BJ's Wholesale Club, Inc. (BJ)
Capitalizing on the Perfect Storm, Driving Long-Term Shareholder Value

Reiterate Outperform rating. 1Q was a blow-out quarter (merchandise comps +27%; EPS +165%), and key fundamental trends remain robust QTD (comps >20%, healthy new member signup pace). While BJ is clearly benefiting from the COVID-19 pandemic, we see several long-lasting benefits from this "perfect storm" (accelerated new member signups, access to new vendors, potential real estate opportunities, capital allocation optionality given cash flow windfall). When combined with BJ's defensive positioning in a recessionary environment, we continue to like the risk/reward at ~9x EBITDA. Raising estimates, price target goes to $40.

- **Blow-out quarter.** Robust merchandise comps (+27% vs. +10%E) and strong MFI resulted in EPS of $0.69 (vs. our/Street's $0.38E/$0.36E). While outsized gas profits helped (~$0.17/sh), higher bonus accruals represented a similarly-sized headwind.

- **Comps remain robust QTD.** Merchandise comps were driven by strength in grocery (+33%) as general merchandise/services dipped 3%. Comps surged to +40% in March and remained robust in April (+23%). While trends will slow at some point, May to-date is running >20%. Looking ahead, we expect an elevated level of "base" demand to persist (given increased at-home consumption) and view BJ as particularly well positioned in a recessionary environment. Accordingly, we have increased our 2Q/3Q merchandise comp estimates to 10%/3% from 2%/2% (4Q remains +3%).

- **Digital traction encouraging.** Digital sales surged ~350% (~5% of sales vs. ~1.5% LY), with >75% of this growth driven by same-day delivery (up eight-fold) and BOPIC. With the rollout of curbside pickup and fresh BOPIC still in the early stages, we see an opportunity for BJ to further enhance credibility around same-day convenience and help drive increased engagement with members (particularly younger demographics).

- **Capitalizing on this unique member acquisition opportunity.** COVID-19 helped drive a ~40% increase in new members during 1Q, and signups have remained healthy 2Q to-date. With upgraded operating standards, improved systems, and new digital capabilities, BJ has the tools in place to cultivate these relationships and expand spend per member over time.

- **Pushing forward with assortment changes.** Strong sell-through of "center-store" grocery inventory has allowed BJ to accelerate various assortment changes within the category. Further, BJ is gaining access to new general merchandise vendors given the challenges facing certain retail sectors.

- **Capital allocation optionality.** Robust FCF generation ($435M vs. FY19's ~ $158M) allowed BJ to retire $330M in debt and end 1Q at ~1.9x net debt-to-EBITDA (vs. FY21 goal of 2.0x-2.5x). With prospects for continued strong FCF generation, BJ has plenty of capacity to fund accelerated investments in the business (including potential opportunistic real estate transactions) while also returning incremental capital to shareholders.

- **Raising estimates.** While BJ did not update its FY20 outlook, we are raising our go-forward estimates to account for stronger sales and increased new members signups. When combined with the 1Q beat, FY20E/FY21E EPS go to $2.15/$2.05 (from $1.69/$1.80). New $40 price target reflects ~10x FY21E EBITDA.

BJ's operates 218 warehouse clubs across the eastern US, offering a narrow assortment of food and general merchandise items.

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Details

**Blow-out quarter.** EPS increased 165% y/y to $0.69 – handily exceeding our/Street's $0.38E/$0.36E. Upside vs. our model was driven by robust sales (merchandise comps +27% vs. our +10%E) and associated SG&A leverage. MFI growth was also better-than-expected at +8.4% (vs. our +4.2%E), and a lower tax rate added ~$0.05 vs. our model. While outsized gas profits helped by ~$30M (~$0.17/sh), higher bonus accruals (as BJ has effectively accrued for a max bonus payout in FY20) represented a similarly-sized headwind. All told, EBIT dollars grew ~100% y/y to $144M – exceeding our $94M estimate by >50%.

**Comps surged during 1Q and remain >20% 2Q to-date.** Merchandise comps surged 27%, with an equal contribution from traffic and average ticket. Strength was primarily concentrated in Grocery categories (+33%), which offset a 3% decline in General Merchandise. From a cadence standpoint, demand started to accelerate in late-February (low-teens) before surging in March (comps +40%). April comped up 23% despite clubs being closed on Easter, and trends remain robust in May (comps >20%, General Merchandise back to positive). While comps will slow at some point as stimulus benefits fade, we expect an elevated level of "base" demand to persist going forward (given increased consumption at-home) and view BJ as particularly well positioned in a recessionary environment (as consumers increasingly seek out value). Accordingly, we have increased our 2Q/3Q/4Q merchandise comp estimates to 10%/3%/3% from 1%/1%/2%. Below we highlight some additional color as it relates to 1Q sales:

- Grocery comped +33%: perishables, edible grocery, and non-edible grocery all >30%; strongest categories were paper, cleaning, dairy, fresh foods, and packaged goods
- General Merchandise/Services -3%: apparel drove the bulk of the decline; services also contributed to the weakness as BJ shut them down; sales of TVs, small appliances, and recreational products were strong

**Robust Grocery Comps Offset Weakness in General Merchandise (Driven Primarily By Apparel)**

<table>
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<tr>
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<th>1Q18</th>
<th>2Q18</th>
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<td>Edible grocery</td>
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<td>3%</td>
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<td>1%</td>
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<tr>
<td>Non-edible grocery</td>
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<td>1%</td>
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<tr>
<td>General merchandise</td>
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<td>5%</td>
<td>6%</td>
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<td>6%</td>
<td>0%</td>
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<td>1.6%</td>
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<td>1.6%</td>
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<td>1.1%</td>
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**Digital traction encouraging.** Digital sales surged ~350% to ~5% of sales (vs. ~1.5% LY), contributing 500bps to merchandise comps. More than >75% of this growth was driven by same-day delivery (up eight-fold; a profit-neutral transaction for BJ...) and BOPIC. With the rollout of curbside pickup and fresh BOPIC still in the early stages, we see an opportunity for BJ to further enhance credibility around same-day convenience and help drive increased engagement with members (particularly younger demographics).
Capitalizing on this unique member acquisition opportunity. MFI grew 8.4% y/y to $79.6M, comfortably above our $76.5M (+4.2%) and an acceleration from 4Q’s 6.2%. Cash MFI was even stronger at +16%, reflecting a ~40% increase in new member signups during the quarter. While still early, BJ is seeing strong spend (not surprising given consumption tied to the pandemic) and increased digital engagement from this cohort of members, and the pace of new member signups remains strong 2Q to-date. Big picture, With upgraded operating standards, improved systems (assortment/space optimization), and new digital/omni-channel capabilities, BJ has the tools in place to cultivate these relationships and expand spend per member over time.

MFI Growth Re-Accelerating, Helped in Part by a Significant Increase in New Member Signups

Margin/expense dynamics. While merchandise margins declined 30bps, some temporal factors were at play (weakness in seasonal apparel, temporary shutdown of higher margin services). In fact, the continued execution of BJ’s CPI initiatives as well as lower shrink/salvage drove ~10bps of rate improvement during the quarter. When combined with lower gas sales penetration and outsized gas margins, overall GM expanded 136bps. SG&A dollars tracked well above our model (COVID-19 expenses were ~$62M vs. our ~$20M estimate) though still leveraged ~40bps on stronger sales.

Capital allocation optionality. Robust FCF generation ($435M vs. FY19’s ~$158M) allowed BJ to retire $330M in debt and end 1Q at ~1.9x net debt to EBITDA (vs. FY21 goal of 2.0x-2.5x). With prospects for continued strong FCF generation, BJ has plenty of capacity to fund accelerated investments in growth (including potential opportunistic real estate transactions) while also returning incremental capital to shareholders.
Investment Thesis

- **A differentiated approach to club retail.** BJ’s offers a broader assortment than its club competitors, with a greater emphasis on perishables/grocery in smaller pack sizes. When combined with a smaller/convenient club format, BJ’s is primarily focused on capturing the weekly/fill-in grocery trip from conventional supermarkets/grocers.

- **BJ’s 2.0.** After a nearly seven-year absence, BJ’s reentered the public markets last year having repositioned the business under a new management team. Investments to modernize IT/systems ($230M spent on systems as a private company, including SAP implementation) have significantly enhanced BJ’s capabilities around data analytics, which, in turn, have helped reshape the company’s approach to merchandising/marketing/member acquisition/retention and laid the foundation for a comprehensive omni-channel offering.

- **Pushing harder with convenience.** BJ has spent the past few years building and commercializing its omni-channel platform. The focus in FY20 centers on driving greater awareness/adoption of existing capabilities (Buy-Online-Pickup-In-Club, or "BOPIC", and same-day delivery), broadening the rollout of in-store ExpressPay, and piloting some new offers (fresh BOPIC, curbside pickup). In short, BJ’s credibility around convenience should improve as the year plays out and presumably help drive increased engagement with members (particularly younger demographics).

- **Capitalizing on this unique member acquisition opportunity.** COVID-19 is helping drive an influx of new members to the club (new member signups up ~40% in 1Q). While still early, BJ is seeing strong spend and increased digital engagement from this cohort of members. With upgraded operating standards, improved systems, and new digital capabilities, BJ has the tools in place to cultivate these relationships and expand spend per member over time.

- **Assortment changes on tap.** Following extensive piloting, BJ is poised to introduce a variety of assortment/space allocation changes in FY20. Specifically, ~2/3 of the clubs will see a rationalized/improved assortment of “center-store” grocery items (replace slow growth items with more organics, plant-based foods) this spring, while space optimization learnings will be used to flex seasonal apparel sets more frequently across the year. Importantly, management expects these changes to be executed with minimal disruption.

- **Capital allocation optionality.** Aggressive debt paydown has reduced leverage to <2x debt to adjusted EBITDA from pre-IPO levels of ~6x. While capex is moving higher as club growth accelerates, stable top line growth and continued margin expansion should result in a growing free cash flow profile. With prospects for continued strong FCF generation, BJ has plenty of capacity to fund accelerated investments in the business (including potential opportunistic real estate transactions) while also returning incremental capital to shareholders.

- **Price target rationale.** Our $40 price target assumes ~10x our FY21E EBITDA, a premium to KR at ~7x but a significant discount to COST at ~17x. We believe this valuation profile is justified as strategy and operational enhancements drive fundamental improvement over the coming quarters.

Risks & Caveats

- **Geographic concentration of stores.** Given BJ’s concentrated market presence (East Coast footprint; ~25% of sales come from NY metro), the company’s operations are more susceptible to regional economic trends, adverse weather events, and/or natural disasters relative to its primary club competitors.

- **Decline in membership renewal rates.** Any decline in membership renewal rates would negatively affect profit trends given BJ’s dependence on membership fee income (>70% of operating income).
- **Self-cannibalization.** BJ's intends to build 15-20 new clubs over the next five years, with a focus on infill and adjacent markets. A more aggressive approach to club expansion could impact comps (from self-cannibalization) and possibly pressure ROIC.

- **Inflation in commodity prices.** Any increase in commodity prices may adversely impact product margins if BJ's is unable to pass through such increases in the form of higher retail prices to its customers.

- **Operational disruption related to perishable products.** Representing nearly 30% of sales, perishables (typically higher-margin, higher-shrink goods) require unique ordering, supply chain, and in-store operational expertise and processes. Any disruption to BJ's perishable products operations could adversely impact the company's sales and margins.

- **Intense competition.** BJ competes predominantly with other major warehouse clubs (Costco and Sam's Club), both of which have significantly greater financial and marketing resources, as well as large food and drug retailers, discounters, and supermarket chains. Aggressive pricing by the competition to drive traffic and gain market share could pressure sales and margin.

- **Increasing gasoline penetration.** Financials could be negatively impacted by increased penetration of gasoline, as gas generates the lowest gross margin for BJ. Volatility in gas prices also leads to wide swings in gas margins, which can magnify EPS volatility.

- **Economic conditions.** A contraction in consumer spending resulting from macro factors such as higher interest rates, rising fuel/energy costs, weakness in the housing market, and increased unemployment levels could negatively impact sales.

## Company Description

BJ's Wholesale Club, Inc. operates membership warehouse clubs across the eastern U.S., offering a limited assortment of food and general merchandise items across a wide range of product categories. Merchandise selections are generally limited to leading brand-name items and private-label assortments. Paid membership is an essential part of BJ's warehouse club concept, as it provides an "annuity-like" profit stream and reinforces customer loyalty. The company has two types of members: Inner Circle members (individual customers) and business members, but places most of its focus on its Inner Circle members.
Appendix - Important Disclosures and Analyst Certification

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Rating and Price Target History for: BJ's Wholesale Club, Inc. (BJ) as of 05-20-2020

1 Robert W. Baird & Co. Incorporated makes a market in the securities of BJ.

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