**Equities**

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# What's In Store? Issue 48

## Focusing on Shrinkage to Grow Profit

■ Industry Overview

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- **Protecting inventory** — In Australia, over $3.6 billion in inventory goes "missing" each year. This shrinkage is an important source of margin gains in an environment where margins are under pressure. In Issue 48 of *What's In Store?*, we look at the benchmarks in shrinkage, the Australian retailers performance and earnings upside from reducing shrinkage. Myer and JB Hi-Fi are best in class, while the improvement has been significant at Coles and there may be upside for clothing retailers.

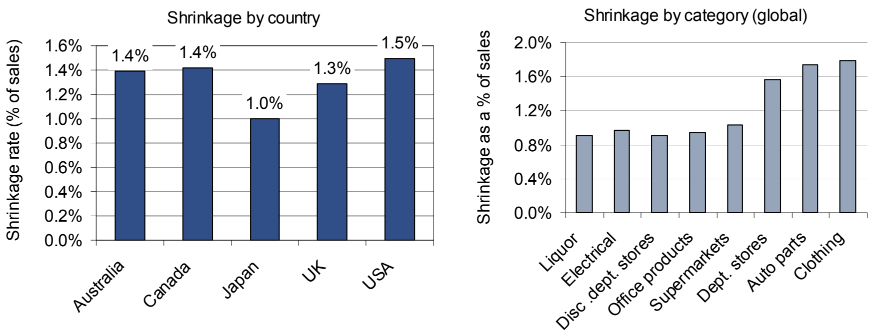
- **Shrinkage compared** — Shrinkage is not just shoplifting. In fact, more inventory is lost to employee theft and processing errors than through shoplifting. In Australia, shrinkage represents 1.4% of sales. This is near global benchmarks. Shrinkage tends to be highest in department stores, auto stores and clothing retail outlets.

- **Best in class in Australia** — As an example of the prize from shrinkage, Coles and Myer have each saved over 100bp in margins through shrinkage and wastage reduction over the past three years. Myer is at 1% of sales, far below the department store average of 1.56%. While systems such as CCTV and RFID can help detect shrinkage, staffing investment and fast stock turns tend to help prevent shrinkage.

- **Earnings upside from shrinkage** — We estimate shrinkage by retailer in this report. Only three disclose statistics on their measures. JB Hi-Fi is the lowest at 0.26% of sales. The upside from a 10% reduction in shrinkage is anywhere from 1%-3% EBIT growth. The biggest gains are for soft goods retailers like Premier Investments and Target.

- **Citi Retail sales indicator up 6.2% in March 2012** — ABS retail sales strengthened in March, primarily given the school holiday shift in our view. The strongest growth was in supermarkets. While furniture and hardware were both in decline.

**Shrinkage rates in retailing (2010)**




Source: Global Theft Barometer 2010

**See Appendix A-1 for Analyst Certification, Important Disclosures and non-US research analyst disclosures.**

# Contents

# What's In Store? Issue 48

**Shrinkage is the billions of dollars of inventory that goes "missing" in retail stores. There are many reasons for it and the impact on profits can be significant. In Issue 48 of *What's In Store?*, we assess the sources of shrinkage and look at the retailers like Coles, Myer and JB Hi-Fi which release details of shrinkage. Finally, we estimate the opportunity for retailers to lift profitability by reducing their shrinkage rate. Myer has halved its shrinkage in three years, while Coles has captured more than 100bp in margin gains. We see soft goods retailers as the best beneficiaries going forward, such as Premier Investments, David Jones and Target.**

## Why is shrinkage important?

As retail profit margins contract, retailers have to search for internal efficiency gains to generate better profits. One avenue is reduced shrinkage. Shrinkage is the loss of stock and represents a material cost for most retailers. In Australia, we've seen companies including Coles, Woolworths and Myer specifically note shrinkage improvements as a source of margin gain. In this report, we explore:

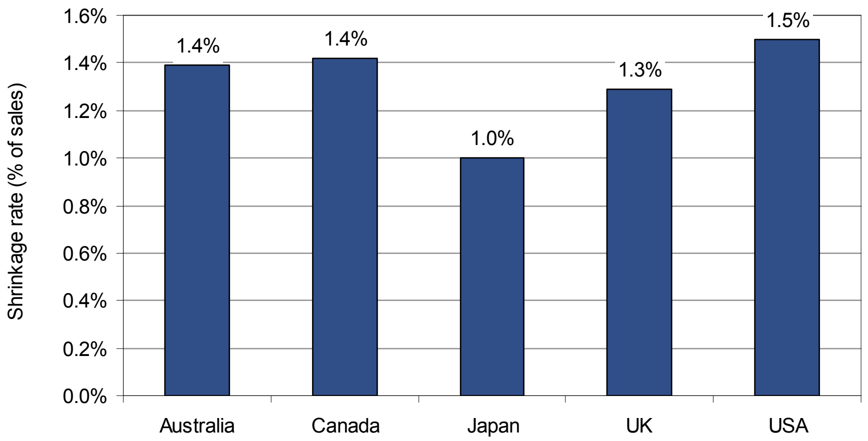
- The sources of shrinkage.
- The Australian retailer progress in reducing shrinkage.
- Opportunities to improve earnings through shrinkage reduction techniques.

### Shrinkage dollars down the drain

Shrinkage is defined as the difference between the book value expected of inventory at the end of a period and the actual inventory counted through a stocktake. Shrinkage is not theft.

In Australia, shrinkage represented 1.4% of retail sales in 2010 according to a survey of shrinkage conducted globally by the Centre for Retail Research. The survey included 31 Australian retailers and 1,100 retailers globally. If this is an accurate estimate for 2011, shrinkage would represent $3.6 billion in forgone profits for Australian retailers.

**Figure 1. Shrinkage rates globally (2010)**

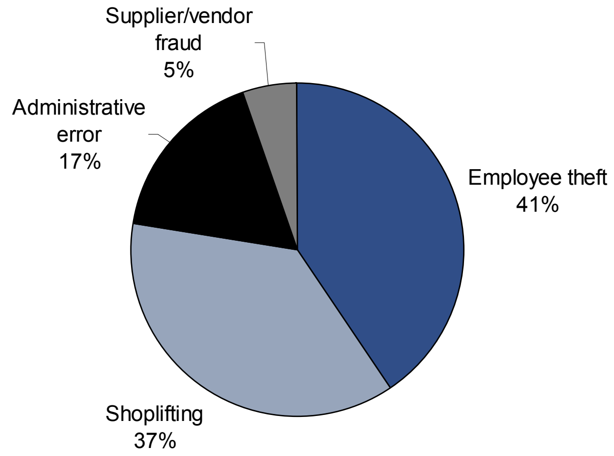



Source: Global theft Barometer, Citi Investment Research and Analysis

## What drives shrinkage?

Shrinkage is more than just shoplifting. As shown in Figure 2, the break-down of shrinkage includes employee theft as a larger item than shoplifting. Administrative errors are also significant.

**Figure 2. Australian shrinkage components (2010)**




Source: The Global Retail Theft Barometer (2010), Citi Investment Research and Analysis

1. **Employee theft** – Employee theft accounts for the largest portion of the overall retail shrinkage. Most common practice is the returns fraud wherein the employee directly takes cash out of the register and records a fake "return". Since there is no "item" to be returned, the loss goes in as shrinkage.

2. **Shoplifting** – This is where the consumer exits the store without paying for the merchandise.

3. **Administrative errors** – These refer to internal system errors. In most cases, the inventory is not "lost" or "stolen" but gets sold at a price lower than the shelf price. For instance, an item is ticketed as $10 in the system instead of $100 as the correct price given a typographical error.

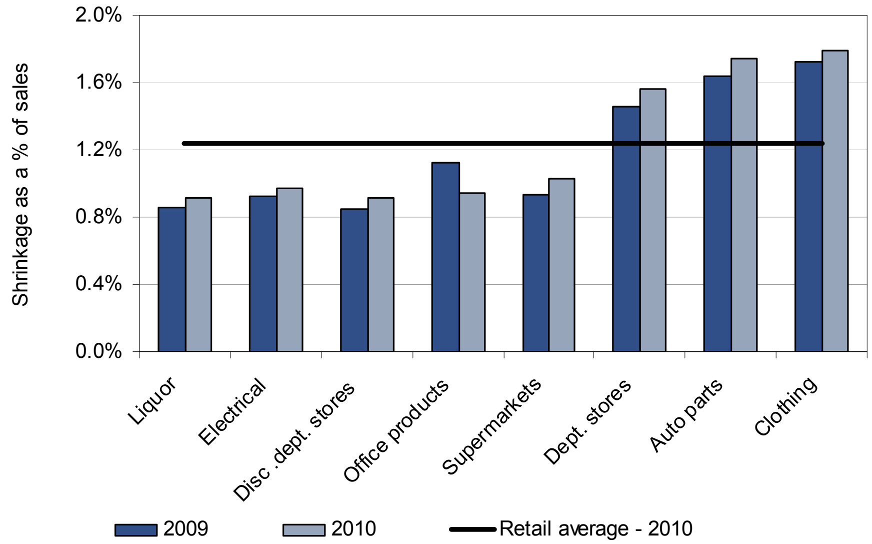
4. **Vendor fraud** – This is fraud wherein the vendor supplies merchandise only on paper/system and collects payment from the retailer based on the documents. This is usually done in conjunction with retailer employees responsible for record-keeping.

In food retailing, there is additional shrinkage related to products with a limited shelf-life. This can be attributed to poor stock management practices in either ordering or stock rotation. According to Efficient Consumer Response Australasia (ECRA, an industry body representing the grocery sector), grocery sector shrinkage was 1.52% of sales in 2002.

## Fashion the highest shrink segment

Shrinkage rates are highest in clothing, auto parts and department stores. We show the global average shrinkage rates in Figure 3 as a reference point. We suspect shrinkage rates are highest where product parts are small and also where formal security measures are less likely to be implemented.

**Figure 3. Category shrinkage rates (global)**




Source: The Global Retail Theft Barometer (2011), Citi Investment Research and Analysis

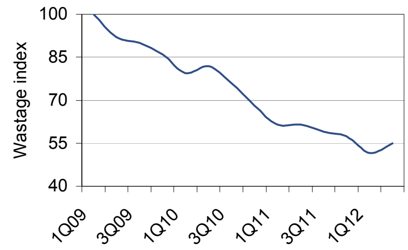
## Australian retailers are working on shrink

While Australian company disclosures on shrinkage are sporadic[1], we see evidence of Australian retailers addressing the opportunity to lower shrinkage. Myer's shrinkage rate is very low at 1.0% of sales, down from 2.0% only three years ago.

JB Hi-Fi reports its shrinkage at 0.26% of sales, while Specialty Fashion has said that its shrinkage is 0.89% of sales.

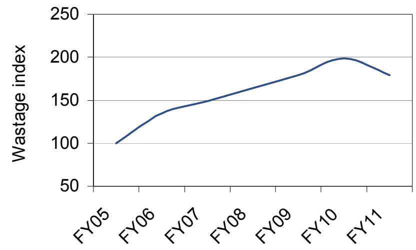
We show an index of the shrinkage trends for selected retailers in Figure 4 to Figure 7.

**Figure 4. Inventory shrinkage trend at Coles**




Sources: Company reports, Citi Investment Research and Analysis

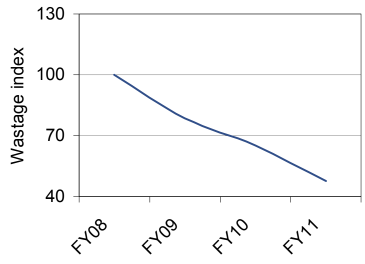
**Figure 5. Inventory shrinkage trend at JB Hi-Fi**




Sources: Company reports, Citi Investment Research and Analysis

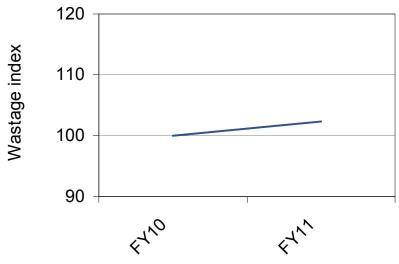
[1] Only JB Hi-Fi and Specialty Fashion have clear dollar shrinkage disclosures. Coles disclosed shrinkage index during its result release, while we have estimated Myer shrinkage based on company presentations.

Figure 6. Inventory shrinkage trend at Myer




Sources: Company Reports, Citi Investment Research and Analysis

Figure 7. Inventory shrinkage at Specialty Fashion




Sources: Company reports, Citi Investment Research and Analysis

Coles has reported a dramatic drop in shrinkage since the change of ownership in 2007. The company acknowledged that it was poorly managing its inventory. Much of the shrinkage related to fresh categories, where a lack of turnover resulted in spoilage. We estimate Coles shrinkage was over 2.5% of sales before Wesfarmers acquired the business. Assuming this is accurate, the index of shrinkage reduction at Coles, would indicate 110bp of margin improvement from shrinkage alone.

## People and technology = reduced shrinkage

A retailer is likely to assess the return on investment of any business initiative. There are two clear ways to reduce shrinkage:

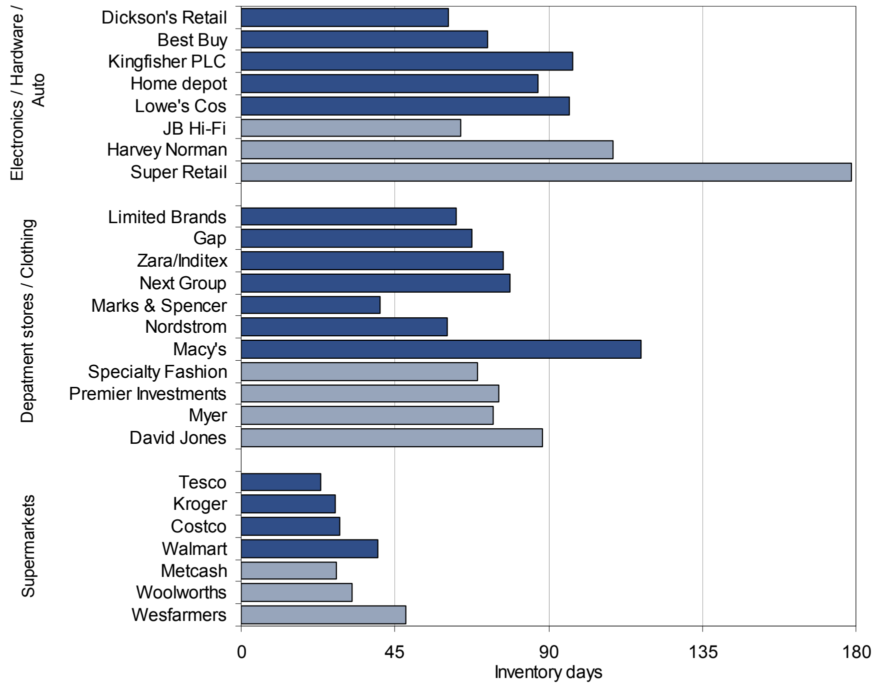
1. Improve inventory stock turns to reduce out of date stock or "dead space" in stores

2. Implement new systems and processes to reduce the causes of shrinkage.

### Inventory cycles for retailers

As shown in Figure 8, Australian retailers' inventory turns are largely near global benchmarks or even better than their overseas counterparts. One reason may be that Australian retailers often operate from smaller store footprints than offshore retailers given the high cost of rent.

**Figure 8. Inventory days in retail vs overseas benchmarks (FY11)**




Source: Wesfarmers inventory days are at a consolidated level, including its non-retail divisions; Citi Investment Research and Analysis

## The systems to reduce shrinkage

Below we highlight some of the common measures that retailers implement to counter shrinkage. Some of the measures are capital investments, while others require additional staff costs. JB Hi-Fi has acknowledged a direct correlation between its expenditure on security staffing at stores and shrinkage. While systems can detect forms of theft, only people can prevent the act.

**Figure 9. Techniques to counter retail shrinkage**

| Tools | Description | Advantages | Disadvantages/Limitations |
|---|---|---|---|
| Closed circuit television (CCTV) | CCTV refers to transmission of live videos to a set of monitors | 1. Enables proof of theft<br>2. Preventive rather than reactive for theft | 1. Invasion of privacy<br>2. Cannot cover every square inch of the shopping floor<br>3. Needs constant supervision to have a preventive rather than a reactive action to thefts |
| Radio Frequency Identification (RFID) | Uses radio frequencies to identify/track items | 1. Can be installed inside the product, thus, making it un-detachable<br>2. Real-time notification if product leaves the store without payment | 1. Consumers may have reservations about RFID inserted products, as RFID can track location<br>2. May not be read if inserted in metal / liquid<br>3. Prone to interference if walkie-talkies are in the vicinity<br>4. More expensive vs. barcodes |
| Sensor tags + exit scanners | Sensor tags are attached to items and can only be removed with matching hardware | 1. Less expensive vs. other items. The scanner is a one time investment (costs up to $1,000), but tags cost less than a dollar per piece | 1. Consumers may take the items to trial room (not covered by CCTVs) to detach tags<br>2. Doesn't provide any proof<br>3. A lot depends on the integrity of the security personnel<br>4. The person stealing can take the sideways route (outside the sensors) and not get caught |
| Product alarms | Used for display only items that are fixed on a dock-like set. The alarm goes off if the product is removed from the dock. | 1. Instant alarm if the product is detached from the alarm device | 1. Highly sensitive - alarm often goes off even when the item is only being inspected by the prospective consumer. This may create misunderstandings and unnecessary inconvenience to the customers |
| Security staff | Increasing security staff which can monitor maximum customers | 1. Unlike, scanners and equipment, trained security staff can use judgment to trace shop lifters | 1. "Judgment" may be influenced by shoplifters by offering a share in "profit"<br>2. Single security person can monitor limited space at a time<br>3. Genuine shoppers may get uncomfortable seeing security persons all over the store<br>4. Most expensive operationally |

Source: Citi Investment Research and Analysis

## Implications for retail profitability

We expect Australian retailers to focus on shrinkage as a way to save basis points in margins. The clothing retailers and David Jones are likely to have most to gain. Generally for retailers a 10% improvement in shrinkage can provide a 1%-3% lift in earnings, holding all else constant.

### Shrinkage estimates by company

Below we estimate shrinkage as a percentage of sales for our covered retailers. We use this shrinkage level and compare the levels to global benchmarks. We expect Australian retailers generally operate near global averages. Myer is a good example of the returns from better shrinkage management. The company is at 1%, compared with the global benchmark of 1.56%. Our estimates are shown in Figure 10. We note that JB Hi-Fi, Myer and Specialty Fashion have explicit published figures on shrinkage.

**Figure 10. Current estimated shrinkage levels for Australian retailers**

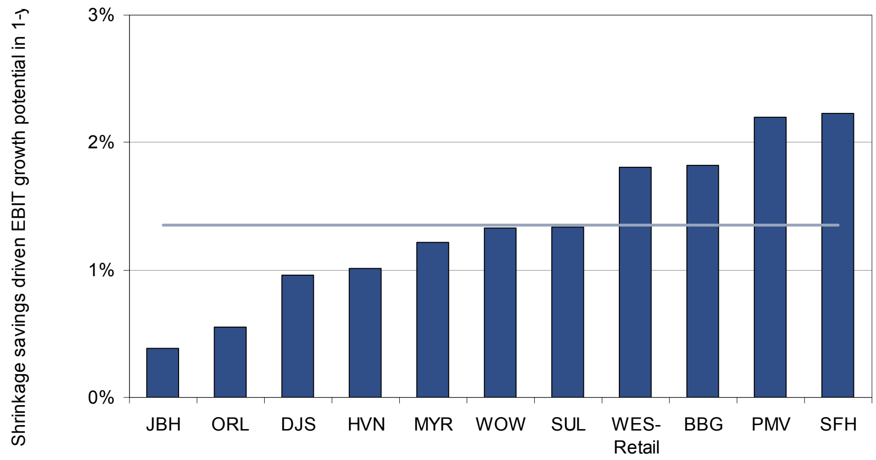
| Company | Global shrinkage benchmark | Citi estimated company shrinkage |
|---|---|---|
| David Jones | 1.46% | 1.21% |
| Myer* | 1.46% | 1.00% |
| Billabong | 1.72% | 1.62% |
| Oroton | 1.72% | 1.22% |
| Premier Investments | 1.72% | 1.62% |
| Specialty Fashion* | 1.72% | 0.89% |
| Super Retail | 1.26% | 1.15% |
| Auto & Cycle | 1.64% | 1.50% |
| Leisure | 1.14% | 1.20% |
| Harvey Norman | 0.92% | 0.64% |
| JB Hi-Fi* | 0.92% | 0.26% |
| Woolworths | 0.92% | 0.92% |
| Food & Liquor Australia | 0.93% | 0.93% |
| Food & Liquor New Zealand | 0.93% | 0.93% |
| Big W | 0.85% | 0.85% |
| Wesfarmers | 0.90% | 0.74% |
| Home Improvement | 0.91% | 1.07% |
| Officeworks | 0.90% | 0.74% |
| Food & Liquor | 0.92% | 0.92% |
| Target | 0.93% | 1.20% |
| Kmart | 0.85% | 1.05% |

* Companies report dollar shrinkage levels;
Sources: Citi Investment Research and Analysis estimates

## Earnings uplift from lowering shrinkage

In Figure 11, we show the EBIT sensitivity if retailers are able to reduce shrinkage as a percentage of sales by 10%. Premier Investments and Specialty Fashion Group have the greatest potential given they currently have a high shrinkage to sales ratio relative to their global counterparts. Similarly, JB Hi-Fi is least impacted due to efficient shrinkage levels.

**Figure 11. EBIT sensitivity from 10% shrinkage saving**



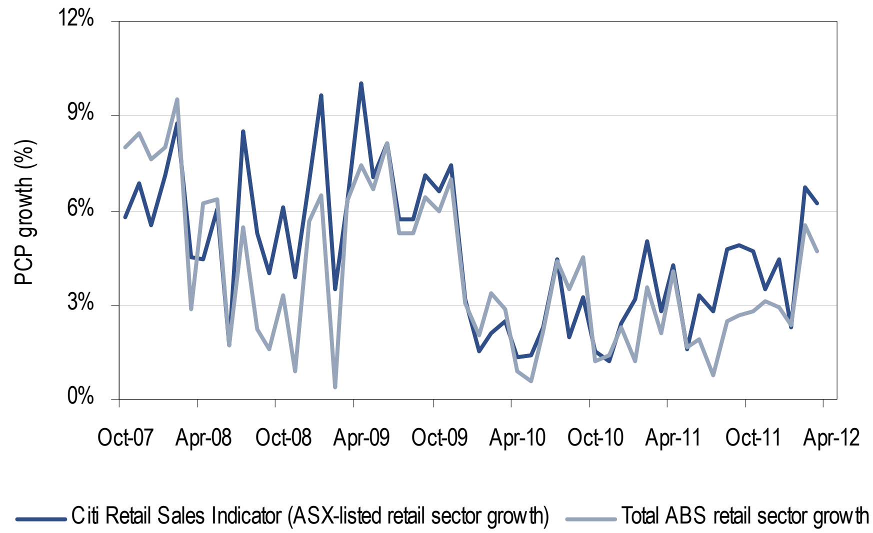

Source: Company reports, Citi Investment Research and Analysis

# Retail sector overview

## Citi Retail Sales Indicator

Citi's Retail Sales Indicator measures the growth of retail sales weighted by the categories relevant to ASX-listed retailers. The indicator grew 6.2% in March 2012, slightly above the ABS total retail sales growth of 4.7% mainly due to a greater weight assigned to supermarkets vs. other categories.

**Figure 12. Citi Retail Sales Indicator (retail sector sales growth for ASX-listed companies)**




Source: ABS, Citi Investment Research and Analysis

## Sector performance for March 2012

**Figure 13. Retail category monthly growth rate on pcp (%)**

| Month ended: | Mar-11 | Feb-12 | Mar-12 |
|---|---|---|---|
| Supermarket | 3.2 | 6.0 | 5.5 |
| Department | -4.2 | 1.3 | 2.1 |
| Clothing | 2.2 | -0.3 | 1.8 |
| Furniture | 2.0 | 0.4 | -1.0 |
| Electrical | -3.4 | 4.4 | 4.8 |
| Hardware | 6.9 | 2.2 | -2.3 |
| Total (Industry) | 2.1 | 5.5 | 4.7 |

Sources: ABS, Citi Investment Research and Analysis

ABS Retail Sales for March 2012 grew at 4.7% on pcp, using original data. Both food and discretionary retail categories performed well. The strong sales result can be partially explained by the timing of the Easter holiday in April 2012. We suspect the earlier Easter break resulted in a pull-forward of sales into March 2012.

### Key points

- **Supermarkets up 5.5%** - Supermarket sales were strong in the March 2012 quarter rising 4.3% on pcp. This shows underlying sales growth remains robust despite the impact of produce price deflation during the quarter. Reported 3Q12 sales growth for Coles and Woolworths was 4.1% and 2.9%, respectively.

- **Department stores up 2.1%** - Department store spending improved in March 2012 to 2.1% from 1.3% in February 2012. The department stores David Jones and Myer had a slightly earlier promotional calendar this year.

- **Clothing up 1.8%** - Clothing sales improved in March 2012 supported by favourable weather due to cooler temperatures in Sydney and Brisbane. Despite the improvement, it is important to note that clothing sales remain volatile and promotionally driven.

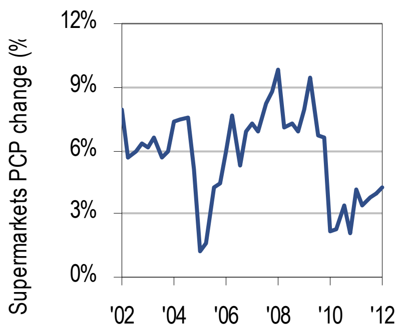
- **Electrical up 4.8%** - Electrical retail sales improved in March 2012 to 4.8%, but it was driven by strong promotional activity. The market has been impacted by the closure of WOW Sight n Sound and select Dick Smith stores. Harvey Norman franchisees had -7.7% LFL sales in 3Q12 and continue to lose market share.

- **Furniture down 1.0%** - Furniture sales deteriorated in March 2012. Sales declined 1% during the month compared to solid 4.8% growth in calendar 2011.

- **Hardware down 2.3%** - Hardware had its first decline in industry sales in 20 months. Price deflation is accelerating for the category as competition intensifies with the entry of Masters.

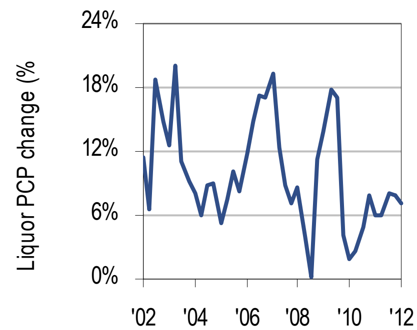
## Sector specific performance – rolling 3 months to Mar '12

**Figure 14. Supermarkets**



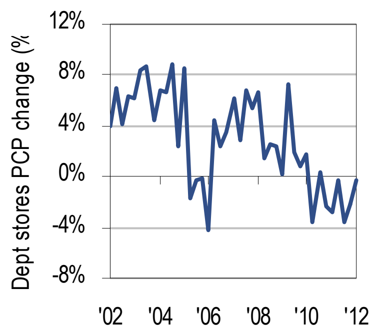

Source: ABS 8501.0

**Figure 15. Liquor retailing**



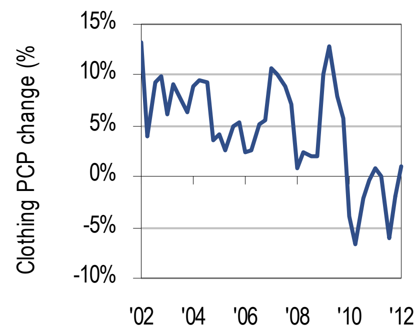

Source: ABS 8501.0

**Figure 16. Department stores**



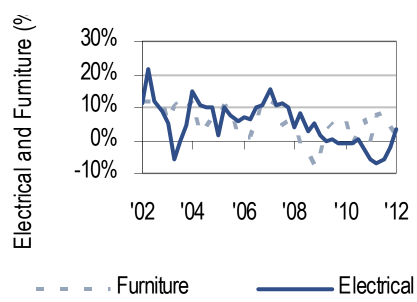

Source: ABS 8501.0

**Figure 17. Clothing**



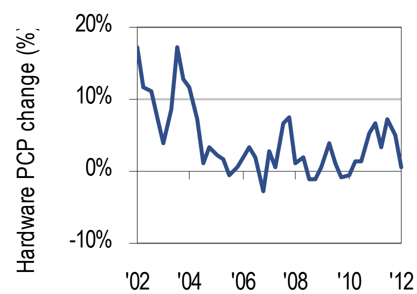

Source: ABS 8501.0

**Figure 18. Electrical and Furniture**




Source: ABS 8501.0

**Figure 19. Hardware**

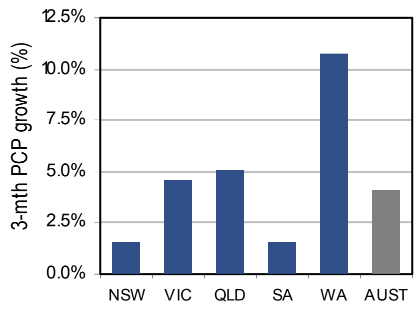



Source: ABS 8501.0

## State based performance

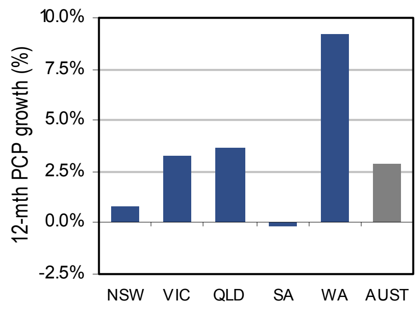
Figure 20 and Figure 21 show the quarterly and yearly sales growth performance for each state respectively.

**Figure 20. 3-month sales growth by state**




Source: ABS 8501.0

**Figure 21. 12-month sales growth by state**




Source: ABS 8501.0

## Economic outlook

Citi Economists forecast a slower pace of improvement in GDP growth in 2013, mainly as the mining strength is largely offset by weakness in other sectors.

**Figure 22. Citi economic forecasts for Australia**

| Calendar year | 2011 | 2012 | 2013 |
|---|---|---|---|
| GDP growth | 1.30% | 3.40% | 3.90% |
| CPI | 2.50% | 2.00% | 3.10% |
| Unemployment rate (end of period) | 5.20% | 5.40% | 4.90% |

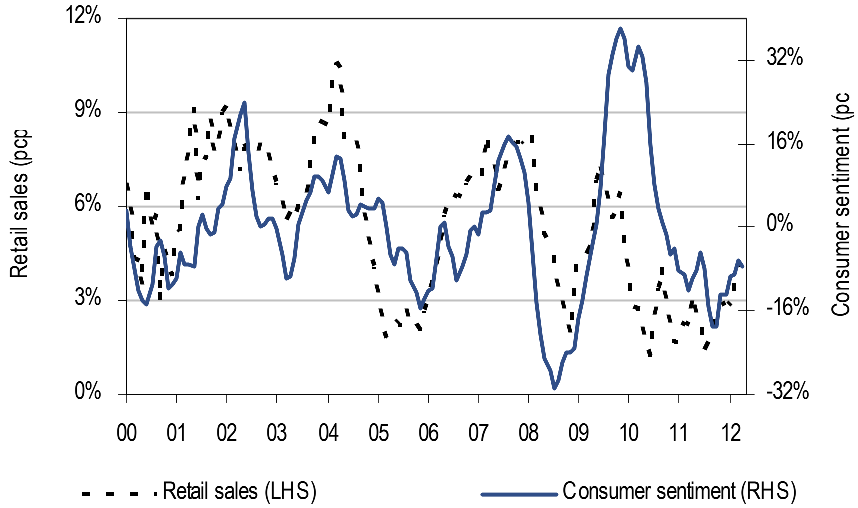
| Period | 04-May-12 | Jun-12 | Dec-12 |
|---|---|---|---|
| Cash rate | 4.25% | 3.75% | 3.75% |
| AUD/USD | 1.03 | 1.03 | 1.01 |

Note: Forecast data as of 4th May 2012; Source: Citi Investment Research and Analysis

## Consumer Sentiment

We find the change in consumer sentiment has a strong co-incident correlation with retail spending. In the most recent reading for April 2012, consumer sentiment was at 94.5. This is down 1.7% vs. March 2012, and 10.3% lower compared to the prior year.

**Figure 23. Consumer sentiment and retail sales**

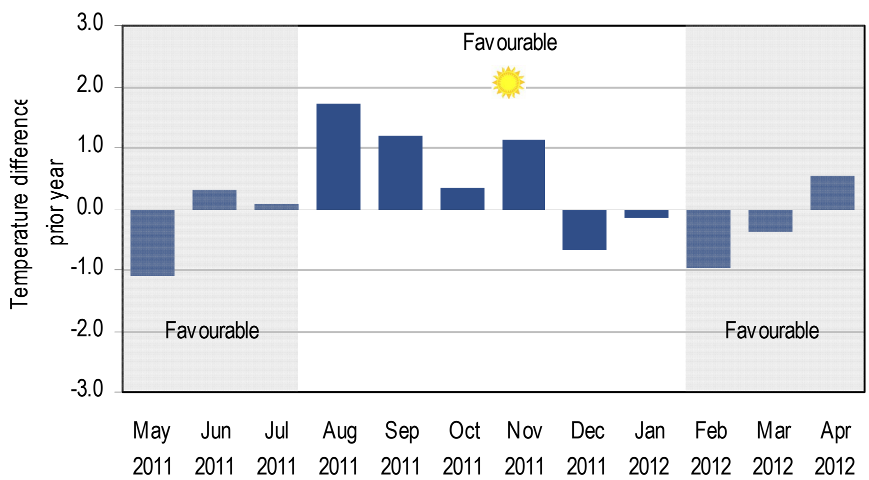



Source: Westpac, ABS, Citi Investment Research & Analysis

## Weather

Figure 24 shows the weighted average temperature difference to the prior year, in the past 12 months. While February and March were favourable for winter clothing retail, April was adversely effected by warmer winter.

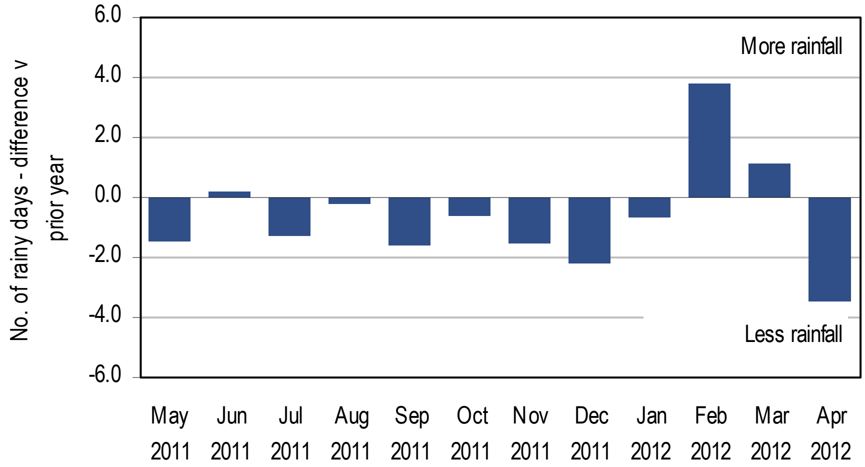
**Figure 24. Temperature change - weighted national average**




Source: BOM, Citi Investment Research & Analysis

Figure 25 shows the weighted average difference in rainfall days to last year.

**Figure 25. Rainfall change – weighted national average**

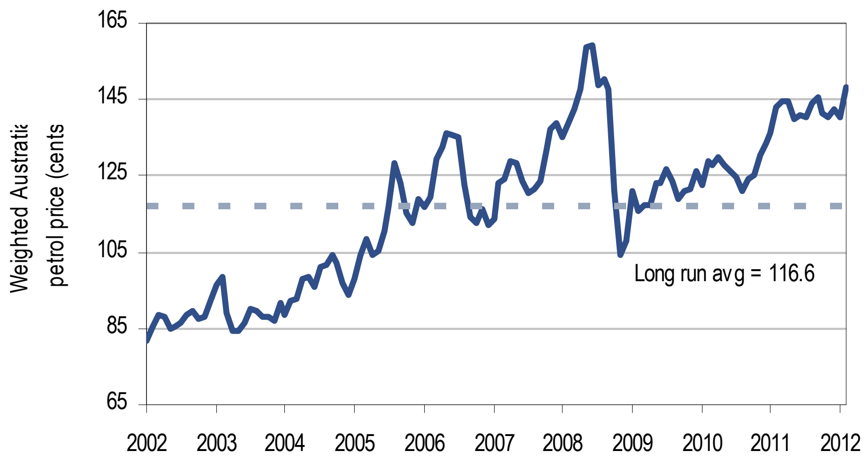



Source: BOM, Citi Investment Research & Analysis

## Petrol prices

Petrol prices averaged 116.6 cents per/litre in March 2012. Prices are 3.6% higher compared to the last year. Continued rises in the price of petrol are draining the available household income for retail purchases.

**Figure 26. Australian petrol prices**

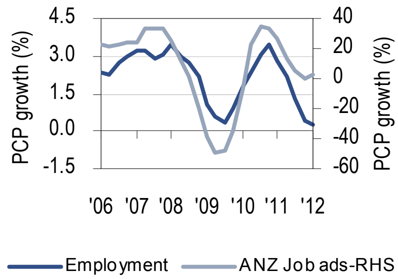



Source: Aust. Automobile Association

## Employment

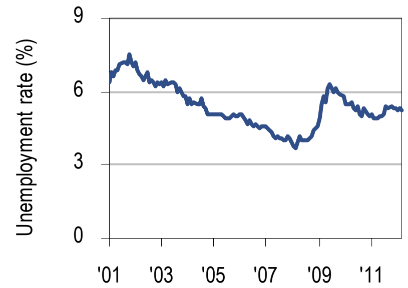
Job ads growth has become volatile since November 2011, with the latest reading at -0.4% for April 2012. While overall employment is still in growth, we note that (1) the rate of increase is below 0.5% now and (2) unemployment rate is starting to edge higher. The mining boom is being offset by weakness in other sectors.

**Figure 27. Employment and job ads growth**




Source: ABS, ANZ

**Figure 28. Unemployment rate**

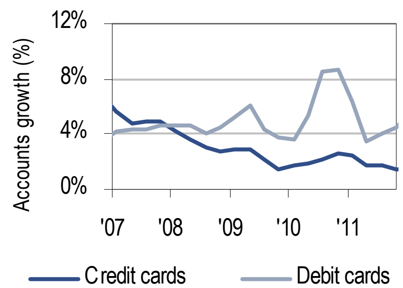



Source: ABS

## Credit and debit card spending growth

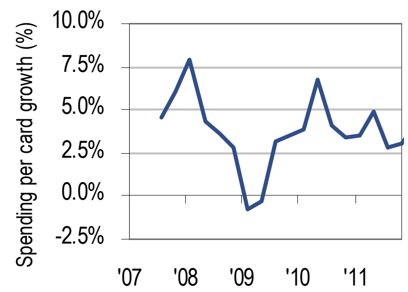
We show in Figure 29 to Figure 32, key Australian credit and debit card statistics. Debit card growth accelerated in 2011 through a combination of strong account growth and increased spending per debit card holder. Spending per credit and debit card holder has slowed in the past six months.

**Figure 29. Credit and debit card accounts**



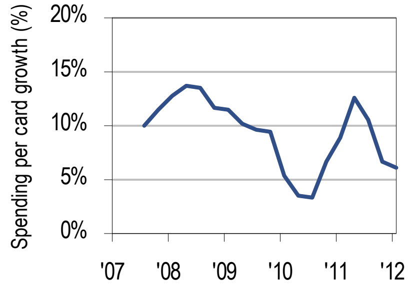

Source: RBA

**Figure 30. Spending per credit card holder**



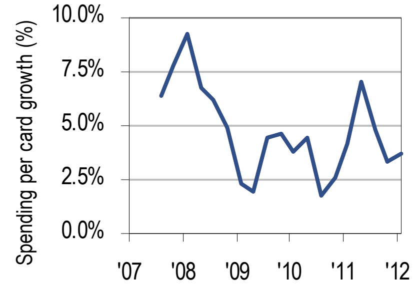

Source: RBA

**Figure 31. Spending per debit card holder**




Source: RBA

**Figure 32. Spending per all card holders**




Source: RBA

## Retail price inflation

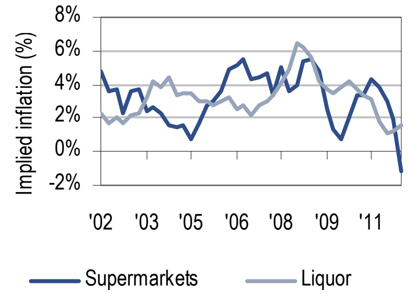
- **Food & Liquor** – Supermarkets inflation turned negative in the March quarter mainly driven by heavy deflation in fresh produce. Liquor inflation however remained positive as brewers continued to compromise volumes for additional pricing.

- **Clothing** – Cotton retail prices remained flat (down 0.3%) in the March 2012 quarter. In recent quarters, clothing experienced significant price deflation given strong competitive pressure, a higher Australian dollar and lower import tariffs. However, this slowed in September 2011 and the trend was inflationary (+1.4%) in the December quarter. Cotton price inflation is now flowing through retail but partially offset by AUD strength and the pass-through.

- **Electronics** – Supply disruptions and high metal prices are adding inflationary pressure to electrical items in the short term. However, this is likely to be offset by intense competition between suppliers. The category continued to be in a deflationary trend in the March 2012 quarter.

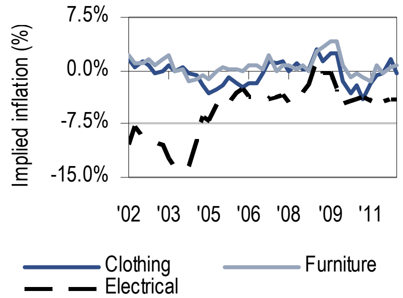
We show implied retail price inflation for a number of key categories in Figure 33 and Figure 34 below.

**Figure 33. Food and Liquor inflation**




Source: ABS, Citi Investment Research & Analysis

**Figure 34. Non-food sector inflation**




Source: ABS, Citi Investment Research & Analysis

## Input cost pressures

- **Food & Liquor** – Input prices declined 6.0% on pcp, in the three months to April 2012 mainly driven by lower coffee, wheat, sugar and dairy, partly offset by inflation in rice and canola oil.

- **Clothing** – Cotton prices have softened since their highs in February 2011. There is usually a 6-9 month lag between changes in spot prices and retail shelf prices. Overall, our input cost basket showed deflation in the 3-month period to April 2012.

- **Electronics** – Deflation in core electronic components (LCD, monitor, DRAM and NAND) more than offset the run-up in prices of HDPE, gold and polystyrene in the three months to April 2012. Our input basket declined by 3.9% in the 3-months to April 2012.

We show our Citi input cost monitor for April 2012 on a monthly and rolling-three month basis in Figure 35 and Figure 36 below.

**Figure 35. Citi input cost monitor (1 mth)**

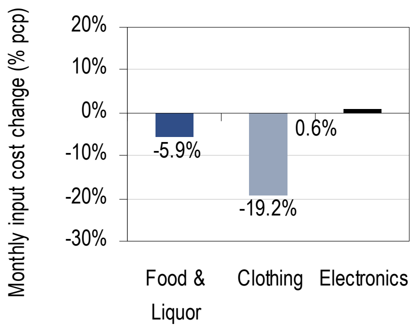
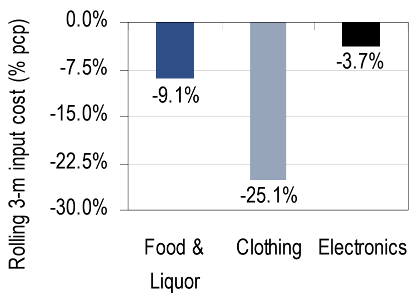



**Figure 36. Citi input cost monitor (3 mths)**

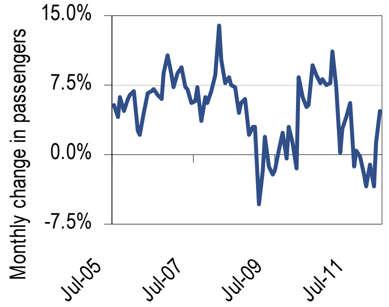



Source: Bloomberg, Citi Investment Research and Analysis

## On the move – transport indicators

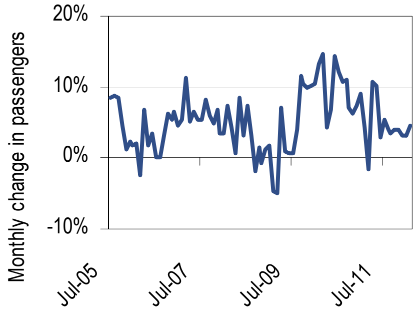
In Figure 37 to Figure 40 we show areas where consumers are "on the move". We include air and road transport indicators as a guide to business and consumer activity. International travel remains strong, while domestic road-traffic has slowed, a sign of weaker domestic activity.

**Figure 37. Change in domestic air passenger traffic (monthly)**



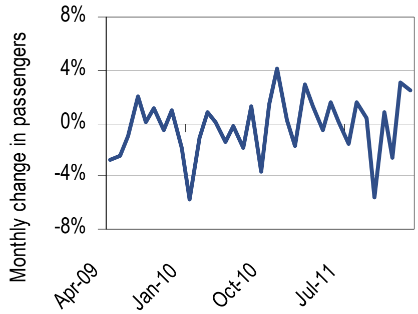

Source: Statistics New Zealand, Citi Investment Research and Analysis

**Figure 38. Change in international air passenger traffic (monthly)**



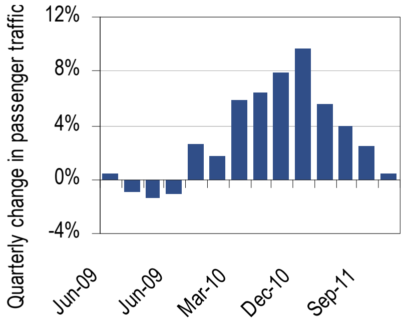

Source: Statistics New Zealand, Citi Investment Research and Analysis

**Figure 39. Automotive fuel sales change against pcp**




Source: Statistics New Zealand, Citi Investment Research and Analysis

**Figure 40. Change in quarterly road traffic volume at tolled roads**




Source: Transurban, Citi Investment Research and Analysis

## Kiwi corner

In Figure 41 we show Citi forecasts for New Zealand's key economic variables.

**Figure 41. Citi economic forecasts for New Zealand**

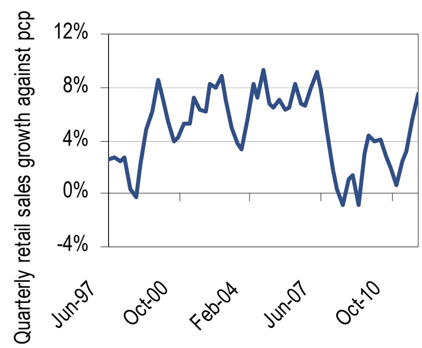
| Calendar year | 2011 | 2012 | 2013 |
|---|---|---|---|
| GDP growth | 1.30% | 1.80% | 2.30% |
| CPI | 2.60% | 2.20% | 2.40% |
| Unemployment rate (end of period) | 6.50% | 6.40% | 5.60% |

| Period | 04-May-12 | Jun-12 | Dec-12 |
|---|---|---|---|
| Cash rate | 2.50% | 2.50% | 2.50% |
| NZD/USD | 0.80 | 0.82 | 0.80 |

Note: Forecast data as of 8th May 2012; Source: Citi Investment Research and Analysis

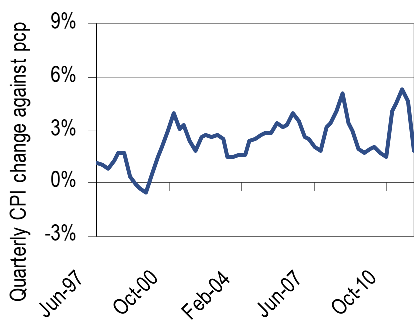
In Figure 42 to Figure 45 we show New Zealand's retail sales growth, CPI growth, unemployment rate and electronics cards transaction growth. In Figure 46 and Figure 47, we show the stock performance chart for selected New Zealand stocks in retail.

**Figure 42. Retail sales growth**



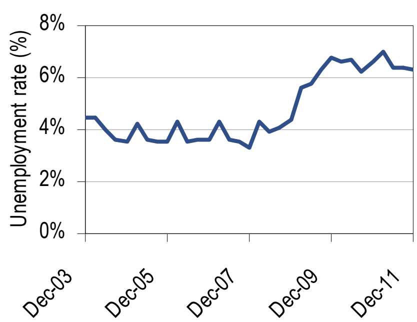

Source: Statistics New Zealand, Citi Investment Research and Analysis

**Figure 43. CPI growth**



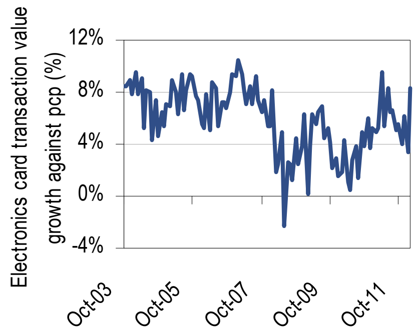

Source: Statistics New Zealand, Citi Investment Research and Analysis

**Figure 44. Unemployment rate**



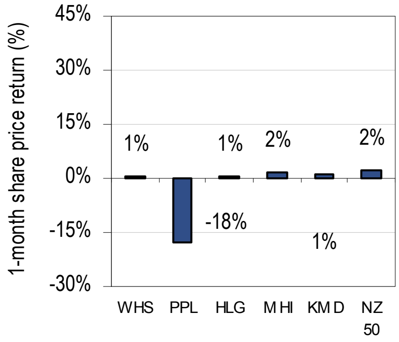

Source: Statistics New Zealand, Citi Investment Research and Analysis

**Figure 45. Electronic card transaction value growth**



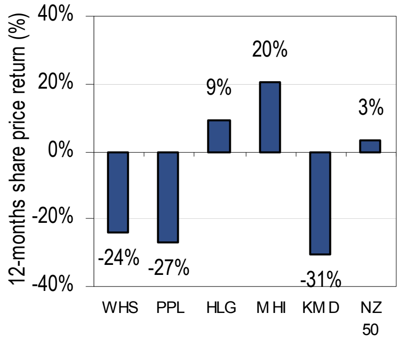

Source: Statistics New Zealand, Citi Investment Research and Analysis

**Figure 46. Stock performance chart - 1 month return**




Note: Market data as of 8th May 2012; Source: Citi Investment Research and Analysis

**Figure 47. Stock performance chart - 12 months return**

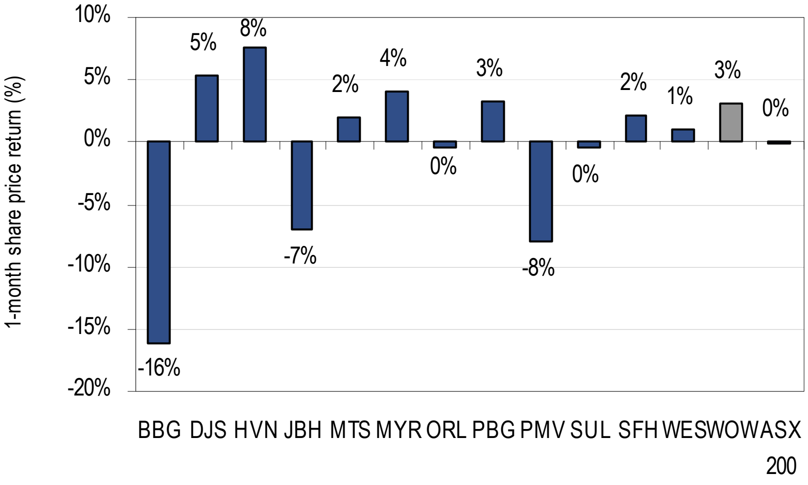



Note: Market data as of 8th May 2012; Source: Citi Investment Research and Analysis

## Share price performance

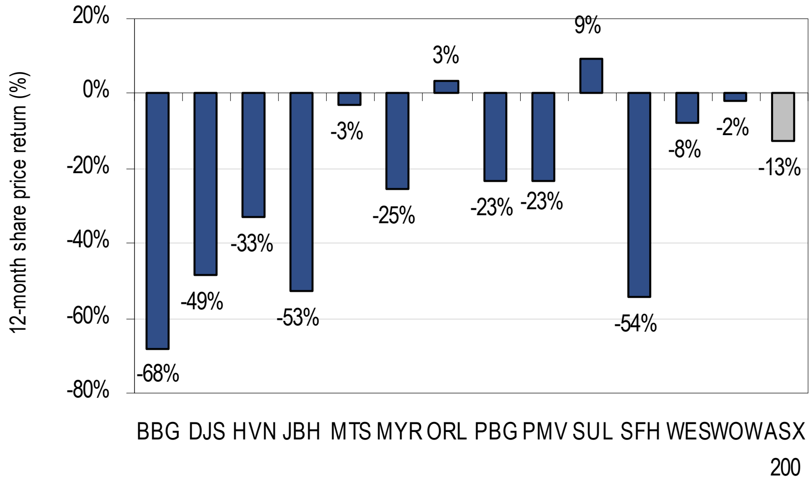
In Figure 48 and Figure 49 we show the 1-month and 12-month share price performance of listed Australian retailers and the ASX 200 Index.

**Figure 48. 1-month share price return for Australian retailers**




Note: Market data as of May 08 2012; Source: Citi Investment Research and Analysis

**Figure 49. 12-month share price return for Australian retailers**

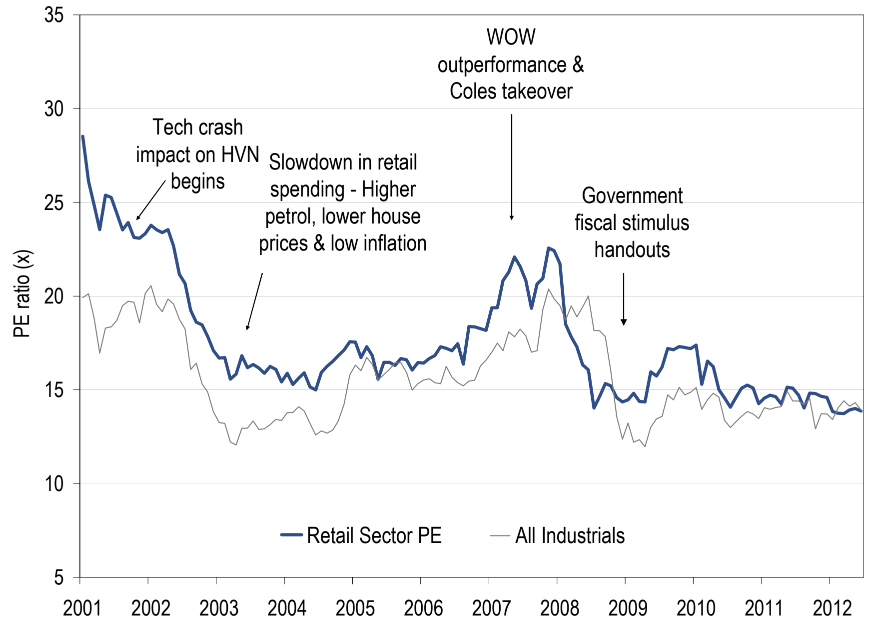



Note: Market data as of May 08 2012; Source: Citi Investment Research and Analysis

# Valuation and financial performance

Figure 50 shows that the retail sector PE is currently trading at a 16% discount to its five year average. The discount reflects concern for discretionary retailers due to the uncertain recovery in retail spending activity.

**Figure 50. Retail sector PE ratio**




Note: Market data as of 8th May 2012; Source: IBES, Citi Investment Research & Analysis

## Retail Sector Valuation

**Figure 51. Retail sector valuation metrics**

| Company | Rating | Target price | Share price | EV/EBIT FY12e | EV/EBIT FY13e | P/E FY12e | P/E FY13e | Div yield FY12e | Div yield FY13e | FCF yield FY12e | FCF yield FY13e |
|---|---|---|---|---|---|---|---|---|---|---|---|
| **Supermarkets** | | | | | | | | | | | |
| Woolworths Ltd (WOW.AX) | 1 | 28.30 | 26.50 | 10.9 | 10.1 | 14.9 | 13.8 | 4.8% | 5.2% | 2.0% | 4.7% |
| Wesfarmers Ltd (WES.AX) | 2 | 29.60 | 30.25 | 12.0 | 11.1 | 16.2 | 14.6 | 5.5% | 6.1% | 1.2% | 3.5% |
| Metcash Ltd (MTS.AX) | 1 | 4.75 | 4.07 | 8.8 | 8.2 | 11.8 | 10.6 | 6.8% | 7.1% | 6.1% | 9.8% |
| ***Global comparable*** | | | | ***7.8*** | ***7.7*** | ***11.5*** | ***10.9*** | ***4.0%*** | ***4.6%*** | | |
| **Department Stores** | | | | | | | | | | | |
| David Jones Ltd (DJS.AX) | 2 | 2.30 | 2.38 | 8.1 | 8.3 | 11.1 | 11.6 | 8.5% | 8.4% | 9.9% | 6.8% |
| Myer Holdings Ltd (MYR.AX) | 2 | 2.30 | 2.34 | 7.3 | 7.2 | 9.4 | 9.5 | 8.6% | 8.5% | 11.9% | 9.6% |
| ***Global comparable*** | | | | ***9.8*** | ***8.9*** | ***12.6*** | ***12.0*** | ***2.2%*** | ***2.5%*** | | |
| **Electrical Retailers** | | | | | | | | | | | |
| Harvey Norman Holdings Ltd (HVN.AX) | 2 | 1.95 | 2.00 | 8.2 | 7.6 | 11.7 | 10.0 | 4.5% | 5.0% | 3.6% | 5.3% |
| JB Hi-Fi Ltd (JBH.AX) | 2 | 10.80 | 9.46 | 6.9 | 6.3 | 9.0 | 8.6 | 7.0% | 7.6% | 8.9% | 9.3% |
| ***Global comparable*** | | | | ***5.4*** | ***4.8*** | ***9.7*** | ***10.7*** | ***0.0%*** | ***0.0%*** | | |
| **Surf/Street wear** | | | | | | | | | | | |
| Billabong International Ltd (BBG.AX) | 2 | 2.80 | 2.40 | 9.4 | 7.9 | 9.6 | 8.1 | 2.5% | 3.3% | 2.6% | 12.7% |
| ***Global comparable*** | | | | ***11.7*** | ***9.7*** | ***16.8*** | ***14.3*** | ***1.5%*** | ***1.6%*** | | |
| **Wholesaler** | | | | | | | | | | | |
| Pacific Brands Ltd (PBG.AX) | 1H | 0.90 | 0.62 | 6.1 | 5.0 | 8.0 | 5.9 | 6.5% | 8.9% | -59.3% | 19.7% |
| ***Global comparable*** | | | | ***10.1*** | ***8.7*** | ***14.7*** | ***14.1*** | ***0.7%*** | ***0.9%*** | | |
| **Clothing retailing** | | | | | | | | | | | |
| Premier Investments Ltd (PMV.AX) | 2 | 5.60 | 5.06 | 6.7 | 6.0 | 13.6 | 12.2 | 7.1% | 7.1% | 8.8% | 8.4% |
| Specialty Fashion Group Ltd (SFH.AX) | 1H | 0.60 | 0.49 | 30.6 | 7.7 | 75.4 | 10.6 | 0.0% | 2.0% | 11.0% | 7.0% |
| ***Global comparable*** | | | | ***9.9*** | ***7.7*** | ***17.6*** | ***14.7*** | ***1.6%*** | ***1.6%*** | | |
| **Luxury Goods** | | | | | | | | | | | |
| OrotonGroup Ltd (ORL.AX) | 2 | 8.40 | 8.46 | 9.2 | 8.3 | 13.3 | 11.9 | 6.1% | 6.7% | 7.7% | 9.1% |
| ***Global comparable*** | | | | ***12.3*** | ***10.7*** | ***18.9*** | ***16.3*** | ***2.1%*** | ***2.3%*** | | |
| **Auto-parts retail** | | | | | | | | | | | |
| Super Retail Group Ltd (SUL.AX) | 2 | 7.50 | 7.40 | 10.4 | 9.0 | 14.4 | 12.6 | 4.4% | 4.8% | 5.7% | 4.4% |
| ***Global comparable*** | | | | ***10.3*** | ***9.3*** | ***16.5*** | ***14.2*** | ***0.1%*** | ***0.1%*** | | |

Note: Market data as of 8th May 2012; Source: Citi Investment Research and Analysis

# Retail Sector Financial Forecasts

**Figure 52. Citi retail sector forecasts**

| | Woolworths | Wesfarmers | Metcash | David Jones | Myer | Harvey Norman | JB Hi-Fi | Billabong | Pacific Brands | Premier Investments | Specialty Fashion Group | Oroton Group | Super Retail Group |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | WOW | WES | MTS | DJS | MYR | HVN | JBH | BBG | PBG | PMV | SFH | ORL | SUL |
| **Sales ($m)** | | | | | | | | | | | | | |
| FY11a | 54,143 | 54,513 | 12,364 | 1,962 | 3,159 | 6,176 | 2,959 | 1,685 | 1,615 | 876 | 569 | 164 | 1,092 |
| FY12e | 56,588 | 57,187 | 12,819 | 1,870 | 3,135 | 5,797 | 3,116 | 1,691 | 1,372 | 836 | 568 | 181 | 1,650 |
| FY13e | 59,798 | 60,063 | 13,004 | 1,896 | 3,196 | 5,794 | 3,235 | 1,603 | 1,383 | 875 | 565 | 193 | 1,960 |
| **Sales growth (%)** | | | | | | | | | | | | | |
| FY11a | 4.7% | 5.9% | 7.4% | -4.4% | -5.0% | 1.6% | 8.3% | 13.6% | -7.3% | -0.3% | -0.4% | 12.3% | 16.5% |
| FY12e | 4.5% | 4.9% | 3.7% | -4.7% | -0.7% | -6.1% | 5.3% | 0.3% | -15.0% | -4.5% | -0.2% | 10.2% | 51.0% |
| FY13e | 5.7% | 5.0% | 1.4% | 1.4% | 1.9% | 0.0% | 3.8% | -5.2% | 0.8% | 4.6% | -0.5% | 6.3% | 18.8% |
| **EBIT margin (%)** | | | | | | | | | | | | | |
| FY11a | 6.1% | 5.7% | 3.5% | 12.6% | 8.2% | 25.3% | 6.6% | 8.9% | 11.5% | 7.4% | 4.0% | 22.2% | 8.0% |
| FY12e | 6.0% | 6.0% | 3.5% | 8.7% | 7.7% | 21.8% | 5.2% | 6.4% | 9.5% | 9.1% | 0.7% | 21.6% | 9.6% |
| FY13e | 6.2% | 6.3% | 3.8% | 8.9% | 7.7% | 23.9% | 5.3% | 7.0% | 11.3% | 9.5% | 2.5% | 22.4% | 10.1% |
| **Core EPS (cents)** | | | | | | | | | | | | | |
| FY11a | 173.6 | 166.3 | 33.3 | 32.4 | 27.8 | 22.4 | 124.0 | 47.0 | 11.1 | 33.0 | 7.6 | 60.6 | 40.1 |
| FY12e | 178.0 | 187.1 | 34.0 | 20.5 | 24.6 | 17.1 | 105.4 | 25.0 | 7.7 | 37.6 | 0.6 | 63.8 | 51.3 |
| FY13e | 191.8 | 206.9 | 37.7 | 20.5 | 24.7 | 19.9 | 110.5 | 29.5 | 10.5 | 41.7 | 4.6 | 71.7 | 58.7 |
| **EPS growth (%)** | | | | | | | | | | | | | |
| FY11a | 6.4% | 15.6% | 4.3% | -1.9% | -5.6% | -17.8% | 14.3% | -18.6% | 14.4% | -21.1% | -51.8% | 8.0% | 22.4% |
| FY12e | 2.5% | 12.5% | 2.0% | -36.7% | -11.4% | -23.9% | -14.9% | -46.8% | -30.4% | 14.0% | -91.4% | 5.3% | 28.1% |
| FY13e | 7.8% | 10.6% | 10.9% | -0.4% | 0.4% | 16.8% | 4.8% | 18.0% | 35.9% | 11.0% | 610.0% | 12.4% | 14.3% |
| **DPS (cents)** | | | | | | | | | | | | | |
| FY11a | 122.0 | 150.0 | 27.0 | 28.0 | 22.5 | 12.0 | 77.0 | 29.0 | 6.2 | 36.0 | 4.0 | 50.0 | 27.3 |
| FY12e | 126.0 | 165.0 | 27.5 | 19.5 | 20.0 | 9.0 | 66.0 | 6.0 | 4.0 | 36.0 | 0.0 | 52.0 | 32.5 |
| FY13e | 138.0 | 185.0 | 28.5 | 20.0 | 20.0 | 10.0 | 72.0 | 8.0 | 5.5 | 36.0 | 1.0 | 57.0 | 35.5 |
| **ROE (%)** | | | | | | | | | | | | | |
| FY11a | 28.0% | 7.7% | 17.9% | 22.0% | 18.7% | 11.7% | 49.2% | 9.9% | -10.3% | 3.4% | 25.5% | 84.9% | 19.4% |
| FY12e | 24.7% | 8.3% | 8.8% | 13.8% | 16.7% | 9.1% | 56.8% | 6.7% | -33.2% | 4.9% | 2.3% | 82.2% | 17.1% |
| FY13e | 27.4% | 9.4% | 21.9% | 13.9% | 16.3% | 8.4% | 46.7% | 6.5% | 11.5% | 5.4% | 14.6% | 79.5% | 16.4% |
| **Working cap to sales (%)** | | | | | | | | | | | | | |
| FY11a | -1.2% | 3.8% | 4.7% | 4.7% | -0.2% | 8.9% | 5.5% | 22.5% | 19.3% | 3.8% | 0.4% | 14.1% | 17.6% |
| FY12e | -1.2% | 3.5% | 4.2% | 2.5% | -0.4% | 8.8% | 5.2% | 19.9% | 21.4% | 3.2% | 0.2% | 15.6% | 14.9% |
| FY13e | -1.5% | 3.0% | 3.9% | 2.5% | -0.5% | 9.1% | 4.6% | 18.4% | 20.1% | 2.4% | 0.9% | 14.8% | 14.1% |
| **Capex to sales (%)** | | | | | | | | | | | | | |
| FY11a | 3.9% | 3.8% | 0.3% | 4.1% | 4.3% | 5.6% | 1.5% | 3.1% | 1.3% | 2.6% | 6.0% | 3.8% | 3.4% |
| FY12e | 4.1% | 4.9% | 0.6% | 4.1% | 1.9% | 3.8% | 1.7% | 5.5% | 1.6% | 1.9% | 2.4% | 2.6% | 2.8% |
| FY13e | 3.5% | 4.0% | 0.4% | 4.2% | 3.4% | 2.5% | 1.7% | 4.2% | 1.5% | 2.8% | 2.6% | 2.2% | 3.1% |
| **EBITDA interest cover (x)** | | | | | | | | | | | | | |
| FY11a | 15.8 | 10.6 | 7.3 | 40.8 | 9.5 | 13.7 | 55.4 | 8.3 | 5.8 | nm | 28.5 | 40.0 | 11.2 |
| FY12e | 14.5 | 11.5 | 7.1 | 20.7 | 9.6 | 9.0 | 14.9 | 5.2 | 5.2 | nm | 13.3 | 38.7 | 7.9 |
| FY13e | 16.6 | 11.5 | 7.4 | 17.4 | 9.7 | 9.3 | 15.6 | 6.9 | 7.1 | nm | 22.6 | 45.3 | 7.3 |

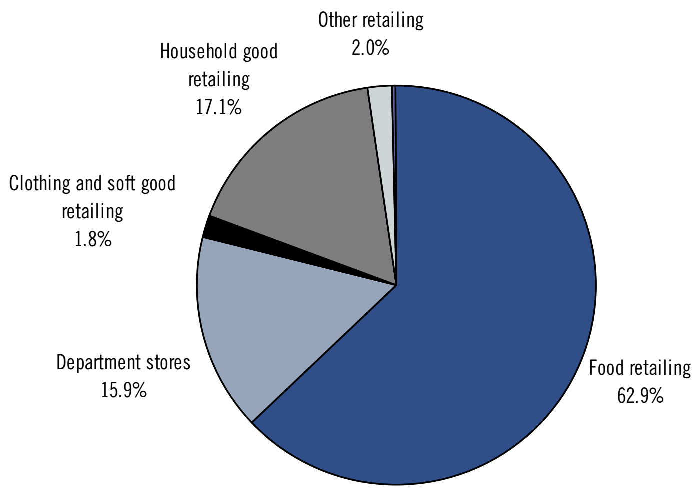
Note: Market data as of 8th May 2012; Source: Citi Investment Research and Analysis

# Appendix 1 Explanation of data

## Retail sales indicator

The Citi Retail Sales Indicator comprises of a basket of listed retail sector companies with market capitalisations above $100 million. We calculate our indicator by weighting each retail category within the Australian Bureau of Statistics (ABS) Retail Trade series, by the total listed company sales mix. Figure 31 shows the sales base of the listed company's, with an obvious bias towards Food retailing, given Woolworths and Wesfarmers' inclusion.

**Figure 53. Listed company sales base assumption**




Source: Citi Investment Research & Analysis

## Retail sales and prices

Industry retail sales performance is compared to the previous corresponding period, by category and is presented on a rolling quarterly basis. The data supplied by the ABS. We assess real growth and the implied inflation by category using chain volume data supplied by the ABS.

## Weather

We use a weighted average of the yearly difference in monthly maximum temperature readings from each major Australian capital city. The maximum temperature reading by capital city is supplied by the Bureau of Meteorology.

## Petrol

We use the average unleaded petrol price for each capital city in Australia to derive a weighted national petrol price. Our weights are population based.

## Valuation and financial forecasts

Our sector PE chart is derived from the one year-forward PE's. We weight each company's by the respective market capitalisation to compute our sector PE.

The remainder of the financial forecasts within the 'Valuation' section are Citi's forecasts.

# Appendix 2 Previous Issues

**Issue 37 (9 June 2011)**
**Thinking Like a Retailer**

**Companies mentioned: WOW, WES, PMV, JBH, DJS, MYR, SUL**

## Issue 38: Thinking Like a Retailer

Measures of retail performance often focus on comparable stores sales growth and EBIT margins. These are limited and prone to being massaged to satisfy investor expectations. In Issue 38 of What's In Store?, we explore retail measures used by retailers themselves. These measures look at the productivity of floor space and success in working through inventory. On these measures Premier Investments is the strongest performing retailer, followed by David Jones, Woolworths and Myer. Moreover Australian retailers actually stack up well versus international peers, primarily associated the limited retail floor space in most categories.

https://www.citigroupgeo.com/pdf/SAU81927.pdf

**Issue 39 (8 July 2011)**

**Where does the Household Savings Rate Settle?**

**Companies mentioned: WOW, MTS, JBH, DJS, MYR, HVN**

## Issue 39: Where does the Household Savings Rate Settle?

The Australian household has had a reality check over the past three years. After drawing on savings for many years, they have now developed a more rational balance between spending and saving. In this issue of What's In Store?, we assess at the outlook for the household savings rate and implications for retail spending. The fifty year average for savings is 8.8% of income and the current run-rate is 8.9%. In our view, the likely range is 8%-14%, with three factors to watch – house prices, interest rates and the AUD/USD. The implications for retail spending are sub-trend growth and we expect all discretionary categories to be affected. Food retailers are clearly more defensive, but discretionary retailers are already trading depressed PE ratios that reflect a weak outlook.

https://www.citigroupgeo.com/pdf/SAU11780.pdf

**Issue 40 (16 August 2011)**

**Demystifying Retail Leases**

**Companies mentioned: WOW, JBH, DJS, MYR, HVN, WES, SUL, PMV**

## Issue 40: Demystifying Retail Leases

Leases are prevalent in Australian retailing and can be a source of cost pressure in a slow sales environment. In Issue 40 of What's In Store?, we delve into the detail to understand the nature of retail lease agreements and the implications for profit margins. “Anchor” tenants, such as Wesfarmers and Woolworths, and high profile retailers like JB Hi-Fi are best placed because their lease agreements typically provide for turnover contingent rents that ensure lease costs remain fairly constant with sales. However, specialty retailers like Premier Investments need sales growth ahead of inflation to avoid rental cost ratios escalating. We also explore the implications of placing leases on balance sheet, which may eventuate under new accounting rules. The most significant increase in balance sheet gearing is for Myer and Premier Investments.

https://www.citigroupgeo.com/pdf/SAU12107.pdf

**Issue 41 (9 September 2011)**

**Retailers addicted to discounts**

**Companies mentioned: WOW, JBH, DJS, MYR, SFH, SUL, PMV**

## Issue 41: Retailers addicted to discounts

Retailers are searching for new ways to grow their profits. The focus is increasingly shifting to higher gross profit margins. In Issue 41 of What's In Store?, we assess the scope to reduce discounting. In our view, the discounting over the past year has been driven by the pass through of the higher Australian dollar. Retailers are more prepared to use discounts, rather than lower shelf price points in such an environment. The implication for retailers like David Jones, Myer and Premier Investments is that lower levels of discounting will be difficult to achieve unless shelf prices are reduced, or lower volumes budgeted for. We have Hold ratings on these retailers and see better value in electronics retailers JB Hi-Fi and Harvey Norman where valuation multiples are more attractive.

https://www.citivelocity.com/geo/pdf/SAU88689.pdf

**Issue 42 (6 October 2011)**

**FY11 results - Trying to Protect Margins**

**Companies mentioned: WOW, WES, MTS, HVN, JBH, DJS, MYR, BBG, PMV, PBG, SUL, SFH**

### Issue 42: Trying to Protect Margins

Retail reporting season has drawn to a close for FY11. The results were mixed, a reflection of the retail sales environment. In Issue 42 of What's In Store?, we analyse the results of 31 retailers. While sales have been weak, more than half the retailers had an increase in operating earnings, primarily through higher gross margins. Retailers are lucky that the surging Australian dollar has provided a gross margin cushion to the weaker sales backdrop. The outlook is more constrained. The majority of retailers had a rise in inventory and many are signaling an investment in online and staffing that may also crimp margins. Our investment preference is for companies that have store rollout opportunities such as JB Hi-Fi and Super Retail Group.

https://www.citivelocity.com/geo/pdf/SAU90508.pdf

**Issue 43 (9 November 2011)**

**An Age Old Question for Retailers**

**Companies mentioned: SFH, FLT**

### Issue 43: An Age Old Question for Retailers

Australia's population is aging, like many other developed countries. In Issue 43 of What's In Store?, we look at the changing age profile for Australia and the impact on retail spending. The population over 65 will grow by 2.3% per annum over the next forty years to 7.6 million, while those under 65 will only grow at 0.8%. Older Australians tend to spend more on medical expenses, fresh foods and holidays and less on furniture, clothing and alcohol & tobacco. There are two retail companies set to benefit from the aging profile – Specialty Fashion Group, which has clothing stores that target older demographics, and Flight Centre, which offers travel services. We have Buy ratings on both companies.

https://www.citivelocity.com/geo/pdf/SAU12788.pdf

**Issue 44 (14 December 2011)**

**Elusive Factory Outlet Options**

**Companies mentioned: DJS, HVN, JBH, MYR, ORL, PBG, PMV, SFH**

### Issue 44: Elusive Factory Outlet Options

Factory outlets are embraced by some retailers, but shunned by others. In Australia, it is a $2 billion retail market and in our view a way to segment shopper preferences effectively. Moreover, the profit margins and return on capital are often higher in outlet stores because sales productivity is higher and rental costs are lower. While developing this channel may be a growth option for David Jones, Myer and Premier Investments, the under-utilised floor space for full-line department stores or specialty stores needs to reduce, a challenge given lease terms. We expect some growth in factory outlet retailing online, through flash sale websites.

https://www.citivelocity.com/geo/pdf/SAUT1NYT.pdf

**Issue 45 (9 February 2012)**

**Consumers Spending Elsewhere**

**Companies mentioned: FLT, SUL, MTS**

### Issue 45: Consumers Spending Elsewhere

Retailers are complaining because shoppers are not spending money in their stores. The reality is that retail spending is much weaker than broader consumer spending. In Issue 45 of What's In Store?, we explore the substitution between retail and other spending categories. In discretionary retailing, travel has taken almost half of the growth from retail. In food retailing, restaurants and café's are not taking away share from supermarkets but are rather complementing its growth. These trends are partly lifestyle driven and partly price driven. The implication is weak retail sales growth again in 2012 as consumers switch more of their spending to travel, recreation and personal care. We prefer Metcash for its defensive attributes and both Flight Centre and Super Retail Group for their ability to tap into these consumer trends.

https://www.citivelocity.com/geo/pdf/SAUJQYIU.pdf

**Issue 46 (5 March2012)**

**Private Equity Eyes on Retail**

**Companies mentioned: BBG, DJS, HVN, JBH, MTS, MYR, ORL, PBG, PMV, SFH, SUL, WHS, WES, WOW**

## Issue 46: Private Equity Eyes on Retail

Private equity is circling the Australian retail sector. In Issue 46 of What's In Store?, we analyse the private equity interest in listed retailers by using the typical private equity framework. There are three distinct groups of companies of interest – margin recovery, asset plays and cash flow returns. There are four companies that present the highest interest on our scorecard and the potential internal rate of return (IRR) – Billabong, Pacific Brands, Harvey Norman and Specialty Fashion Group. While Billabong and Pacific Brands are well known, Harvey Norman and Specialty Fashion have large blocking shareholders that present the most significant hurdle for potential bidders.

https://www.citivelocity.com/geo/pdf/SAUN100Q.pdf

**Issue 47 (10 April 2012)**

**Close to the Edge**

**Companies mentioned: BBG, DJS, HVN, JBH, MTS, MYR, ORL, PBG, PMV, SFH, SUL, WHS, WES, WOW**

## Issue 47: Close to the Edge

The retail sector earnings result season provides a great snapshot of the painful adjustments retailers need to make. Most retailers reported weak sales and rising operating costs during 1H12. The only saviour was the higher Australian dollar by supporting gross profit margins. In Issue 47 of What's in Store?, we analyse the recent financial results and implications for future profitability. The sales headwinds will persist, primarily through deflation and living cost pressures. Currency gains may carry through for another six months, but the need to become price competitive will be a bigger headwind over the medium term. Moreover, over three quarters of the 31 retailers we analyse reported an increase in inventory days, posing risks for the next year's profit margins. Given these challenges, our stock preferences are Metcash and Woolworths, where the online retailing threat is minimal and industry structure highly attractive. We have Buy ratings on both companies.

https://www.citivelocity.com/geo/pdf/SAUZNWKT.pdf

## Notes

## Notes

# Appendix A-1

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