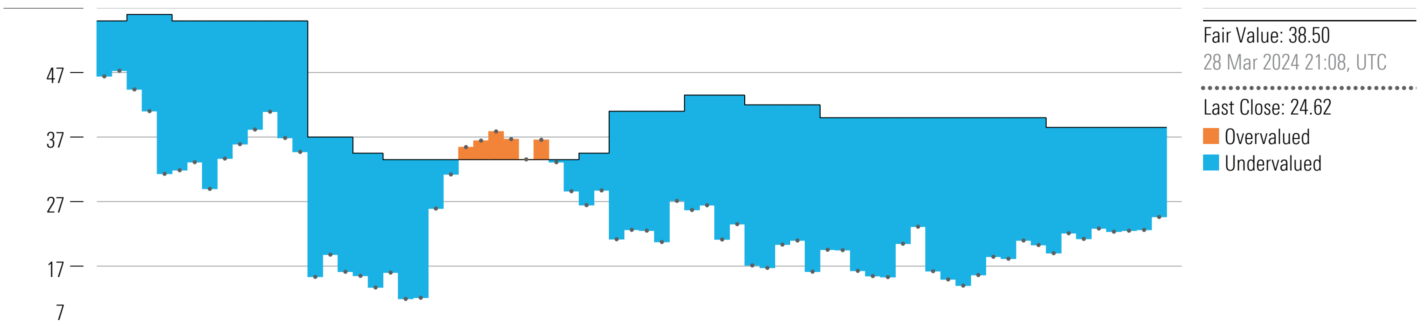
Morningstar Equity Analyst Report | Report as of 27 Nov 2024 12:15, UTC | Reporting Currency: USD | Trading Currency: USD | Exchange: NEW YORK STOCK EXCHANGE, INC. Page 1 of 24

Nordstrom Inc JWN ★★★★ 26 Nov 2024 22:39, UTC

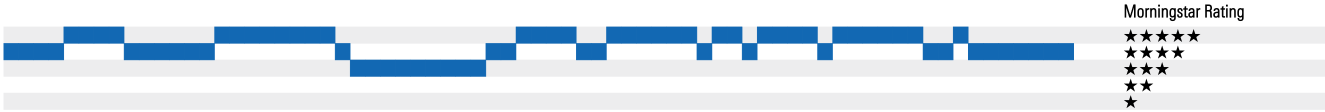
Last Price	Fair Value Estimate	Price/FVE	Market Cap	Economic Moat™	Equity Style Box	Uncertainty	Capital Allocation	ESG Risk Rating Assessment[1]
24.62 USD 26 Nov 2024	38.50 USD 28 Mar 2024 21:08, UTC	0.64	4.04 USD Bil 26 Nov 2024	None	Small Value	Very High	Standard	6 Nov 2024 06:00, UTC

Price vs. Fair Value



	2019	2020	2021	2022	2023	YTD	
	0.74	0.93	0.55	0.38	0.46	0.64	Price/Fair Value
	-9.01	-22.84	-27.52	-25.29	19.02	36.53	Total Return %

Morningstar Rating



Total Return % as of 26 Nov 2024. Last Close as of 26 Nov 2024. Fair Value as of 28 Mar 2024 21:08, UTC.

Contents

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The primary analyst covering this company does not own its stock.

[1]The ESG Risk Rating Assessment is a representation of Sustainalytics' ESG Risk Rating.

Nordstrom Earnings: Solid Results, but Investors Focus on Holiday and Buyout; Shares Undervalued

Analyst Note David Swartz, Senior Equity Analyst, 27 Nov 2024

No-moat Nordstrom's third-quarter sales and earnings surpassed our expectations. These results suggest that the plan to improve operating efficiency, expand Rack, and improve Nordstrom banner sales is working in a tough retail environment. However, despite the outperformance, the company did not lift its full-year outlook for adjusted operating margin and EPS ranges of 3.6%-4% and $1.75-$2.05, respectively, and indicated that sales slowed in the latter part of the quarter. Nordstrom's guidance suggests an operating margin of about 5%-6% for the fourth quarter, which accounts for about 40% of its annual operating income.

Nordstrom's sales beat our flat estimate by rising 5% in the quarter. Despite the hit from the timing of the anniversary sale, sales for the Nordstrom banner (62% of total) beat our estimate of negative 1% after rising 1%, while Rack's sales (38%) increased 11%. Given that there was unfavorable warm weather and most other department stores had sales declines in the period, we rate these sales numbers as encouraging.

Further, Nordstrom's 2.9% adjusted EBIT margin outpaced our 2.2% estimate due to sales outperformance and a smaller decline in credit card revenue than we had anticipated. We think the firm can build up to 6% annual operating margins over the next three years. Overall, adjusted EPS of $0.33 was $0.13 above our estimate.

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Sector	Industry
Consumer Cyclical	Department Stores

Business Description

Nordstrom is a fashion retailer that operates about 93 department stores and more than 260 off-price Nordstrom Rack stores. The company also operates both full- and off-price e-commerce sites, two clearance stores, and seven Local locations. Nordstrom's largest merchandise categories are women's apparel (27% of 2023 sales), shoes (26% of 2023 sales), men's apparel (15% of 2023 sales), and beauty (13% of 2023 sales). Nordstrom, which traces its history to a shoe store opened in Seattle in 1901, continues to be partially owned and managed by members of the eponymous family.

Meanwhile, Nordstrom provided no update on the offer from the Nordstrom family and El Puerto de Liverpool to buy the company for $23 per share. As discussed in our Sept. 4 stock analyst note, we regard the offer as low relative to our $38.50 fair value estimate, which we maintain. Our expectation is that the board will ask for a higher price and it seems that the market agrees as Nordstrom's shares have been trading above $23. It is not known if the buyout group will raise its bid, but we think it is likely as it appears to be motivated and well funded. We maintain our Standard Morningstar Capital Allocation Rating.

Business Strategy & Outlook David Swartz, Senior Equity Analyst, 3 Sep 2024

Nordstrom has a loyal customer base built on differentiated fashion products, quality brands, and first-rate service. While we once thought that these strengths provided a competitive advantage based on a brand intangible asset, we no longer believe that they do. Realistically, Nordstrom's recovery from the pandemic has been rocky, and the US apparel retail market has only become more competitive.

Nordstrom has 93 full-price stores, nearly all of them in desirable Class A malls (sales per square foot above $500) or major urban centers. While this store base may provide an advantage over department stores in lower-tier malls, the productivity of Nordstrom's full-price stores has been declining all the same. The firm has invested heavily in e-commerce (36% of 2023 sales) to adapt, but digital sales seem to have come at the expense of store sales.

Nordstrom is aggressively expanding Rack, its discount retail concept. Nineteen Rack stores opened in 2023, and another 23 or so openings are expected in 2024, bringing the total to about 280 stores. Rack, however, has not always kept pace with peer discount retailers in recent years, suggesting that it lacks a competitive edge.

Nordstrom unveiled a plan, Closer to You, in early 2021 that emphasizes e-commerce, growth in key cities (through Local and other initiatives), and a broader off-price offering. Among the merchandising changes, Nordstrom intends to increase its private-label sales (to 20% of sales from about 10% now) and greatly expand the number of items offered through partnerships (to 30% from about 5% now). The firm set medium-term targets of annual revenue of $16 billion-$18 billion, operating margins above 6%, annual operating cash flow of more than $1 billion, and ROICs in the low teens. Nordstrom's recent struggles and exit from Canada have put these goals in doubt. We forecast it will return to low teens adjusted ROICs (including goodwill) by 2027, but we anticipate operating margins will top out at only 6% in the long run.

Members of the Nordstrom family are exploring the possibility of taking the company private. We may support a sale if their offer is fair to outside investors.

Bulls Say David Swartz, Senior Equity Analyst, 3 Sep 2024

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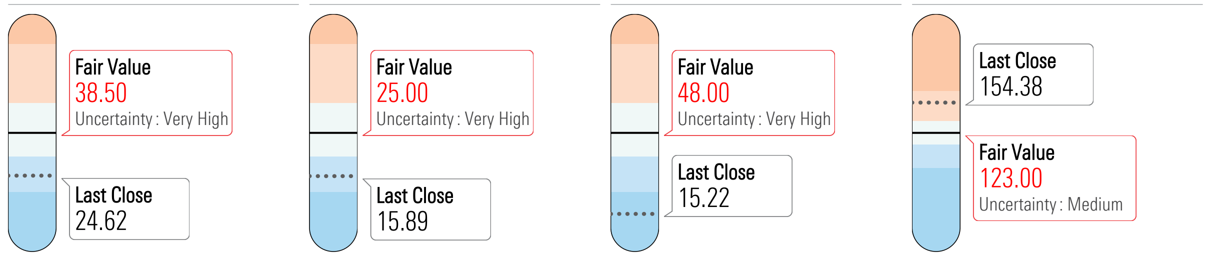
Competitors



	Nordstrom Inc JWN	Macy's Inc M	Kohl's Corp KSS	Ross Stores Inc ROST
Economic Moat	None	None	None	Wide
Currency	USD	USD	USD	USD
Fair Value	38.50 28 Mar 2024 21:08, UTC	25.00 25 Aug 2023 15:03, UTC	48.00 3 Jun 2024 14:43, UTC	123.00 30 Aug 2024 17:43, UTC
1-Star Price	67.38	43.75	84.00	166.05
5-Star Price	19.25	12.50	24.00	86.10
Assessment	Undervalued 26 Nov 2024	Undervalued 26 Nov 2024	Undervalued 26 Nov 2024	Overvalued 26 Nov 2024
Morningstar Rating	★★★★26 Nov 2024 22:39, UTC	★★★★26 Nov 2024 22:40, UTC	★★★★★26 Nov 2024 22:40, UTC	★★26 Nov 2024 22:39, UTC
Analyst	David Swartz, Senior Equity Analyst	David Swartz, Senior Equity Analyst	David Swartz, Senior Equity Analyst	Noah Rohr, Equity Analyst
Capital Allocation	Standard	Standard	Standard	Standard
Price/Fair Value	0.64	0.64	0.32	1.26
Price/Sales	0.27	0.19	0.10	2.42
Price/Book	4.25	1.02	0.45	9.73
Price/Earning	15.58	4.57	6.86	24.31
Dividend Yield	3.09%	4.32%	13.14%	0.93%
Market Cap	4.04 Bil	4.41 Bil	1.69 Bil	51.22 Bil
52-Week Range	14.65—24.99	14.06—22.10	14.22—29.60	127.53—163.60
Investment Style	Small Value	Small Value	Small Value	Mid Blend

- Nordstrom's digital sales were about $5.2 billion in 2023, making it one of the largest e-commerce firms in the United States.
- As an operator of both an upscale department store and a discount chain, Nordstrom can reach a broader customer base than many competitors. Moreover, the availability of upscale brands at Rack provides an advantage over other discounters.
- Nordstrom has reduced supply chain expenses over the past two years while improving delivery speed for customers.

Bears Say David Swartz, Senior Equity Analyst, 3 Sep 2024

- Large amounts of apparel sales have shifted to outlets, e-commerce, and specialty stores. Annual US department store sales have dropped by more than half over the past 15 years.
- While some competitors are thriving, Nordstrom’s investments have failed to generate meaningful sales growth in either its full- or off-price segments.

- Nordstrom's operating margins were declining in the prepandemic years and have yet to recover to even those levels.

Economic Moat David Swartz, Senior Equity Analyst, 3 Sep 2024

We recently downgraded our moat rating on Nordstrom to none from narrow.

Nordstrom operates the largest US luxury department store company by sales, and Rack is one of the larger off-price concepts in the market. As such, we have viewed it differently than other traditional department stores, like Macy's and Kohl's, both of which are rated as no-moat. However, recent financial results suggest that the market forces, including wide-moat Amazon's apparel offerings, that have worked against most traditional department stores are negatively impacting Nordstrom, as well. Over the past decade or so, the company's operating margins have declined to the midsingle digits from the low double digits as its sales growth has been inconsistent and its selling, general, and administrative costs have risen to about 34% of net sales from less than 28% prior to 2015. While its management often discusses various solutions to its problems, we anticipate significant spending will be needed to generate even modest sales growth. Specifically, we project 2% and 6% annual sales growth and operating margins, respectively, in the long run.

As its operating results have weakened, Nordstrom's returns on investment have followed. It adjusted ROICs including goodwill have slid to an average of less than 9% over the past three years from 18% in the 2014-17 period. Although we forecast its ROICs will be above our 9.2% WACC estimate for most of the next decade, there are other apparel retailers, such as Gap and Revolve, that typically generate double-digit ROICs that are nonetheless rated as no-moat by Morningstar. Ultimately, we think competition has caught up with each of Nordstrom's nameplates and that its moat has eroded.

Nordstrom's full-price stores are known for providing quality customer service and access to some brands not available at most department and mass market retailers. Unlike many other department stores, the company is not dealing with large numbers of stores in struggling malls in second-tier markets as approximately 95% of its full-price stores are in malls rated A (malls with annual sales per square foot of $500 or more) or better. Yet, the performance of Nordstrom's full-price stores over the past few years suggests that these potential advantages are not enough to overcome the competitive threats. Since 2020, the firm has closed 17 full-price stores in the US and all six that it once operated in Canada, thereby reducing its full-price store base by 20%. While closing its most challenged stores should have theoretically improved Nordstrom's profitability, there is no clear evidence that it has.

After an anticipated decline in 2024, we forecast Nordstrom's full-price sales will rise by just 1.5% per year, a rate that is short of the expected 3.7% annual sales growth for US apparel and footwear at retail (Euromonitor). Over the past decade, Nordstrom's full-price sales growth has been inconsistent, and we do not believe that any of the company's plans will lead to significantly larger volumes or price increases in the future.

We believe Nordstrom's full-price stores are under pressure because retail in its major categories (beauty, apparel, jewelry, and accessories) has changed rapidly over the past few years as new physical and online shopping opportunities have emerged. While the company has tried to deal with these threats through technology and changes to its store operations, its ability to do so has been hampered by a selling model was designed for a different marketplace. One of Nordstrom's biggest problems has been that many of its vendors have built out their own store bases and e-commerce, especially in luxury. Another issue has been the rise of smaller-format specialty stores, such as narrow-moat Ulta and wide-moat LVMH's Sephora in beauty, that have drawn people away from malls and traditional department stores. Nordstrom and other luxury operators have struggled to deal with these threats, as evidenced by the bankruptcies of Barneys New York in 2019 (liquidated) and Neiman Marcus in 2020 (still operating but downsized). While we rate Nordstrom as the strongest of the luxury department stores, there is no reason to believe that the channel's relevance will return to historical levels.

As its full-price business has stagnated, Nordstrom seeks growth from its off-price Rack stores. The company opened 19 new Rack locations in 2023 and is in the process of opening 23 more in 2024, representing store base growth of about 15% in just two years. Compared with the full-price stores, Rack may be better suited to the new reality of apparel and home shopping given its lower prices and off-mall locations. Indeed, between 2014 and 2019, Rack's yearly sales increased to $5.2 billion from $3.6 billion while Nordstrom's full-price sales barely moved. Moreover, Rack often outpaced peers like Burlington and wide-moats TJX and Ross with mid-single-digit comparable sales growth in the pandemic years. However, Rack's performance since the crisis suggests that its potential strengths are not enough to provide a competitive advantage.

Even as it opens stores, Nordstrom's management has struggled to explain how Rack can stand out in a very crowded field. In theory, Rack benefits from its association with Nordstrom as it competes with other off-mall apparel retailers. It is less of a clearance store like Ross, Marshalls, or TJ Maxx and more of a place to buy quality products at reasonable prices. However, Rack suffered a 35% sales decline in 2020 due to the pandemic, and its recovery has been slower than that of other off-price retailers. Nordstrom's management seems to be uncertain as to whether Rack is for the discount shopper or for the more affluent Nordstrom shopper. Meanwhile, competitors like Ross and TJX have been drawing traffic and reporting strong sales growth numbers. Given these dynamics, we do not think Rack is strong enough in the discount space to provide a moat for Nordstrom. Moreover, off-price operations account for only about one third of Nordstrom's sales, so the firm remains dependent on its large department stores despite Rack's growth.

Nordstrom's large investments have seemingly fallen flat. In the years before the pandemic, the company expanded into Canada and New York City as part of what it called its "Generational Investments." In Manhattan, after years of planning and construction, it opened a 320,000-square foot flagship in 2019 adjacent to a smaller men's store that had opened in the previous year. It has also opened Rack stores in the area. This expansion was unorthodox (and horribly timed, as it turned out) given that most US department stores have been downsizing their inner-city physical selling space as consumers have shifted to shopping in suburban strip centers and online. Thus far, Nordstrom has provided little quantitative evidence to suggest that the New York City investment (estimated at over $500 million) has paid off. Meanwhile, after opening its first store in Canada in 2014, Nordstrom slowly built its fleet to six full-price and seven Rack stores by 2022. Then, in 2023, it admitted that it saw no path to profitability in Canada and abruptly closed all 13 stores. Ultimately, it could not compete with more established retailers in the country. Given these results, we do not think Nordstrom's geographic expansions have improved its competitiveness.

As both of Nordstrom's retail concepts have struggled, the company has put a high priority on e-commerce. In contrast to many competitors that outsourced their online businesses, Nordstrom.com, was launched in 1998 and was integrated into the rest of the business from the beginning. In the off-price channel, Nordstromrack.com was launched in 2014. In the last few years, Nordstrom has united its on- and off-line operations as much as possible by, for example, having a single loyalty program across all platforms and allowing returns of merchandise bought online in either store. Aided by the pandemic, we estimate that Nordstrom's online sales rose to a peak of $6.1 billion (43% of total) in 2021 from $3.5 billion (24% of total) in 2016.

Despite its development, we believe Nordstrom's investments in online sales have been mostly defensive. Realistically, the company has had no choice but to go online—between 2010 and 2023, the share of footwear and apparel sold through e-commerce in the US rose to 39% from 9% while department stores' share fell to 6% from 17% (Euromonitor). This huge market transition has been difficult for traditional retailers like Nordstrom. Indeed, although its annual online sales increased significantly between 2016 and 2021, its operating margins fell and its total sales were flat, suggesting that online sales were less profitable and came at the expense of in-store sales. Moreover, Nordstrom's e-commerce has begun to stall out as we estimate that its digital sales declined 6% in 2022 and then another 10% in 2023 due, in part, to new policies designed to reduce low-profit sales through Nordstromrack.com. Given these factors, we do not think Nordstrom's e-commerce is enough to overcome the company's problems or provide it with a moat based on an intangible brand asset.

Beyond intangibles, we do not believe any other moat sources could be applied to Nordstrom. The company has no production cost advantage, as it sources its apparel from many of the same manufacturers as other fashion retailers. We do not believe it has the power to negotiate lower prices from producers. Nordstrom does not have efficient scale, either, as its distribution system is like that of competitors. There is no network effect in the apparel retailing business, and switching costs are nonexistent.

Fair Value and Profit Drivers David Swartz, Senior Equity Analyst, 3 Sep 2024

We are holding our per-share fair value estimate for Nordstrom to $38.50.

As the outlook for consumer spending on apparel is shaky, Nordstrom has issued underwhelming guidance of $1.75-$2.05 in adjusted EPS for 2024, as compared with adjusted EPS of $2.12 last year. In addition to demand uncertainty, a switch to cost accounting is expected to reduce profitability in 2024. Even so, Nordstrom's second-quarter adjusted EPS of $0.94 was $0.07 above our forecast on a 6.4% operating margin that beat our forecast by 80 basis points. For 2024, we project $1.91 in adjusted EPS on 1% total sales growth. For 2025, we forecast 2% sales growth and $2.15 in EPS as the full-price business recovers from an expected sales decline in 2024. Our valuation implies a 2025 price/earnings and EV/adjusted EBITDA to of 18 and 7 times, respectively.

Despite its problems, we believe Nordstrom is recovering from the pandemic effects and its Closer to You strategy is beginning to take shape. Among the initiatives under this plan, the company is increasing the amount of private-label and partnered merchandise that it sells, cutting costs, improving its Rack selection, and boosting its online offerings. We believe these initiatives are poised to lift operating margins to about 6% in the medium term. However, we do not think Nordstrom will return to historical profitability as we do not think it has an advantage that would allow it to withstand the rising competition.

After a projected 1.7% drop in 2024, our model assumes full-price sales growth around 1.5% in the long run. While mall traffic may be declining, we think Nordstrom has a loyal customer base and strong e-commerce, which accounted for 36% of 2023 sales. Further, we forecast Rack will achieve 6.4% sales growth in 2024 and increase at an annual rate of 3% thereafter.

We think the Closer to You plan and recent large investments to build out Nordstrom's e-commerce platform and network of stores should lead to continued sales and profit gains over time. We forecast total revenue increases from $14.7 billion in 2023 to $17.8 billion in 2033, a compound average annual growth rate of just 2%. Our forecast assumes gross margins on net sales (excludes credit card revenue) average 36% over the next 10 years, slightly above the average of the five years before the pandemic. Our model also anticipates SG&A as a percentage of revenue stabilizes around 32% over the next decade, better than its five-year historical average of 34.2% due to cost cuts and higher sales.

Our estimates could be a risk if the US (contrary to our economic forecast) enters a major recession. Nordstrom suffered in the 2008-09 recession, as it experienced same-store sales declines at its full-price stores of negative 12.4% in 2008 and negative 7.2% in 2009.

Nordstrom has invested hundreds of millions of dollars in its properties in Manhattan, a market that already has many fashion retailers. Unfortunately, Nordstrom's entry into the market was almost immediately impacted by the pandemic. Thus far, the expansion into Manhattan has yet to boost total sales materially.

Risk and Uncertainty David Swartz, Senior Equity Analyst, 3 Sep 2024

We assign a Very High Morningstar Uncertainty Rating to Nordstrom. The company has struggled to recover from the pandemic, which caused a sharp drop in sales in 2020. While US stores are now operating normally, inflation and changes in consumer behavior have brought inconsistent demand for apparel.

Nordstrom is exposed to weakness in US physical retail. More than two dozen American apparel retailers have filed for bankruptcy in the past few years, including direct competitors like Lord & Taylor, Neiman Marcus, and Barneys New York. While Nordstrom closed 16 of its stores in 2020 and then exited Canada in early 2023, we think it is in better shape than some mall retailers as 95% of its full-price stores are in Class A (greater than $500 in sales per square foot) malls. Also, Nordstrom's significant e-commerce business (36% of 2023 sales) provides some shelter from weakness at physical retail. However, we believe that our Very High Uncertainty Rating is warranted as Nordstrom's investments and strategic plans have yet to translate into strong store traffic growth or improved profit margins.

Nordstrom's long-term debt of $2.6 billion limits its financial flexibility, although we believe its debt is manageable as near-term maturities are minimal.

Apparel and footwear account for more than 70% of Nordstrom's sales. As China is the world's largest exporter of clothing protectionist measures on imports from the country could increase Nordstrom's costs and reduce margins.

We do not believe Nordstrom faces material environmental, social, and governance risks. However, like most firms in the apparel retail industry, it is subject to controversies related to the treatment of workers in its supply chain and the large environmental cost of clothing production.

Members of the Nordstrom family are exploring a possible acquisition of the company. There is a chance that a deal may be unfavorable to outside shareholders.

Capital Allocation David Swartz, Senior Equity Analyst, 3 Sep 2024

We assign a Standard Capital Allocation Rating to Nordstrom. Members of the Nordstrom family own about 30% of the outstanding shares and manage the company as well. While we like that the family manages the company with a long-term view, we also think that some recent investments, such as the expansions into Canada (now exited) and Manhattan, have failed to boost profitability and that more radical changes may be needed.

Erik and Peter Nordstrom are exploring a possible bid for the company that they manage. While taking Nordstrom private makes some sense, there is a possibility that their offer could be better for them than outside shareholders.

Nordstrom's chief financial officer of five years, Anne Bramman left the company in late 2022. In May 2023, experienced financial executive Cathy Smith was named to the position. Given the influence of the Nordstrom family, this change does not impact the firm's capital allocation plans or our rating.

Nordstrom closed July 2024 with $2.6 billion in debt, partially offset by $679 million in cash. In 2021, it issued $675 million in new bonds to pay down the $600 million in high-interest (8.75%) debt that it raised during the pandemic, helping to reduce its annual interest expense. As we expect net debt/adjusted EBITDA will fall to 2 times by the end of 2024, we believe its debt is manageable.

Capital expenditures were elevated for many years as Nordstrom built its Manhattan flagship, expanded into Canada, and invested in digital capabilities. Between 2013 and 2019, its annual capital expenditures averaged about 6% of revenue. Now that its largest investments are complete, however, we forecast yearly capital expenditures at less than 4% of revenue over the next decade.

Nordstrom has had mixed success with its large investments. Its digital investments have mostly been successful as e-commerce transactions account for about 35% of its sales. Its expansion into Manhattan was slowed by the pandemic but is becoming more important. However, its expansion into Canada has been abandoned after years of losses. More recently, Nordstrom has invested in its supply chain and in new Rack stores. These efforts appear to have a better likelihood of success than its past efforts. Overall, we think Nordstrom's investments support a Standard Capital Allocation Rating.

Although Nordstrom suspended dividends and share repurchases during the pandemic, we think it has a good record of returning cash to shareholders. The company has reduced its share count by more than 30% since 2007 and paid out about 42% of earnings as dividends over the 10 years before the crisis. Nordstrom resumed share repurchases and dividends in 2022 due to its cash generation ($473 million in free cash flow to equity in 2022) and its debt reduction. We forecast the firm’s long-term dividend payout ratio at 25%-30%. However, we anticipate limited buyback activity in the short term as Nordstrom concentrates on improving its sales and margins.

Analyst Notes Archive

Nordstrom: Buyout Financing Looks Solid but Price Is Low; No Change to $38.50 Fair Value Estimate

David Swartz, Senior Equity Analyst, 4 Sep 2024

No-moat Nordstrom received an acquisition offer from the founding family and Mexican retailer El

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Puerto de Liverpool. Together, they control about 43% of the outstanding shares and have offered to buy the rest for $23 per share. While this is a premium of 35% to the price at which Nordstrom's shares were trading when rumors of a buyout were reported in March, it is well short of our $38.50 fair value estimate, which we are not currently changing. Indeed, we do not believe that the offer fully compensates Nordstrom's smaller shareholders for expected improvement in profitability, which has been depressed relative to its historical standards. Specifically, over the next three years, we project its adjusted operating margins will improve to about 6% from less than 4% this year.

The biggest surprise regarding the current offer is that the Nordstroms will be an almost equal partner with an outside investor. El Puerto de Liverpool (publicly traded in Mexico) acquired just under 10% of Nordstrom as a passive investment in 2022 and will contribute about $1.2 billion to raise its ownership stake to 49.9%. Meanwhile, the family will contribute about $450 million to increase its equity stake to 50.1% from 33%. Additionally, there will be $250 million in new bank financing. Given the large cash contributions from Liverpool and the Nordstroms, there appears to be low risk that the deal will be rejected due to uncertainty around financing, as happened in the recent takeover attempt of Macy's.

As an offer has been widely anticipated, Nordstrom's shares have been trading close to the proposed price. The offer is being evaluated by a special committee of unaffiliated board members and must be approved by most of the outside shareholders. Given that we regard the price as low, we think there is a good chance that the committee will ask for an increase. In the Macy's situation, the final offer was 18% above the initial one. We are maintaining our Standard Capital Allocation Rating.

Nordstrom Earnings: Improving Results Boost Confidence in Strategy; Shares Attractive David Swartz, Senior Equity Analyst, 28 Aug 2024

We do not expect to make any material change to our $38.50 per share fair value estimate after no-moat Nordstrom's profitability eclipsed expectations. Aided by strong full-price sell-through, its 36.6% gross margin on net sales was its highest for a second quarter in many years and beat our forecast by 110 basis points. Although in the early stages, this result provides confidence that the firm's efficiency, merchandising, inventory management, and store opening plans are working. Nordstrom's shares rallied 7% in Aug. 27 postmarket trading but remain undervalued.

Nordstrom's second-quarter sales growth of 3.4% was very close to our 3.6% estimate. The period included one extra week of its annual anniversary sale compared with last year (included in our forecast). By brand, Nordstrom (66% of sales) and Rack (34%) posted sales increases of 0.9% and 8.8%, respectively, versus our estimates of 1.5% and 8%. Rack's comparable sales grew 4.1%, a solid result in a difficult market for apparel retail and an affirmation of the ongoing expansion of the concept (23 stores new stores in 2024).

Boosted by the gross margin performance, Nordstrom's 6.4% adjusted operating margin was 80 basis points above our estimate. This result excluded a one-time $54 million charge for a canceled fulfillment center project. Nordstrom has decided the facility is no longer needed due to other supply chain investments, including RFID inventory tracking. In addition, the firm is changing how it stores and accesses data in anticipation of artificial intelligence. We think these are prudent moves that can improve margins through better inventory management and pricing.

There was no update on any potential buyout by Erik and Pete Nordstrom. A special committee will evaluate any offer. Given our no-moat rating and the challenges facing apparel stores, we think the committee should consider any fair offer. We are maintaining our Standard Capital Allocation Rating.

Nordstrom Earnings: Solid Sales Performance but Disappointing Profitability; Shares Very Undervalued David Swartz, Senior Equity Analyst, 31 May 2024

Nordstrom showed progress on its sales initiatives in the first quarter, although some unusual factors negatively affected its gross margin. More importantly, the firm held to its full-year guidance for same-store sales of down 1% to up 2%, an EBIT margin of 3.5%-4%, and $1.65-$2.05 in earnings per share. As our forecast aligns with this outlook, we do not expect to make any material change to our $38.50 fair value estimate, leaving shares very undervalued. Although its results have been rocky since the pandemic, we think Nordstrom can reach its 6% operating margin goal in about two years.

Meanwhile, there was no update on the Nordstrom brothers' interest in taking the firm private. We believe that they are lining up financing and may bring an offer to the board. We view Nordstrom as a no-moat firm in a competitive industry but think that a deal at this time could undervalue the firm.

Nordstrom surpassed our 1% projection with 5% sales growth in the quarter. Full-price sales (63% of the total) rose 1% versus our negative 1% estimate, but Rack (37% of total) outperformed our 6% forecast with 14% growth. This result suggests a stronger contribution from new stores than in prior periods, which we think supports the aggressive Rack store expansion plan.

On the downside, although Nordstrom's operating expenses aligned with our forecast, its 31.6% gross margin on net sales missed our 33.2% estimate and was down from 33.8% last year. The shortfall was attributed to transitory factors, including the shift to cost accounting (higher inventory reserves), a supply chain theft, and reserves related to its loyalty program. While the result was a small operating loss (less than 1% of sales) and EPS of negative $0.24 (below our negative $0.09 forecast), the effect on full-year results should be minimal given that Nordstrom's gross margin should improve, and as the second (anniversary sale) and fourth (holiday) quarters are much more important drivers of profitability anyway.

Nordstrom: Value of Possible Acquisition by Insiders Depends on Price Offered; Shares Undervalued
David Swartz, Senior Equity Analyst, 18 Apr 2024

Confirming a recent media report, no-moat Nordstrom's board has formed a special committee to evaluate a possible offer by Erik and Pete Nordstrom to take the company private. According to a related 13D filing, Erik (CEO) and Pete (president) are acting as trustees for their elderly father and largest shareholder, Bruce Nordstrom. As a group, members of the family own about 30% of the company. Thus far, no offer price has been reported, and funding has not been arranged. The latter could be a roadblock given the current higher interest rates. More importantly, as Nordstrom's shares trade at about half our per-share $38.50 fair value estimate, we are concerned that an offer price may not provide full value to shareholders. About six years ago, the Nordstrom family proposed taking the company private at a much-higher price of $50 per share, but the offer was rejected by the board due to funding uncertainty and concern that the offer was too low.

As suggested by its underwhelming stock price, Nordstrom's sales and profitability have not recovered well from the pandemic. Among other problems, it has exited Canada, closed full-price stores in the US, and posted weak adjusted operating margins below 4%. Consequently, its average yearly adjusted EBITDA over the past three fiscal years was about 27% lower than in the three years before the pandemic. Moreover, the outlook for 2024 is not strong; we forecast $1.82 in adjusted EPS, down from $2.12 in 2023. Given these problems, it is understandable that the Nordstroms may want to take the company private to implement their efficiency and growth plans, including the rollout of Rack stores, away from the pressures of being a public company. However, we believe that Nordstrom's sales and operating margins will improve in 2025 so it would be unfair to shareholders if the insiders buy the company at a valuation that we believe is only temporarily depressed. For now, we are maintaining our Standard Capital Allocation Rating.

Nordstrom Earnings: Signs of Progress but Outlook for 2024 Disappoints; Shares Attractive David Swartz, Senior Equity Analyst, 6 Mar 2024

Although no-moat Nordstrom's fourth-quarter sales and adjusted profitability surpassed our expectations, its shares slid 9% in aftermarket trading on March 5 as its 2024 guidance was underwhelming. Like some peers in the retail space (including no-moat Macy's), Nordstrom anticipates weak consumer demand for apparel, especially in the first half of the year. Given this outlook, we expect to lower our $40 per share fair value estimate by a mid-single-digit percentage. Even so, there are signs of progress at the company, including in its inventory control (down 3%), logistics, and costs.

Nordstrom's 2.2% sales increase in the quarter beat our 0.6% estimate. However, there was a sizable split by segment, as off-price sales increased nearly 15% but full-price sales fell 3%. While Rack's performance benefited from store openings (19 in 2023), an extra week of sales, and an easy comparison, it also reflects improved customer traffic and merchandising. On the other hand, Nordstrom's full-price business, which still makes up about two thirds of its sales, is struggling. Improving results in this segment is Nordstrom's top priority for 2024, but few specific strategies have been revealed apart from the launch of an online marketplace in April.

Nordstrom's 34.4% gross margin on net sales in the quarter was an improvement of 125 basis points over the prior year, but was short of our 35.3% estimate. We think the firm can lift its gross margin to 36% within about two years through better management of its inventory and supply chain, but this improvement will also require more consistent sales growth from each of its two banners. Further, Nordstrom posted a 5.7% adjusted operating margin, beating our forecast by 40 basis points on sales leverage and its efficiency efforts. We think the firm can raise its operating margin above 6% in the medium term, but do not believe that it will reach historical highs due to intense competition in apparel and beauty retail.

Nordstrom: Moat Rating Downgraded to None as Retail Competition Intensifies; Shares Attractive

David Swartz, Senior Equity Analyst, 22 Feb 2024

We are adjusting our moat rating on Nordstrom to none from narrow as we no longer believe it has a competitive advantage based on a brand intangible asset. The company operates the largest US luxury department store company by sales, and Rack is one of the larger off-price concepts in the market. As such, we have historically believed it had an advantage over other traditional department stores like Macy's and Kohl's, both rated as no-moat. However, recent financial results suggest that the market forces, such wide-moat Amazon's apparel offerings, that have drawn sales from traditional department stores are negatively impacting Nordstrom, as well. Over the past decade or so, its operating margins have declined to the midsingle digits from the low double digits as its sales growth has been inconsistent and its selling, general, and administrative costs have risen to about 34% of net sales from less than 28% prior to 2015. While its management often discusses various solutions to its problems, we anticipate significant spending will be needed to contend with the competitive threats to both of its nameplates.

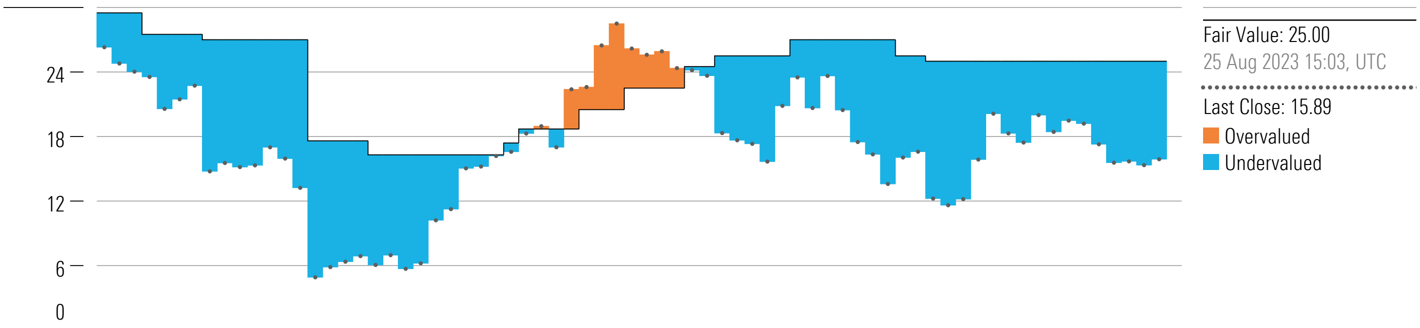
Despite the change in our moat rating, we are holding our fair value estimate on Nordstrom's shares at $40 as the impact of the change on our 10-year discounted cash flow model is minimal. Thus, we believe shares are attractive at current levels. We anticipate Nordstrom will return to a consistent low-single-digit sales growth and 6% operating margins (up from about 4% at present) within two years as macroeconomic concerns fade and it realizes the benefits of its key initiatives of improving Rack's performance, optimizing its supply chain, and managing its inventory more efficiently. In addition, Nordstrom offers a 4% dividend yield, which we believe is safe. We forecast its debt/adjusted EBITDA will decline below the targeted 2.5 times by the end of 2024 due to EBITDA growth and debt reduction, and that share repurchases will resume in 2025.

Morningstar Equity Analyst Report | Report as of 27 Nov 2024 12:15, UTC | Reporting Currency: USD | Trading Currency: USD | Exchange: NEW YORK STOCK EXCHANGE, INC. Page 14 of 24

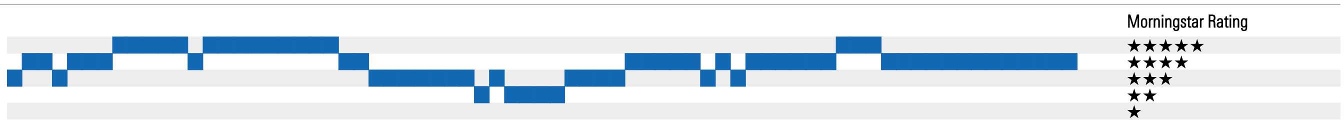
Nordstrom Inc JWN ★★★★ 26 Nov 2024 22:39, UTC

Competitors Price vs. Fair Value

Macy's Inc M

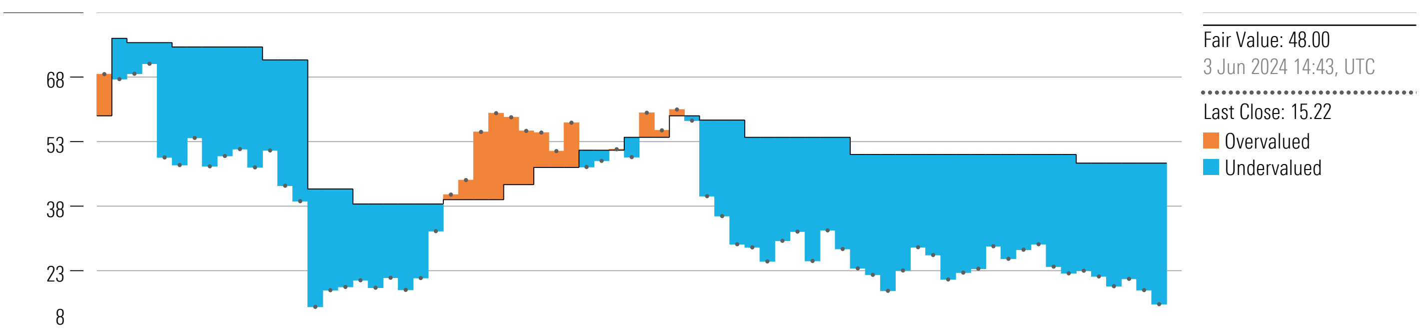


	2019	2020	2021	2022	2023	YTD	
	0.63	0.69	1.16	0.76	0.80	0.64	Price/Fair Value
	-37.84	-31.60	135.38	-18.72	0.64	-18.43	Total Return %

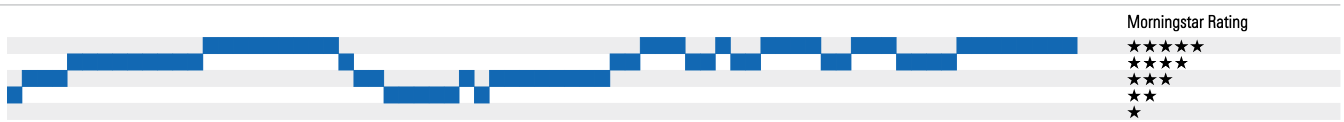


Total Return % as of 26 Nov 2024. Last Close as of 26 Nov 2024. Fair Value as of 25 Aug 2023 15:03, UTC.

Kohl's Corp KSS



	2019	2020	2021	2022	2023	YTD	
	0.71	1.03	0.91	0.47	0.57	0.32	Price/Fair Value
	-19.16	-18.76	23.84	-44.83	21.50	-41.70	Total Return %



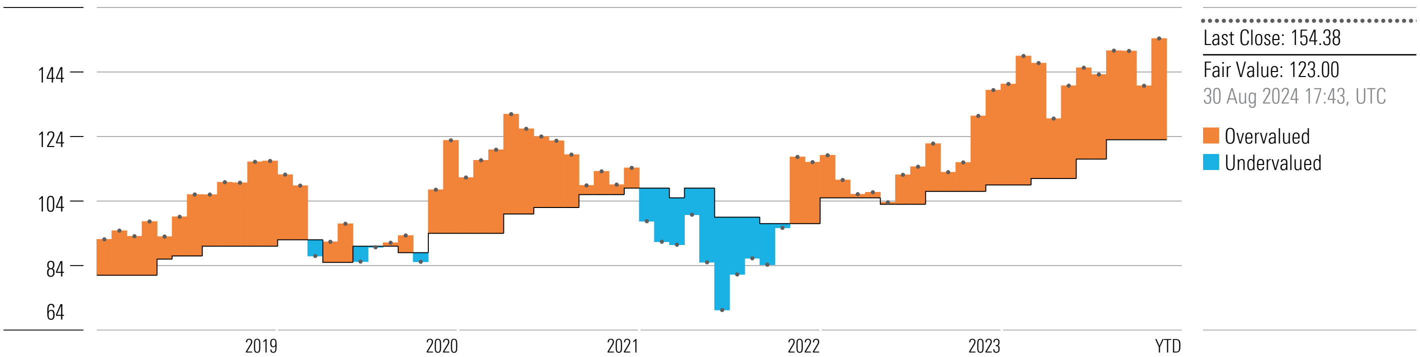
Total Return % as of 26 Nov 2024. Last Close as of 26 Nov 2024. Fair Value as of 3 Jun 2024 14:43, UTC.

Morningstar Equity Analyst Report | Report as of 27 Nov 2024 12:15, UTC | Reporting Currency: USD | Trading Currency: USD | Exchange: NEW YORK STOCK EXCHANGE, INC. Page 15 of 24

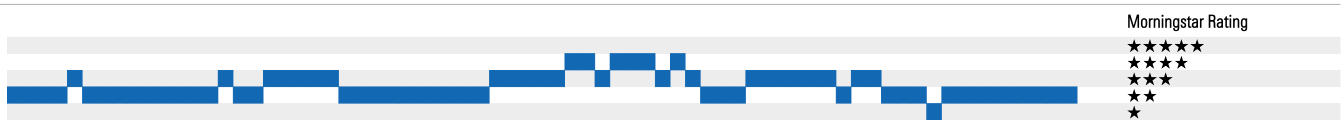
Nordstrom Inc JWN ★★★★ 26 Nov 2024 22:39, UTC

Competitors Price vs. Fair Value

Ross Stores Inc ROST



	2019	2020	2021	2022	2023	YTD
Price/Fair Value	1.29	1.31	1.06	1.20	1.27	1.26
Total Return %	41.15	5.73	-6.02	2.65	20.38	12.35



Total Return % as of 26 Nov 2024. Last Close as of 26 Nov 2024. Fair Value as of 30 Aug 2024 17:43, UTC.

Morningstar Equity Analyst Report | Report as of 27 Nov 2024 12:15, UTC | Reporting Currency: USD | Trading Currency: USD | Exchange: NEW YORK STOCK EXCHANGE, INC. Page 16 of 24

Nordstrom Inc JWN ★★★★ 26 Nov 2024 22:39, UTC

Last Price	Fair Value Estimate	Price/FVE	Market Cap	Economic Moat™	Equity Style Box	Uncertainty	Capital Allocation	ESG Risk Rating Assessment[1]
24.62 USD 26 Nov 2024	38.50 USD 28 Mar 2024 21:08, UTC	0.64	4.04 USD Bil 26 Nov 2024	None	Small Value	Very High	Standard	6 Nov 2024 06:00, UTC

Morningstar Historical Summary

Financials as of 31 Jul 2024

Fiscal Year, ends 31 Jan	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	YTD	TTM
Revenue (USD Bil)	13	14	14	15	15	16	16	11	15	16	7	15
Revenue Growth %	3.4	7.7	6.9	2.2	4.9	2.5	-2.1	-31.0	38.0	5.0	4.0	1.0
EBITDA (USD Mil)	1,805	1,832	1,677	1,451	1,597	1,521	1,648	-205	1,283	1,264	581	1,316
EBITDA Margin %	14.4	13.6	11.6	9.8	10.3	9.6	10.6	-1.9	8.7	8.1	8.0	8.8
Operating Income (USD Mil)	1,350	1,323	1,101	1,002	926	837	784	-1,047	492	465	169	462
Operating Margin %	10.8	9.8	7.6	6.8	6.0	5.3	5.1	-9.8	3.3	3.0	2.3	3.1
Net Income (USD Mil)	734	720	600	354	437	564	496	-690	178	245	83	284
Net Margin %	5.9	5.3	4.2	2.4	2.8	3.6	3.2	-6.4	1.2	1.6	1.2	1.9
Diluted Shares Outstanding (Mil)	198	194	190	176	169	170	156	157	163	162	167	166
Diluted Earnings Per Share (USD)	3.71	3.72	3.15	2.02	2.59	3.32	3.18	-4.39	1.10	1.51	0.49	1.73
Dividends Per Share (USD)	1.20	1.32	1.48	1.48	1.48	1.48	1.48	0.37	0.00	0.76	0.38	0.76

Valuation as of 31 Oct 2024

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Recent Qtr	TTM
Price/Sales	1.2	0.7	0.6	0.5	0.5	0.4	0.4	0.3	0.2	0.2	0.3	0.3
Price/Earnings	21.1	14.3	25.9	16.6	17.0	12.0	-9.3	322.6	8.0	24.9	13.0	13.1
Price/Cash Flow	13.8	3.9	5.4	5.9	5.5	5.3	21.2	9.8	4.0	3.7	5.5	5.5
Dividend Yield %	1.66	2.97	3.09	3.12	3.18	3.62	2.37	—	4.71	4.12	3.38	3.36
Price/Book	6.6	6.5	9.7	9.2	6.5	7.5	19.5	10.0	4.3	4.1	3.9	3.9
EV/EBITDA	9.9	6.1	6.3	6.9	5.9	7.0	5.8	-40.1	5.5	5.6	0.0	0.0

Operating Performance / Profitability as of 31 Jul 2024

Fiscal Year, ends 31 Jan	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	YTD	TTM
ROA %	8.8	8.1	7.1	4.6	5.5	7.0	5.6	-7.2	1.9	2.8	1.0	3.3
ROE %	36.8	31.9	36.2	40.7	47.3	61.0	53.6	-107	40.2	37.1	9.2	35.0
ROIC %	16.3	14.9	14.6	11.7	14.6	17.7	12.2	-9.9	6.6	6.4	2.3	7.0
Asset Turnover	1.5	1.5	1.7	1.9	1.9	2.0	1.8	1.1	1.6	1.8	0.8	1.7

Financial Leverage

Fiscal Year, ends 31 Jan	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023	Recent Qtr	TTM
Debt/Capital %	59.9	56.1	76.2	76.1	73.3	75.4	82.3	93.6	88.4	85.6	80.8	—
Equity/Assets %	24.3	26.4	11.3	11.1	12.0	11.1	10.1	3.2	6.6	8.5	11.0	—
Total Debt/EBITDA	1.7	1.7	1.7	1.9	1.7	1.8	2.9	-25.4	3.6	3.7	7.3	—
EBITDA/Interest Expense	11.1	13.2	13.4	11.9	11.3	12.8	14.7	-1.1	5.2	9.2	8.5	9.7

Morningstar Analyst Historical/Forecast Summary as of 03 Sep 2024

Financials

			Estimates		
Fiscal Year, ends 3 Feb 2024	2023	2024	2025	2026	2027
Revenue (USD Mil)	15,530	14,693	14,805	15,101	15,409
Revenue Growth %	5.0	-5.4	0.8	2.0	2.0
EBITDA (USD Mil)	1,034	1,084	1,039	1,147	1,322
EBITDA Margin %	6.7	7.4	7.0	7.6	8.6
Operating Income (USD Mil)	465	535	491	588	752
Operating Margin %	3.0	3.6	3.3	3.9	4.9
Net Income (USD Mil)	274	347	320	356	480
Net Margin %	1.8	2.4	2.2	2.4	3.1
Diluted Shares Outstanding (Mil)	162	163	167	166	160
Diluted Earnings Per Share(USD)	1.69	2.12	1.91	2.15	3.00
Dividends Per Share(USD)	0.00	0.76	0.76	0.76	0.84

Forward Valuation

			Estimates		
	2023	2024	2025	2026	2027
Price/Sales	0.2	0.2	0.3	0.3	0.3
Price/Earnings	11.5	9.9	12.9	11.5	8.2
Price/Cash Flow	—	—	—	—	—
Dividend Yield %	—	3.6	3.1	3.1	3.4
Price/Book	4.3	4.0	4.1	3.5	3.1
EV/EBITDA	7.3	6.5	7.3	6.6	5.7

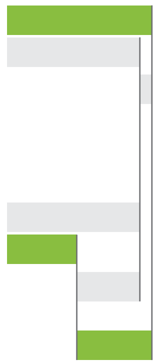
Morningstar Equity Analyst Report | Report as of 27 Nov 2024 12:15, UTC | Reporting Currency: USD | Trading Currency: USD | Exchange: NEW YORK STOCK EXCHANGE, INC. Page 17 of 24

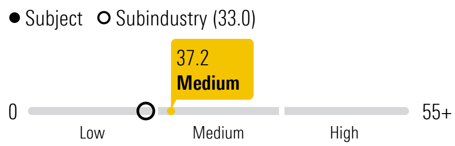
Nordstrom Inc JWN ★★★★ 26 Nov 2024 22:39, UTC

Last Price	Fair Value Estimate	Price/FVE	Market Cap	Economic Moat™	Equity Style Box	Uncertainty	Capital Allocation	ESG Risk Rating Assessment[1]
24.62 USD 26 Nov 2024	38.50 USD 28 Mar 2024 21:08, UTC	0.64	4.04 USD Bil 26 Nov 2024	None	Small Value	Very High	Standard	6 Nov 2024 06:00, UTC

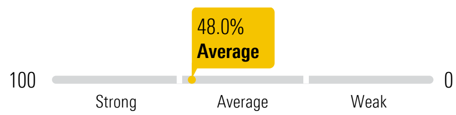
ESG Risk Rating Breakdown

Exposure	
Company Exposure[1]	37.2
– Manageable Risk	34.1
Unmanageable Risk[2]	**3.0**
Management	
Manageable Risk	34.1
– Managed Risk[3]	16.4
Management Gap[4]	**17.8**
Overall Unmanaged Risk	**20.8**



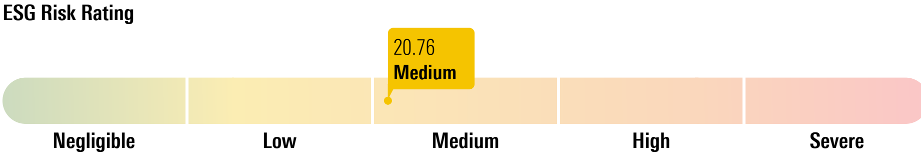


- Exposure represents a company's vulnerability to ESG risks driven by their business model
- Exposure is assessed at the Subindustry level and then specified at the company level
- Scoring ranges from 0-55+ with categories of low, medium, and high-risk exposure



- Management measures a company's ability to manage ESG risks through its commitments and actions
- Management assesses a company's efficiency on ESG programs, practices, and policies
- Management score ranges from 0-100% showing how much manageable risk a company is managing

ESG Risk Rating



ESG Risk Ratings measure the degree to which a company's value is impacted by environmental, social, and governance risks, by evaluating the company's ability to manage the ESG risks it faces.

1. A company's Exposure to material ESG issues 2. Unmanageable Risk refers to risks that are inherent to a particular business model that cannot be managed by programs or initiatives 3. Managed Risk = Manageable Risk multiplied by a Management score of 48.0% 4. Management Gap assesses risks that are not managed, but are considered manageable 5. ESG Risk Rating Assessment = Overall Unmanaged Risk = Management Gap plus Unmanageable Risk

ESG Risk Rating Assessment[5]

ESG Risk Rating is of Nov 06, 2024. Highest Controversy Level is as of Nov 08, 2024. Sustainalytics Subindustry: Department Stores. Sustainalytics provides Morningstar with company ESG ratings and metrics on a monthly basis and as such, the ratings in Morningstar may not necessarily reflect current Sustainalytics' scores for the company. For the most up to date rating and more information, please visit: sustainalytics.com/esg-ratings/.

Peer Analysis 06 Nov 2024

Peers are selected from the company's Sustainalytics-defined Subindustry and are displayed based on the closest market cap values

Company Name	Exposure			Management			ESG Risk Rating		
Nordstrom Inc	37.2 | Medium	0	55+	48.0 | Average	100	0	20.8 | Medium	0	40+
Macy's Inc	37.8 | Medium	0	55+	49.8 | Average	100	0	20.6 | Medium	0	40+
Kohl's Corp	34.6 | Low	0	55+	51.7 | Strong	100	0	18.1 | Low	0	40+
Ross Stores Inc	26.3 | Low	0	55+	38.9 | Average	100	0	17.0 | Low	0	40+
TJX Companies Inc	27.2 | Low	0	55+	47.7 | Average	100	0	15.5 | Low	0	40+

Morningstar Equity Analyst Report | Report as of 27 Nov 2024 12:15, UTC | Reporting Currency: USD | Trading Currency: USD | Exchange: NEW YORK STOCK EXCHANGE, INC. Page 18 of 24

Appendix
Historical Morningstar Rating

Nordstrom Inc JWN 26 Nov 2024 22:39, UTC

Dec 2024 —	Nov 2024 ★★★★	Oct 2024 ★★★★	Sep 2024 ★★★★	Aug 2024 ★★★★	Jul 2024 ★★★★	Jun 2024 ★★★★	May 2024 ★★★★	Apr 2024 ★★★★★	Mar 2024 ★★★★	Feb 2024 ★★★★	Jan 2024 ★★★★★
Dec 2023 ★★★★★	Nov 2023 ★★★★★	Oct 2023 ★★★★★	Sep 2023 ★★★★★	Aug 2023 ★★★★★	Jul 2023 ★★★★	Jun 2023 ★★★★★	May 2023 ★★★★★	Apr 2023 ★★★★★	Mar 2023 ★★★★★	Feb 2023 ★★★★	Jan 2023 ★★★★★
Dec 2022 ★★★★★	Nov 2022 ★★★★	Oct 2022 ★★★★★	Sep 2022 ★★★★★	Aug 2022 ★★★★★	Jul 2022 ★★★★★	Jun 2022 ★★★★★	May 2022 ★★★★★	Apr 2022 ★★★★	Mar 2022 ★★★★	Feb 2022 ★★★★★	Jan 2022 ★★★★★
Dec 2021 ★★★★★	Nov 2021 ★★★★★	Oct 2021 ★★★★	Sep 2021 ★★★★	Aug 2021 ★★★	Jul 2021 ★★★	Jun 2021 ★★★	May 2021 ★★★	Apr 2021 ★★★	Mar 2021 ★★★	Feb 2021 ★★★	Jan 2021 ★★★
Dec 2020 ★★★	Nov 2020 ★★★★	Oct 2020 ★★★★★	Sep 2020 ★★★★★	Aug 2020 ★★★★★	Jul 2020 ★★★★★	Jun 2020 ★★★★★	May 2020 ★★★★★	Apr 2020 ★★★★★	Mar 2020 ★★★★★	Feb 2020 ★★★★	Jan 2020 ★★★★
Dec 2019 ★★★★	Nov 2019 ★★★★	Oct 2019 ★★★★	Sep 2019 ★★★★	Aug 2019 ★★★★★	Jul 2019 ★★★★★	Jun 2019 ★★★★★	May 2019 ★★★★★	Apr 2019 ★★★★	Mar 2019 ★★★★	Feb 2019 ★★★★	Jan 2019 ★★★★

Macy's Inc M 26 Nov 2024 22:40, UTC

Dec 2024 —	Nov 2024 ★★★★	Oct 2024 ★★★★	Sep 2024 ★★★★	Aug 2024 ★★★★	Jul 2024 ★★★★	Jun 2024 ★★★★	May 2024 ★★★★	Apr 2024 ★★★★	Mar 2024 ★★★★	Feb 2024 ★★★★	Jan 2024 ★★★★
Dec 2023 ★★★★	Nov 2023 ★★★★	Oct 2023 ★★★★★	Sep 2023 ★★★★★	Aug 2023 ★★★★★	Jul 2023 ★★★★	Jun 2023 ★★★★	May 2023 ★★★★	Apr 2023 ★★★★	Mar 2023 ★★★★	Feb 2023 ★★★★	Jan 2023 ★★★
Dec 2022 ★★★★	Nov 2022 ★★★	Oct 2022 ★★★★	Sep 2022 ★★★★	Aug 2022 ★★★★	Jul 2022 ★★★★	Jun 2022 ★★★★	May 2022 ★★★	Apr 2022 ★★★	Mar 2022 ★★★	Feb 2022 ★★★	Jan 2022 ★★
Dec 2021 ★★	Nov 2021 ★★	Oct 2021 ★★	Sep 2021 ★★★	Aug 2021 ★★	Jul 2021 ★★★	Jun 2021 ★★★	May 2021 ★★★	Apr 2021 ★★★	Mar 2021 ★★★	Feb 2021 ★★★	Jan 2021 ★★★
Dec 2020 ★★★★	Nov 2020 ★★★★	Oct 2020 ★★★★★	Sep 2020 ★★★★★	Aug 2020 ★★★★★	Jul 2020 ★★★★★	Jun 2020 ★★★★★	May 2020 ★★★★★	Apr 2020 ★★★★★	Mar 2020 ★★★★★	Feb 2020 ★★★★★	Jan 2020 ★★★★
Dec 2019 ★★★★★	Nov 2019 ★★★★★	Oct 2019 ★★★★★	Sep 2019 ★★★★★	Aug 2019 ★★★★★	Jul 2019 ★★★★	Jun 2019 ★★★★	May 2019 ★★★★	Apr 2019 ★★★	Mar 2019 ★★★★	Feb 2019 ★★★★	Jan 2019 ★★★

Kohl's Corp KSS 26 Nov 2024 22:40, UTC

Dec 2024 —	Nov 2024 ★★★★★	Oct 2024 ★★★★★	Sep 2024 ★★★★★	Aug 2024 ★★★★★	Jul 2024 ★★★★★	Jun 2024 ★★★★★	May 2024 ★★★★★	Apr 2024 ★★★★★	Mar 2024 ★★★★	Feb 2024 ★★★★	Jan 2024 ★★★★
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Morningstar Equity Analyst Report | Report as of 27 Nov 2024 12:15, UTC | Reporting Currency: USD | Trading Currency: USD | Exchange: NEW YORK STOCK EXCHANGE, INC. Page 19 of 24

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Dec 2024 —	Nov 2024 ★★	Oct 2024 ★★	Sep 2024 ★★	Aug 2024 ★★	Jul 2024 ★★	Jun 2024 ★★	May 2024 ★★	Apr 2024 ★★	Mar 2024 ★★	Feb 2024 ★	Jan 2024 ★★
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Research Methodology for Valuing Companies

Overview

At the heart of our valuation system is a detailed projection of a company's future cash flows, resulting from our analysts' research. Analysts create custom industry and company assumptions to feed income statement, balance sheet, and capital investment assumptions into our globally standardized, proprietary discounted cash flow, or DCF, modeling templates. We use scenario analysis, indepth competitive advantage analysis, and a variety of other analytical tools to augment this process. Moreover, we think analyzing valuation through discounted cash flows presents a better lens for viewing cyclical companies, high-growth firms, businesses with finite lives (e.g., mines), or companies expected to generate negative earnings over the next few years. That said, we don't dismiss multiples altogether but rather use them as supporting cross-checks for our DCF-based fair value estimates. We also acknowledge that DCF models offer their own challenges (including a potential proliferation of estimated inputs and the possibility that the method may miss shortterm market-price movements), but we believe these negatives are mitigated by deep analysis and our longterm approach.

Morningstar's equity research group ("we," "our") believes that a company's intrinsic worth results from the future cash flows it can generate. The Morningstar Rating for stocks identifies stocks trading at a discount or premium to their intrinsic worth—or fair value estimate, in Morningstar terminology. Five-star stocks sell for the biggest risk adjusted discount to their fair values, whereas 1-star stocks trade at premiums to their intrinsic worth.

Four key components drive the Morningstar rating: (1) our assessment of the firm's economic moat, (2) our estimate of the stock's fair value, (3) our uncertainty around that fair value estimate and (4) the current market price. This process ultimately culminates in our singlepoint star rating.

1. Economic Moat

The concept of an economic moat plays a vital role not only in our qualitative assessment of a firm's long-term investment potential, but also in the actual calculation of our fair value estimates. An economic moat is a structural feature that allows a firm to sustain excess profits over a long period of time. We define economic profits as returns on invested capital (or ROIC) over and above our estimate of a firm's cost of capital, or weighted average cost of capital (or WACC). Without a moat, profits are more susceptible to competition. We have identified five sources of economic moats: intangible assets, switching costs, network effect, cost advantage, and efficient scale.

Companies with a narrow moat are those we believe are more likely than not to achieve normalized excess returns for at least the next 10 years. Wide-moat companies are those in which we have very high confidence that excess returns will remain for 10 years, with excess returns more likely than not to remain for at least 20 years. The longer a firm generates economic profits, the higher its intrinsic value. We believe low-quality, no-moat companies will see their normalized returns gravitate toward the firm's cost of capital more quickly than companies with moats.

When considering a company's moat, we also assess whether there is a substantial threat of value destruction, stemming from risks related to ESG, industry disruption, financial health, or other idiosyncratic issues. In this context, a risk is considered potentially value destructive if its occurrence would eliminate a firm's economic profit on a cumulative or midcycle basis. If we deem the probability of occurrence sufficiently high, we would not characterize the company as possessing an economic moat.

2. Estimated Fair Value

Combining our analysts' financial forecasts with the firm's economic moat helps us assess how long returns on invested capital are likely to exceed the firm's cost of capital. Returns of firms with a wide economic moat rating are assumed to fade to the perpetuity period over a longer period of time than the returns of narrow-moat firms, and both will fade slower than no-moat firms, increasing our estimate of their intrinsic value.

Our model is divided into three distinct stages:

Stage I: Explicit Forecast

In this stage, which can last five to 10 years, analysts make full financial statement forecasts, including items such as revenue, profit margins, tax rates, changes in workingcapital accounts, and capital spending. Based on these projections, we calculate earnings before interest, after taxes (EBI) and the net new investment (NNI) to derive our annual free cash flow forecast.

Stage II: Fade

The second stage of our model is the period it will take the company's return on new invested capital—the return on capital of the next dollar invested ("RONIC")—to decline (or rise) to its cost of capital. During the Stage II period, we use a formula to approximate cash flows in lieu of explicitly modeling the income statement, balance sheet, and cash flow statement as we do in Stage I. The length of the second stage depends on the strength of the company's economic moat. We forecast this period to last anywhere from one year (for companies with no economic moat) to 10–15 years or more (for wide-moat companies). During this period, cash flows are forecast using four assumptions: an average growth rate for EBI over the period, a normalized investment rate, average return on new invested capital (RONIC), and the number of years until perpetuity, when excess returns cease. The investment rate and return on new invested capital decline until a perpetuity value is calculated. In the case of firms that do not earn their cost of capital, we assume marginal ROICs rise to the firm's cost of capital (usually attributable to less reinvestment), and we may truncate the second stage.

Stage III: Perpetuity

Once a company's marginal ROIC hits its cost of capital, we calculate a continuing value, using a standard perpetuity formula. At perpetuity, we assume that any growth or decline or investment in the business neither creates nor destroys value and that any new investment provides a return in line with estimated WACC.

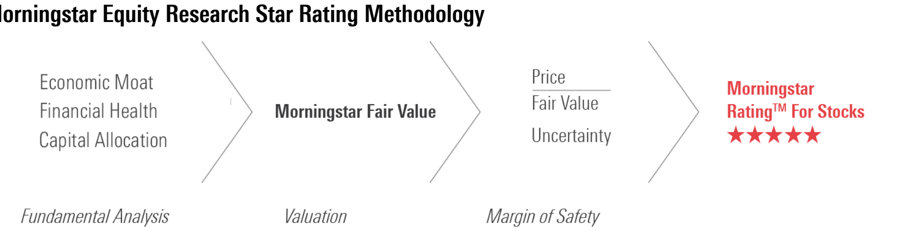
Because a dollar earned today is worth more than a dollar earned tomorrow, we discount our projections of cash flows in stages I, II, and III to arrive at a total present value of expected future cash flows. Because we are modeling free cash flow to the firm—representing cash available to provide a return to all capital providers—we discount future cash flows using the WACC, which is a weighted average of the costs of equity, debt, and preferred stock (and any other funding sources), using expected future proportionate long-term, market-value weights.

3. Uncertainty Around That Fair Value Estimate

Morningstar's Uncertainty Rating is designed to capture the range of potential outcomes for a company's intrinsic value. This rating is used to assign the margin of safety required before investing, which in turn explicitly drives our stock star rating system. The Uncertainty Rating is aimed at identifying the confidence we should have in assigning a fair value estimate for a given stock.

Our Uncertainty Rating is meant to take into account anything that can increase the potential dispersion of future outcomes for the intrinsic value of a company, and any-

Morningstar Equity Research Star Rating Methodology



Morningstar Equity Analyst Report | Report as of 27 Nov 2024 12:15, UTC | Reporting Currency: USD | Trading Currency: USD | Exchange: NEW YORK STOCK EXCHANGE, INC.

Research Methodology for Valuing Companies

thing that can affect our ability to accurately predict these outcomes. The rating begins with a suggested rating produced by a quantitative process based on the trailing 12-month standard deviation of daily stock returns. An analyst overlay is then applied, with analysts using the suggested rating, historical rating data, and their own knowledge of the company to inform them as they make the final Uncertainty Rating decision. Ultimately, the rating decision rests with the analyst. Analysts take into account many characteristics when making their final decision, including cyclical factors, operational and financial factors such as leverage, company-specific events, ESG risks, and anything else that might increase the potential dispersion of future outcomes and our ability to estimate those outcomes.

Our recommended margin of safety—the discount to fair value demanded before we'd recommend buying or selling the stock—widens as our uncertainty of the estimated value of the equity increases. The more uncertain we are about the potential dispersion of outcomes, the greater the discount we require relative to our estimate of the value of the firm before we would recommend the purchase of the shares. In addition, the Uncertainty Rating provides guidance in portfolio construction based on risk tolerance.

Our Uncertainty Ratings are: Low, Medium, High, Very High, and Extreme.

	Margin of Safety	
Qualitative Analysis Uncertainty Ratings	★★★★★Rating	★Rating
Low	20% Discount	25% Premium
Medium	30% Discount	35% Premium
High	40% Discount	55% Premium
Very High	50% Discount	75% Premium
Extreme	75% Discount	300% Premium

Our uncertainty rating is based on the interquartile range, or the middle 50% of potential outcomes, covering the 25th percentile–75th percentile. This means that when a stock hits 5 stars, we expect there is a 75% chance that the intrinsic value of that stock lies above the current market price. Similarly, when a stock hits 1 star, we expect there is a 75% chance that the intrinsic value of that stock lies below the current market price.

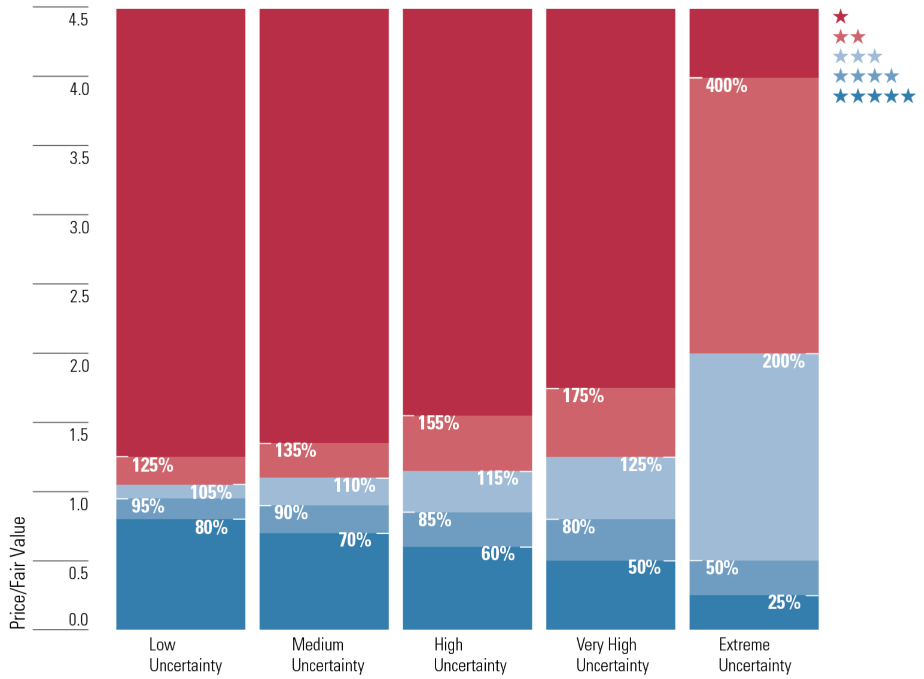
4. Market Price

The market prices used in this analysis and noted in the report come from exchange on which the stock is listed which we believe is a reliable source.

For more details about our methodology, please go to https://shareholders.morningstar.com

Morningstar Star Rating for Stocks

Morningstar Equity Research Star Rating Methodology



Once we determine the fair value estimate of a stock, we compare it with the stock's current market price on a daily basis, and the star rating is automatically re-calculated at the market close on every day the market on which the stock is listed is open. Our analysts keep close tabs on the companies they follow, and, based on thorough and ongoing analysis, raise or lower their fair value estimates as warranted.

Please note, there is no predefined distribution of stars. That is, the percentage of stocks that earn 5 stars can fluctuate daily, so the star ratings, in the aggregate, can serve as a gauge of the broader market's valuation. When there are many 5-star stocks, the stock market as a whole is more undervalued, in our opinion, than when very few companies garner our highest rating.

We expect that if our base-case assumptions are true the market price will converge on our fair value estimate over time generally within three years (although it is impossible to predict the exact time frame in which market prices may adjust).

Our star ratings are guideposts to a broad audience and individuals must consider their own specific investment goals, risk tolerance, tax situation, time horizon, income needs, and complete investment portfolio, among other factors.

The Morningstar Star Ratings for stocks are defined below:

★★★★★ We believe appreciation beyond a fair risk adjusted return is highly likely over a multiyear time frame. Scenario analysis developed by our analysts indicates that the current market price represents an excessively pessimistic outlook, limiting downside risk and maximizing upside potential.

★★★★ We believe appreciation beyond a fair risk-adjusted return is likely.

★★★ Indicates our belief that investors are likely to receive a fair risk-adjusted return (approximately cost of equity).

★★ We believe investors are likely to receive a less than fair risk-adjusted return.

★ Indicates a high probability of undesirable risk-adjusted returns from the current market price over a multiyear time frame, based on our analysis. Scenario analysis by our analysts indicates that the market is pricing in an excessively optimistic outlook, limiting upside potential and leaving the investor exposed to Capital loss.

Other Definitions

Last Price: Price of the stock as of the close of the market of the last trading day before date of the report.

Capital Allocation Rating: Our Capital Allocation (or Stewardship) Rating represents our assessment of the quality of management's capital allocation, with particular emphasis on the firm's balance sheet, investments, and shareholder distributions. Analysts consider compan-

Research Methodology for Valuing Companies

ies' investment strategy and valuation, balance sheet management, and dividend and share buyback policies. Corporate governance factors are only considered if they are likely to materially impact shareholder value, though either the balance sheet, investment, or shareholder distributions. Analysts assign one of three ratings: "Exemplary", "Standard", or "Poor". Analysts judge Capital Allocation from an equity holder's perspective. Ratings are determined on a forward looking and absolute basis. The Standard rating is most common as most managers will exhibit neither exceptionally strong nor poor capital allocation.

Capital Allocation (or Stewardship) analysis published prior to Dec. 9, 2020, was determined using a different process. Beyond investment strategy, financial leverage, and dividend and share buyback policies, analysts also considered execution, compensation, related party transactions, and accounting practices in the rating.

Capital Allocation Rating: Our Capital Allocation (or Stewardship) Rating represents our assessment of the quality of management's capital allocation, with particular emphasis on the firm's balance sheet, investments, and shareholder distributions. Analysts consider companies' investment strategy and valuation, balance sheet management, and dividend and share buyback policies. Corporate governance factors are only considered if they are likely to materially impact shareholder value, though either the balance sheet, investment, or shareholder distributions. Analysts assign one of three ratings: "Exemplary", "Standard", or "Poor". Analysts judge Capital Allocation from an equity holder's perspective. Ratings are determined on a forward looking and absolute basis. The Standard rating is most common as most managers will exhibit neither exceptionally strong nor poor capital allocation.

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Sustainalytics ESG Risk Rating Assessment: The ESG Risk Rating Assessment is provided by Sustainalytics; a Morningstar company.

Sustainalytics' ESG Risk Ratings measure the degree to which company's economic value at risk is driven by environment, social and governance (ESG) factors.

Sustainalytics analyzes over 1,300 data points to assess a company's exposure to and management of ESG risks. In other words, ESG Risk Ratings measures a company's unmanaged ESG Risks represented as a quantitative score. Unmanaged Risk is measured on an open-ended scale starting at zero (no risk) with lower scores representing less unmanaged risk and, for 95% of cases, the unmanaged ESG Risk score is below 50.

Based on their quantitative scores, companies are grouped into one of five Risk Categories (negligible, low, medium, high, severe). These risk categories are absolute, meaning that a 'high risk' assessment reflects a comparable degree of unmanaged ESG risk across all subindustries covered.

The ESG Risk Rating Assessment is a visual representation of Sustainalytics ESG Risk Categories on a 1 to 5 scale. Companies with Negligible Risk = 5 Globes, Low Risk = 4, Medium Risk = 3 Globes, High Risk = 2 Globes, Severe Risk = 1 Globe. For more information, please visit sustainalytics.com/esg-ratings/

Ratings should not be used as the sole basis in evaluating a company or security. Ratings involve unknown risks and uncertainties which may cause our expectations not to occur or to differ significantly from what was expected and should not be considered an offer or solicitation to buy or sell a security.

Risk Warning

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