
Yr./Yr. Change	4%	6%	1%	0%	0%	2%	-7%	-1%	-4%	-4%	-4%	-3%	-7%	-2%	-2%	2%	2%	2%	2%	2%
Ending Inventory per Sq Ft	35	37	43	37	37	36	34	43	35	35	34	33	40	34	34	35	33	40	34	34
Yr./Yr. Change	4%	5%	1%	0%	0%	2%	-7%	-1%	-5%	-5%	-4%	-4%	-8%	-3%	-3%	1%	1%	1%	1%	1%
Total Assets	44,042	44,455	41,762	41,404	41,404	40,446	40,386	41,696	40,850	40,850	41,379	41,082	41,928	39,720	39,720	39,584	39,642	40,842	38,915	38,915
Total Liabilities	27,556	28,022	28,750	27,407	27,407	26,272	26,444	28,440	25,915	25,915	25,600	25,847	27,522	25,695	25,695	25,833	26,105	27,815	25,941	25,941
Total Shareholders Equity	16,486	16,433	13,012	13,997	13,997	14,174	13,942	13,256	14,935	14,935	15,779	15,235	14,406	14,026	14,026	13,751	13,538	13,027	12,974	12,974
Book Value per Share	\$25.83	\$25.74	\$20.34	\$21.73	\$21.87	\$21.93	\$21.75	\$21.08	\$24.02	\$23.54	\$25.97	\$25.65	\$24.81	\$24.71	\$23.87	\$24.61	\$24.62	\$24.06	\$24.33	\$23.77
Total Debt	14,089	14,158	13,106	12,796	12,796	12,766	12,724	12,776	12,776	12,776	12,776	12,776	12,776	12,776	12,776	12,776	12,776	12,776	12,776	12,776
Total Debt / EBITDA	2.1x	2.1x	2.0x	1.9x	1.9x	1.8x	1.7x	1.7x	1.7x	1.7x	1.7x	1.7x	1.7x	1.7x	1.7x	1.6x	1.6x	1.6x	1.6x	1.6x
Total Adjusted Debt / EBITDAR					2.0x					1.9x					1.8x					1.8x

Source: Company Reports, UBS Estimates

**Statement of Risk**

Investing in retail stocks entails certain risks, including but not limited to changes in consumer spending and its components, retail industry competition and general market risk.

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12-Month Rating	Definition	Coverage <sup>1</sup>	IB Services <sup>2</sup>
Buy	FSR is > 6% above the MRA.	49%	33%
Neutral	FSR is between -6% and 6% of the MRA.	40%	26%
Sell	FSR is > 6% below the MRA.	12%	18%
Short-Term Rating	Definition	Coverage <sup>3</sup>	IB Services <sup>4</sup>
Buy	Stock price expected to rise within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%
Sell	Stock price expected to fall within three months from the time the rating was assigned because of a specific catalyst or event.	less than 1%	less than 1%

Source: UBS. Rating allocations are as of 30 September 2015.

1:Percentage of companies under coverage globally within the 12-month rating category. 2:Percentage of companies within the 12-month rating category for which investment banking (IB) services were provided within the past 12 months.

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Company Name	Reuters	12-month rating	Short-term rating	Price	Price date
<b>Advance Auto Parts, Inc.</b> <sup>13, 16</sup>	AAP.N	Buy	N/A	US\$148.83	07 Jan 2016
<b>AutoZone Inc.</b> <sup>16</sup>	AZO.N	Neutral	N/A	US\$735.96	07 Jan 2016
<b>Bed Bath &amp; Beyond Inc.</b> <sup>16</sup>	BBBY.O	Neutral	N/A	US\$46.51	07 Jan 2016
<b>Best Buy Co. Inc.</b> <sup>16</sup>	BBY.N	Neutral	N/A	US\$30.23	07 Jan 2016
<b>Costco Wholesale Corp</b> <sup>16, 18a</sup>	COST.O	Buy	N/A	US\$154.82	07 Jan 2016
<b>Dick's Sporting Goods, Inc.</b> <sup>16</sup>	DKS.N	Buy	N/A	US\$35.83	07 Jan 2016
<b>Dollar General Corp</b> <sup>16</sup>	DG.N	Buy	N/A	US\$71.84	07 Jan 2016
<b>Dollar Tree</b> <sup>16</sup>	DLTR.O	Buy	N/A	US\$78.45	07 Jan 2016
<b>Five Below</b> <sup>16</sup>	FIVE.O	Buy	N/A	US\$33.72	07 Jan 2016
<b>hhgregg, Inc.</b> <sup>16</sup>	HGG.N	Sell	N/A	US\$2.50	07 Jan 2016
<b>Home Depot Inc.</b> <sup>16</sup>	HD.N	Buy	N/A	US\$125.40	07 Jan 2016
<b>Lowe's Companies, Inc.</b> <sup>16</sup>	LOW.N	Buy	N/A	US\$72.07	07 Jan 2016
<b>Mattress Firm Holding Corp</b> <sup>2, 4, 7, 16</sup>	MFRM.O	Neutral	N/A	US\$41.81	07 Jan 2016
<b>Office Depot, Inc.</b> <sup>16, 20</sup>	ODP.O	Neutral (CBE)	N/A	US\$5.65	07 Jan 2016
<b>O'Reilly Automotive, Inc.</b> <sup>16</sup>	ORLY.O	Buy	N/A	US\$240.17	07 Jan 2016
<b>Pier 1 Imports Inc</b> <sup>16</sup>	PIR.N	Sell	N/A	US\$4.70	07 Jan 2016
<b>Restoration Hardware Holdings Inc</b> <sup>16</sup>	RH.N	Buy	N/A	US\$72.66	07 Jan 2016
<b>Staples Inc.</b> <sup>16</sup>	SPLS.O	Buy	N/A	US\$9.83	07 Jan 2016
<b>Target Corporation</b> <sup>16</sup>	TGT.N	Neutral	N/A	US\$73.88	07 Jan 2016
<b>Tractor Supply Company</b> <sup>16</sup>	TSCO.O	Buy	N/A	US\$82.48	07 Jan 2016
<b>Wal-Mart Stores</b> <sup>16, 18b</sup>	WMT.N	Neutral	N/A	US\$65.03	07 Jan 2016
<b>Williams-Sonoma, Inc.</b> <sup>13, 16</sup>	WSM.N	Neutral	N/A	US\$56.49	07 Jan 2016

Source: UBS. All prices as of local market close.

Ratings in this table are the most current published ratings prior to this report. They may be more recent than the stock pricing date

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