

## What's In Store? Issue 50

### Shopping for Imports

#### ■ Industry Overview

- **Importance of imports to Australian retailing** — Australian retailers are increasingly turning to imports. In Issue 50 of What's In Store?, we look at the profit opportunities and risks from this reliance on imports. We expect China to remain the key trading partner for retail goods and see significant growth in imports for food and furniture. While a margin opportunity, it may end up a deflationary disappointment. This is a risk for Harvey Norman, Wesfarmers and Woolworths.
- **How significant has the growth been?** — Over the past twenty years, merchandise imports have grown by 7.1%, compared with retail sales growth of 5.5%. China is the largest provider of imported goods at 18% share, followed by the US at 11%. We estimate over 90% of electronics sales come from imported goods and 63% of clothing and footwear finished goods are imported into Australia.
- **Food and furniture to follow** — The penetration of imports in furniture is 20% and food imports are approximately 15% of Australian sales. Given emerging countries like China have wage rates one-tenth that of Australia, the cost advantage is likely to encourage more offshore sourcing in these categories.
- **Is direct sourcing margin enhancing or deflationary?** — Major retailers like Wesfarmers and Woolworths directly source less than 10% of their goods. Given weak sales, retailers will look to lift direct offshore sourcing. While initially a margin uplift, it is likely to lead to price deflation as competition and few barriers to offshore sourcing see the gains passed through.
- **Citi Retail Sales Indicator up 5.7% in May 2012** — Retail sales accelerated in May particularly for supermarkets, department stores and electronics. We believe one-off government stimulus lifted sales growth.

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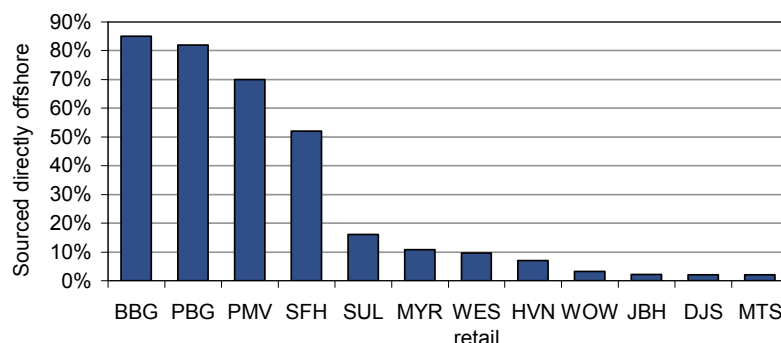
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Proportion of directly sourced goods for Australian retailers (FY12e)



Source: Citi Research estimates

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

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## What's In Store? Issue 50

Australia exports large quantities of raw materials but imports the majority of its finished goods. In Issue 50 of *What's in Store?*, we look at the retail sector's reliance on imports and likely impact on sourcing costs over the next five years. Relative wage costs and productivity make China the natural destination for sourcing in future, despite cost pressures. We expect a notable increase in imports for food and beverages and furniture, which may create deflationary pressures in those categories. This would pose risks for Harvey Norman, Wesfarmers and Woolworths.

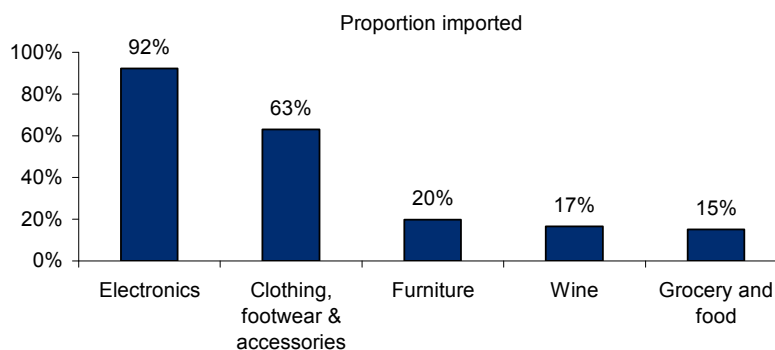
### The importance of imports to Australian retailing

Australia's consumption growth has been fuelled by imports. In this report, we address the following issues:

- What has been the growth of imports and which are the key sourcing countries?
- How reliant are retail categories on these imports?
- What offshore sourcing challenges and opportunities are likely over the next five years?

We estimate that over 90% of electronic items and 63% of clothing and footwear are sourced from offshore. As shown in Figure 1, the proportions are much lower in other retail categories. Will these categories head the same way as electronics and clothing and does that provide a margin upside, or a deflation headwind?

Figure 1. Proportion of retail categories sourced from imports (finished goods)



Source: ABS, Citi Research

#### 1. How significant is the growth in imports?

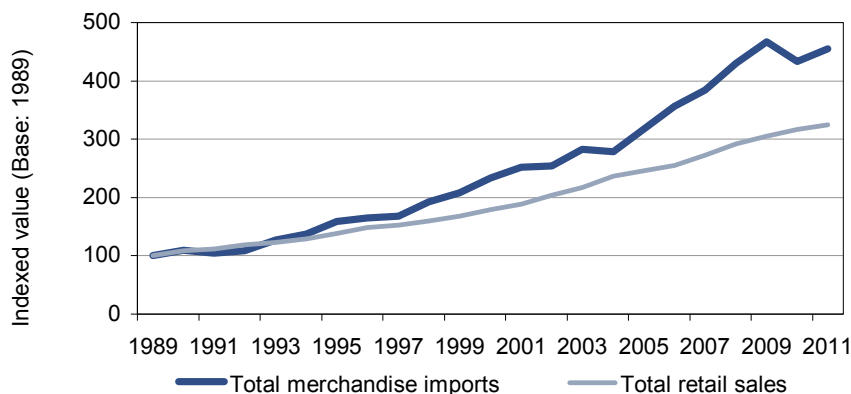
In the 12 months to April 2012, Australia imported \$238 billion in merchandise. Merchandise imports make up 78% of total Australian imports.

As shown in Figure 2, merchandise imports have risen at a faster rate relative to retail sales over the past twenty years. The following factors have driven the strong merchandise import growth:

- Lower tariffs (import duties).
- Liberal trade agreements.

- Rapid industrialization in exporting emerging nations, which have a much lower labour wage rate relative to Australia.
- A stronger Australian dollar.

Figure 2. Merchandise imports vs. overall retail sales trend (1989-2011)

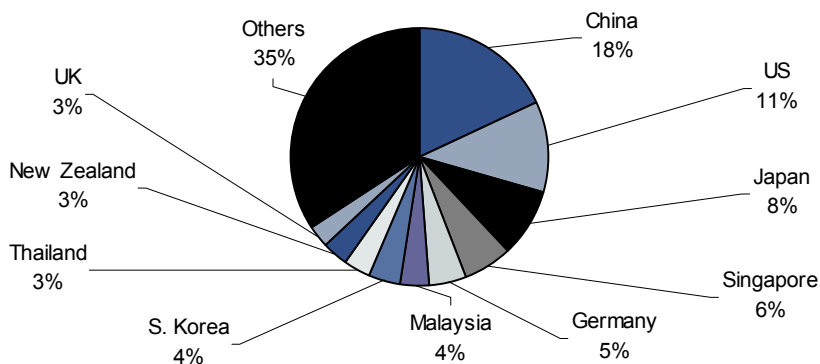


Source: ABS, Citi Research

### Which countries does Australia import from?

For the 12 months to May 2012, China accounted for 18% of total merchandise imports to Australia. The US was the second largest contributor with an 11% share followed by Japan at 8% share.

Figure 3. Merchandise import breakup (12 months to May 2012)

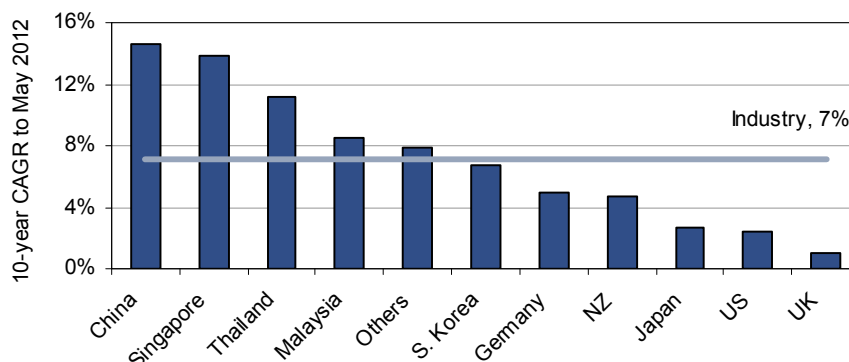


Source: ABS, Citi Research

Total merchandise imports from China have increased at a CAGR of 15% in the past decade. The major drivers were:

- Cheap labour.
- Rapid industrialization.
- Efficient port infrastructure.

Figure 4. Leading Australian importers growth rates (10-year CAGR to May 2012)



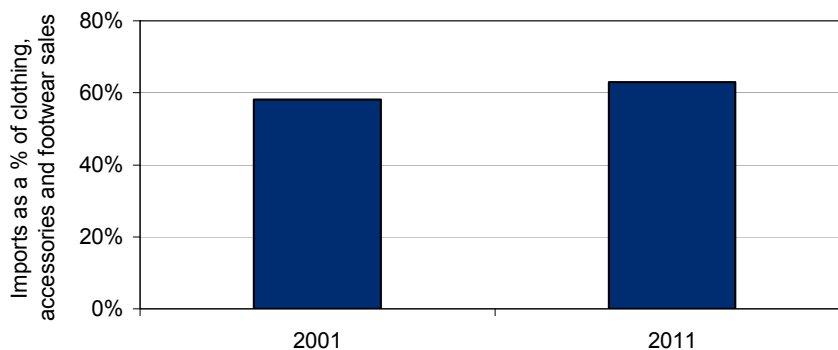
Source: ABS, Citi Research

## 2. How developed are imports across retail categories?

### Clothing imports

We calculate that 63% of clothing and footwear sales in Australia are from directly imported goods. This has increased from 58% in 2001. The increase in imports is notable, but not significant and reflects Australia's early adoption of cheaper production sources in China and proximity to sourcing in South East Asia.

Figure 5. Import share of clothing and footwear retail sales value (2011 vs. 2001)

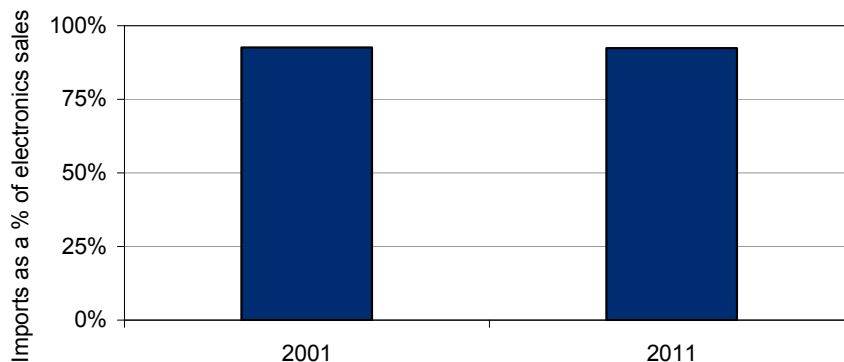


Sources: ABS, Citi Research

### Electronics imports

Electronics imports have remained largely stable as a share of domestic sales over the past decade. Australia has not had trade barriers on electronics products. However, we note that the source of imports have changed over the years. For instance, over the past decade, Japan has lost home electronics import share to Korea and China.

Figure 6. Import share of electricals and electronics retail sales value (2011 vs. 2001)

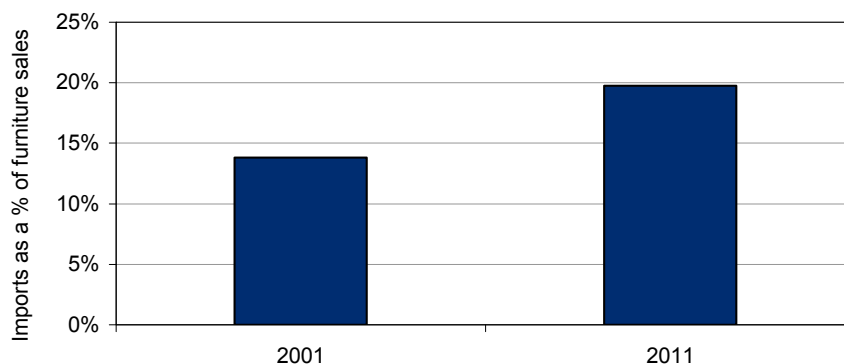


Sources: ABS, Citi Research

### Furniture imports

Imports increased from 14% to 20% of sales in furniture between 2001 and 2011. While the Australian dollar was a factor, we note the increased popularity of cheaper “package deal” products as a driver of import growth. Even though imports are growing, we see a substantial increase over the next five years as the cost of imports, including transport is much lower than domestic production.

Figure 7. Import share of furniture retail sales value (2011 vs. 2001)

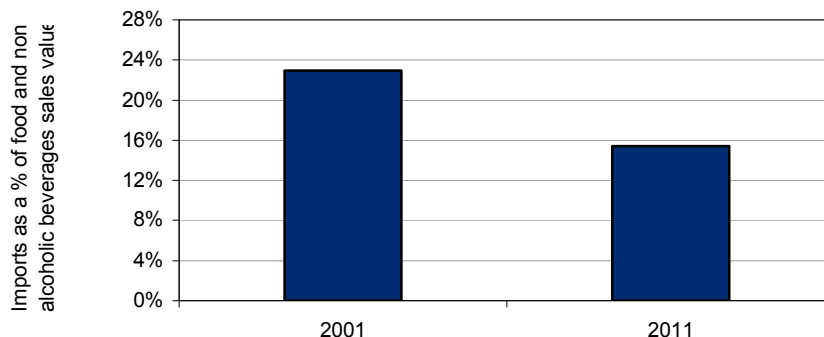


Sources: ABS, Citi Research

### How advanced are food and beverages categories?

Imports in grocery and foods categories are an estimated 15% of all sales, which is below many European markets. The percentage imported has actually decreased over the past 10 years given restrictions on imports of fresh food items. We expect growth to accelerate with the rise in private labels and parallel imports. Even if these products have only limited success, we expect manufacturers to also look at consolidation and costs of labour as reasons to shift production offshore. One limiting factors, is quarantine standards which are discussed below.

Figure 8. Food & non-alcoholic beverages imports as a percentage of total food retail sales

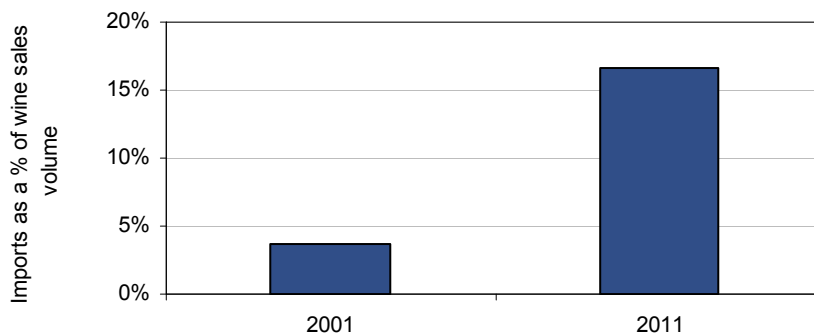


Sources: ABS, Citi Research

## Wine imports

Wine imports have grown strongly over the past decade. Imported wine has increased from 4% of total Australian sales volumes to 17% over the past ten years. We believe there are two main drivers for such strong growth. First, the Australian wine drinker is trading up to finer / imported wines. And second, the combination of Australian dollar strength and the global wine glut has made finer wines more affordable.

Figure 9. Wine imports as a percentage of total wine retail sales



Sources: ABS, Citi Research

## What barriers exist to importation?

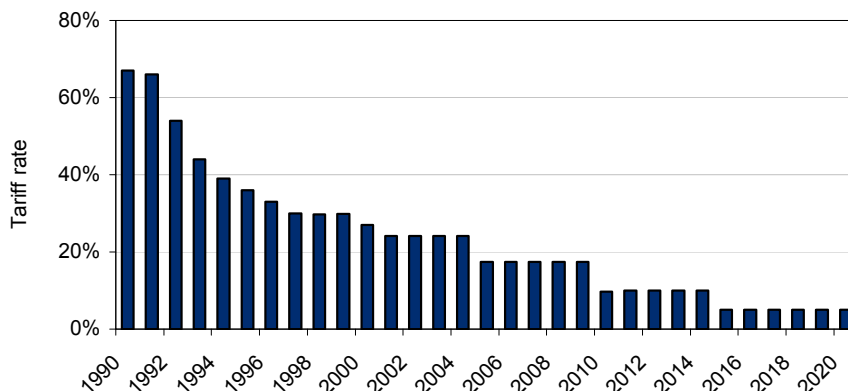
We identify three barriers to imports:

- Quarantine standards.
- Tariffs.
- Cost of shipping.

Australian regulations require passengers, cargo & mail imported into the country to comply with quarantine restrictions. All animals and animal products (like dairy, eggs & meat), as well as plants & parts of plants (like fruit, seeds, cuttings) are subject to quarantine restrictions to protect domestic industries. The full list of goods is included on page 13.

Australian tariffs exist on clothing, footwear and some autoparts. The tariffs have dropped significantly between 1990 and today and will fall to 5% on clothing by 2015. We show the change in tariffs on clothing in Figure 10.

**Figure 10. Import tariff trend for clothing (1990-2020)**



Sources: Australian department of foreign affairs and trade

Shipping costs are volumetric. As a rule of thumb, one container shipped from a port in Shanghai to Sydney would cost approximately A\$1,500. One 40ft container can hold 40-45 sofa sets (ie: 120 seats), or 64,000 adult-sized t-shirts. For furniture, the cost is roughly \$33 per set, which may be an important threshold depending on the price point of the product.

### 3. How will sourcing change over the next five years?

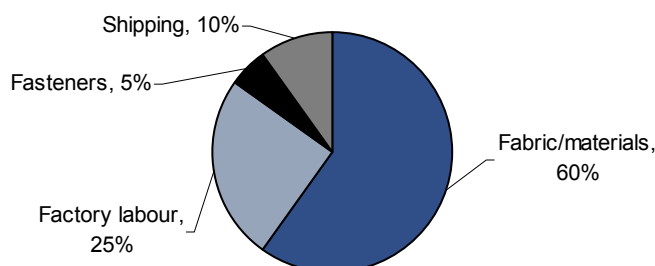
The pressure on retail profitability will result in significant emphasis by retailers to refine their sourcing. The most influential factors are likely to be:

- Cost of local wages.
- Productivity of the workers and quality of output.
- Shipping time.
- Exchange rates.

In Figure 11 below, we show the breakdown of costs for a typical clothing import to Australia. The cost of labour is significant, but material costs are even more important. So the sourcing country's access to fabrics or parts and speed of supply chain are all crucial factors.



Figure 11. Clothing input cost breakdown



Sources: Citi Research

### Cost of wages

Labour cost is an important factor when it comes to assessing savings from outsourcing. This is particularly true for labour intensive industries such as apparel and footwear. In Figure 12 we show the manufacturing industry labour cost for leading importers as well as key emerging markets. On average, developing nations hourly wage rates are roughly one-seventh of the developed nations. Australia has the highest wage rates for manufacturing jobs.

Figure 12. Labour manufacturing cost and population for Australia's leading/potential import markets – 2011e

	Average manufacturing labour costs (A\$/hour) - 2011	Population – 2011
Vietnam	\$0.46	92
India	\$0.46	1205
Indonesia	\$0.66	248
China	\$1.20	1343
Thailand	\$1.22	67
Malaysia	\$1.76	29
South Africa	\$1.91	49
S.Korea	\$4.50	49
Singapore	\$5.87	5
United States	\$7.57	314
United Kingdom	\$9.64	63
Japan	\$10.56	127
Germany	\$12.19	81
New Zealand	\$13.13	4
Australia	\$15.16	22

Done at 12 July 2012 exchange rates to Australian dollar.

Sources: International Labour Organisation, Wage Indicator, IMF, Bloomberg, CIA World Factbook, Citi Research

We expect developing country wage growth to outstrip Australia and other developed countries. However, the contribution of wages to product costs and the differential in wage rates is likely to result in sourcing remaining centred around South East Asia.

### Productivity and quality of the output

Wage rates may be an initial attraction, but one of the more difficult issues to quantify is the productivity of workers and quality of the items made. These issues are important in considering the total cost and realized gross margin on imported goods. Our industry contacts suggest that China's productivity per worker in clothing and footwear is 20-30% higher than other Asian nations like Bangladesh and

Cambodia. In addition, other Asian nations rarely have the ancillary items or raw materials, which must be imported from China, or Europe.

Quality control is also important in offshore sourcing, particularly in private labels where the brand equity ultimately lies with the retailer. Once again our contacts suggest China is far ahead of other Asian nations in quality control procedures and levels.

### Shipping times

Shipping is an important factor in sourcing as it impacts transit time and safety of goods in transit. As shown in Figure 13, China is most efficient in terms of shipping transit time to Australia. South Africa has the longest transit time due to its location disadvantage relative to Australia.

**Figure 13. Shipping time comparison between Australia's leading/potential importing countries**

Market	Shipping time (days)
China	21
Indonesia	22
Vietnam	29
India	28
South Africa	40

Sources: Australian Trade & Shipping, Citi Research

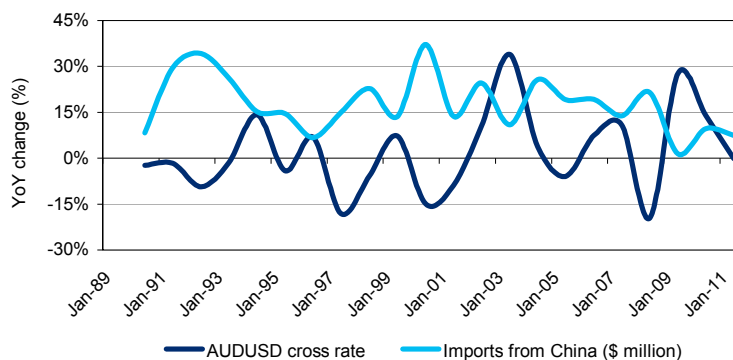
Port infrastructure is also an important parameter for exporters as it directly impacts the safety levels of goods during transit. For developing nations, a World Bank survey found South Africa has the best port infrastructure among key potential importers while China is a close second.

### The importance of currency

The biggest swing variable and most volatile item is the Australian dollar exchange rate. The Australian dollar at parity to the US dollar makes imports highly compelling for most product categories. However, if the currency were to drop 20% against major trading partners, would the economics change? We do not think so. We expect a greater 30%-40% drop in currency would be required to fundamentally change sourcing decisions.

In Figure 14, we show the correlation between changes in imports from China and movements in the Australian dollar. If currency is the motivator, these should be positively correlated. It's not the case.

**Figure 14. Change in AUDUSD cross rate vs. change in imports from China (1990-2011)**

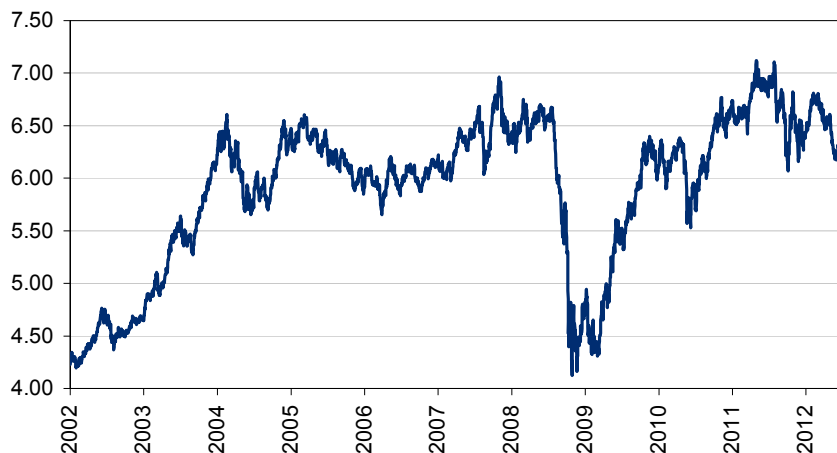


Sources: ABS, Bloomberg, Citi Research

The currency exchange rate that poses a risk for Australian retailers is the AUD against the Chinese Renminbi (RMB). The RMB is pegged against a basket of trading partners currencies and therefore only moves by a modest amount.

Over the past ten years the AUD/RMB exchange rate has appreciated by over 50% but could appreciate further if it were allowed to freely trade in FX markets.

Figure 15. AUD/RMB Exchange Rate

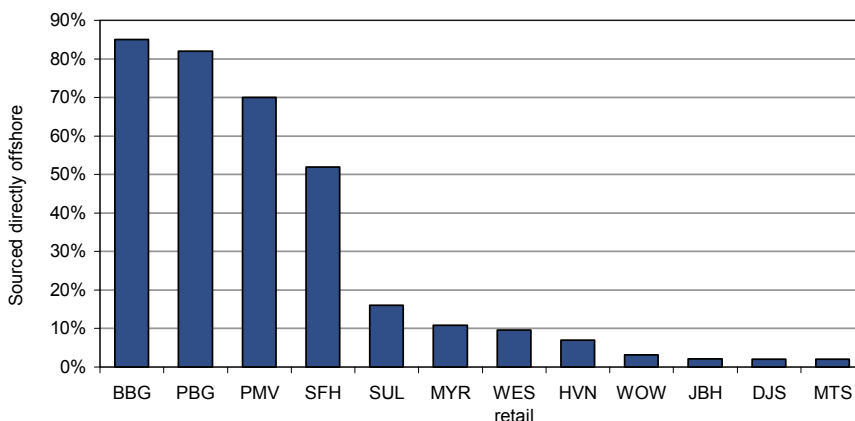


Source: dataCentral, Citi Research

### Conclusion – more sourcing offshore

The Australian listed retailers may sell many imports, but still rely on wholesalers, brand owners or agents in many cases. We expect this to change in the quest to protect profit margins. We show an estimate of the share of offshore direct sourcing by each Australian retailer in Figure 16. It's low for most companies at less 20% for 8 of the 12 retailers.

Figure 16. Direct offshore sourcing estimates by retailer (FY12e)



Source: Citi Research estimates

A gross margin uplift from direct offshore sourcing is the attraction, but deflation may be the outcome. The ease of access and increased productivity in Chinese

factories and ports has made access to offshore sourcing cheaper and easier, therefore lowering the barriers to entry and cost.

We expect import growth to continue to outstrip retail spending growth in Australia as more product is shipped from low cost countries. We expect the growth in imports to contribute to price deflation, rather than add to gross profits for Australian retailers. The categories most vulnerable are furniture and food retailing where the penetration rates are lowest. The retailers at risk from this deflationary trend are Harvey Norman, Wesfarmers and Woolworths.

## Quarantine rules for Australia

Figure 17. Australian quarantine check list

Food commercially prepared, cooked and raw food and ingredients	Dairy and egg products	Animal products	Seeds and nuts	Fresh fruit and vegetables	Live animals and animal products	Other goods	Plant material
Dried fruit and vegetables*	Dairy products (fresh and powdered) including milk, cheese and 'non-dairy' creamers	All uncanned meat including fresh, dried, frozen, cooked, smoked, salted or preserved—from all animal species	Cereal grains, popping corn, raw nuts, pine cones, birdseed, unidentified seeds, some commercially packaged seeds, and ornaments including seeds.	All fresh and frozen fruit and vegetables.	All mammals, birds, birds eggs and nests, fish, reptiles, amphibians and insects	Biological specimens including tissue culture*	All potted/bare rooted plants, cuttings, roots, bulbs, corms, stems and other viable plant material
Instant noodles and rice*	Cheese—must be commercially prepared and packaged and originate from countries free from foot and mouth disease	Sausages, salami and sliced meats	x	x	Feathers, bones, horns, tusks, wool and animal hair	Craft and hobby lines made from animal or plant material	Banana products including food (fresh and dried) and souvenirs made with banana plant material
Packaged meals*	Airline food containing dairy including milk, yoghurt and sandwiches containing cheese	Airline food including sandwiches containing meat	x	x	Skins, hides and furs	Used sporting and camping equipment including tents, footwear, hiking boots, golf equipment and bicycles (need to be checked to ensure they are free from soil contamination)	Souvenirs made with or filled with straw, including Thai cushions
Herbs and spices*	All whole, dried and powdered eggs, and egg products, such as mayonnaise	Fish and other seafood products*	x	x	Stuffed animals and birds (taxidermy certificate required—some may be prohibited under endangered species laws)	Used freshwater watercraft or fishing equipment including rods and nets, waders, kayaks, paddles and life jackets.	Wooden articles and carvings including painted or lacquered items
Herbal and traditional medicines, remedies, tonics and herbal teas*	Homemade egg products including noodles and pasta that are not commercially manufactured.	Pet food—including canned products and rawhide chews	x	x	Shells and coral (including jewellery and souvenirs)	x	Items that include bark
Snack foods*	x	Rawhide articles and handicrafts including drums.	x	x	Bee products including honey,* beeswax and honeycomb	x	Artefacts, handicrafts and souvenirs made from plant material
Biscuits, cakes and confectionery*	x	x	x	x	Used animal equipment including veterinary equipment and medicines, shearing or meat trade tools, saddlery and tack and animal or bird cages.	x	Mats, bags and other items made from plant material, palm fronds or leaves
Black tea, coffee and other beverages	x	x	x	x	x	x	Straw products and packaging*
Infant formula (must be accompanying a child)	x	x	x	x	x	x	Bamboo, cane or rattan basket ware and furnishings
Airline food/snacks.	x	x	x	x	x	x	Potpourri* and coconut shells
x	x	x	x	x	x	x	Christmas decorations, wreaths and ornaments
x	x	x	x	x	x	x	Dried flowers and arrangements
x	x	x	x	x	x	x	Fresh flowers and leis.

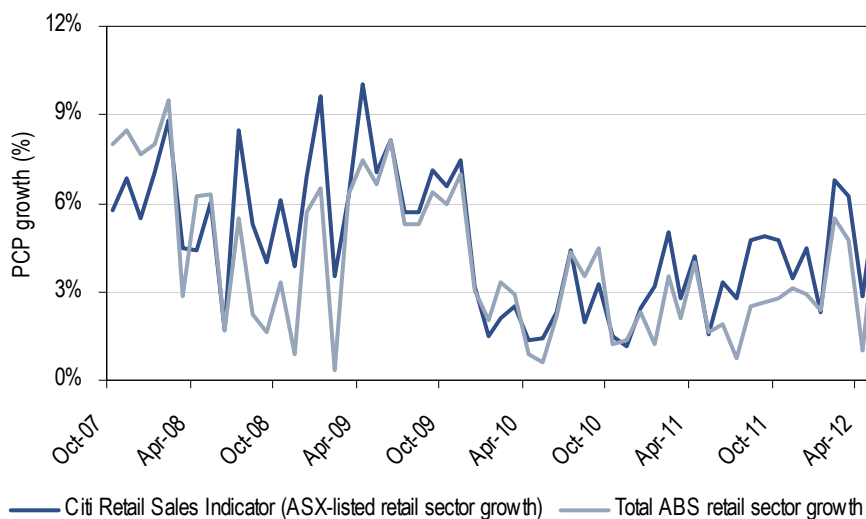
Source: DAFF, Citi Research

## 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 5.7% in May 2012, above the ABS total retail sales growth of 4.8% mainly due to a greater weight assigned to supermarkets vs. other categories.

Figure 18. Citi Retail Sales Indicator (retail sector sales growth for ASX-listed companies)



Source: ABS, Citi Research

## Sector performance for May 2012

Figure 19. Retail category monthly growth rate on pcp (%)

Month ended:	May-11	Apr-12	May-12
Supermarket	1.8	2.5	4.9
Department	-1.3	-5.5	3.4
Clothing	-0.6	-3.5	1.3
Furniture,	8.5	-7.0	-3.2
Electrical	-5.3	0.2	4.7
Hardware	3.2	-1.2	1.0
Total (Industry)	1.6	0.8	4.8

Source: ABS, Citi Research

Retail sales accelerated to 4.8% growth in May 2012 compared with May 2011. This is the strongest growth rate since November 2009 and in our view reflects Government stimulus payments handed out during the month. The largest rebound was seen in department stores and clothing. Furniture sales were in decline.

### Key points

- **Supermarkets up 4.9%** - Supermarket sales accelerated to 4.9% growth in May 2012, up from 2.5% growth in April 2012. The acceleration is mostly attributable to a smaller level of produce deflation. Vegetable prices have been higher with a short-term supply shortage. Cafes, restaurants and takeaway food continues to take share up 8.8% in May 2012.
- **Department stores up 3.4%** - Department store sales were in decline in April, but rebounded in May. The stimulus handouts of \$410 to primary school children and \$820 to secondary school children during the month are likely to have boosted sales for Target, Kmart and Big W.
- **Clothing specialties up 1.3%** – Clothing retailers have experienced a modest rebound. Weather was 0.8 degrees Celsius warmer in May 2012, but the more important challenge has been weaker fashion trends, particularly in womenswear.
- **Electronics up 4.7%** – The electronics category has experienced a notable rebound, which may reflect recent new model introductions in key categories like televisions.
- **Hardware and furniture** – Hardware sales rose 1%, while furniture sales fell 3.2%. The “housing” related categories have softened over the past quarter after very strong growth during 2011. We expect sales trends to remain weak as home purchase activity is slow.

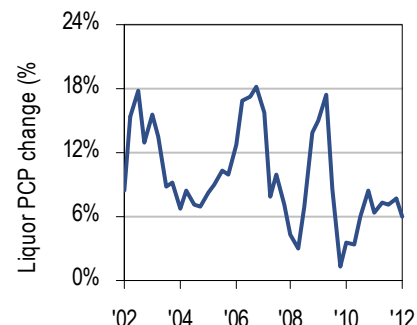
## Sector specific performance – rolling 3 months to May '12

Figure 20. Supermarkets



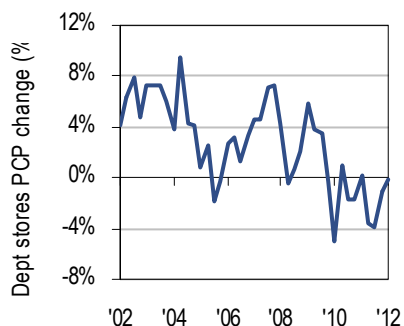
Source: ABS 8501.0

Figure 21. Liquor retailing



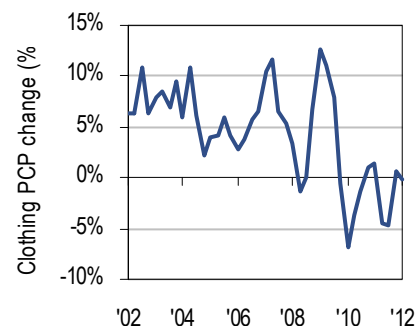
Source: ABS 8501.0

Figure 22. Department stores



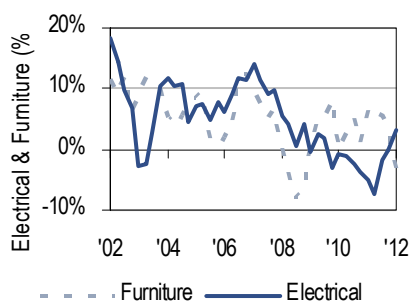
Source: ABS 8501.0

Figure 23. Clothing



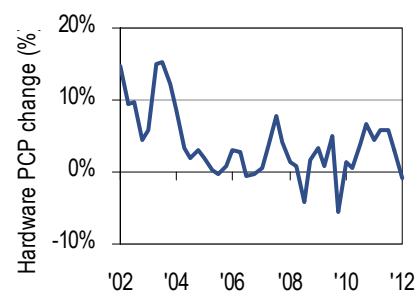
Source: ABS 8501.0

Figure 24. Electrical and Furniture



Source: ABS 8501.0

Figure 25. Hardware



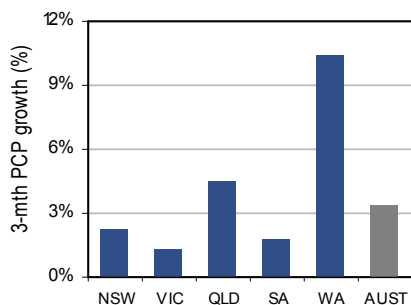
Source: ABS 8501.0



## State based performance

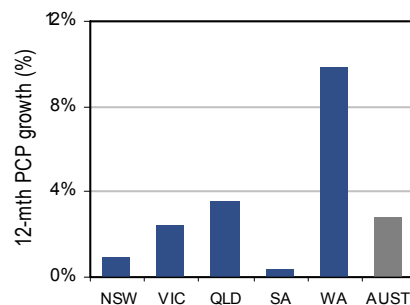
Figure 26 and Figure 27 show the quarterly and yearly sales growth performance for each state respectively.

Figure 26. 3-month sales growth by state



Source: ABS 8501.0

Figure 27. 12-month sales growth by state



Source: ABS 8501.0

## Economic outlook

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

Figure 28. Citi economic forecasts for Australia

Calendar year	.	2011	2012	2013
GDP growth	.	1.90%	3.70%	3.40%
CPI	.	3.10%	1.80%	2.90%
Unemployment rate (end of period)	.	5.30%	5.50%	5.10%

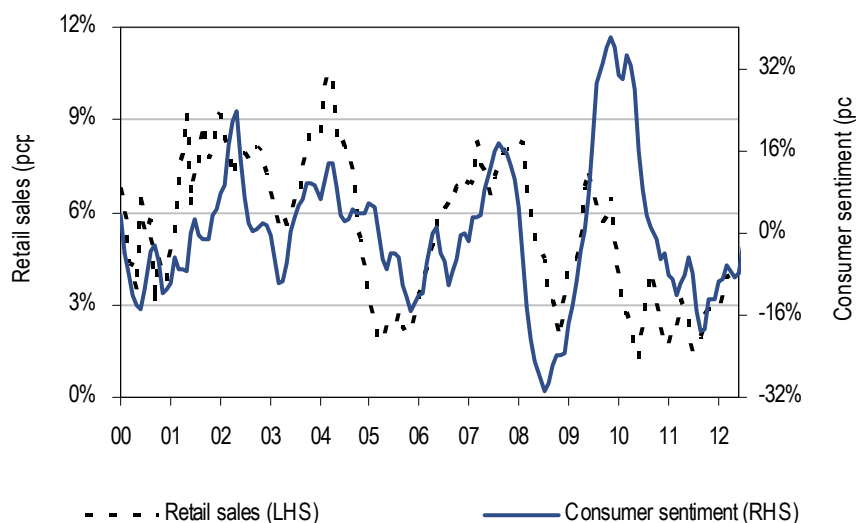
Period	.	06-Jul-12	Jun-12	Jun-13
Cash rate	.	3.50%	3.25%	3.25%
AUD/USD	.	1.03	0.99	0.96

Note: Forecast data as of 6<sup>th</sup> July 2012; Source: Citi Research

## Consumer Sentiment

We find the change in consumer sentiment has a strong co-incident correlation with retail spending. In the most recent reading for July 2012, consumer sentiment was at 99.1. This is up 3.7% vs. June 2012, and +6.8% compared to the prior year.

Figure 29. Consumer sentiment and retail sales

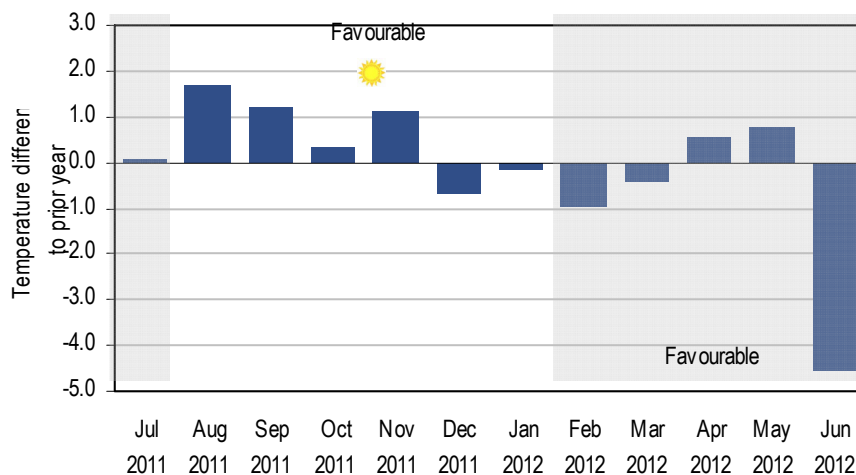


Source: Westpac, ABS, Citi Research

## Weather

Figure 30 shows the weighted average temperature difference to the prior year, in the past 12 months. While April and May were unfavourable for winter clothing retail, June recorded favourable lower temperatures.

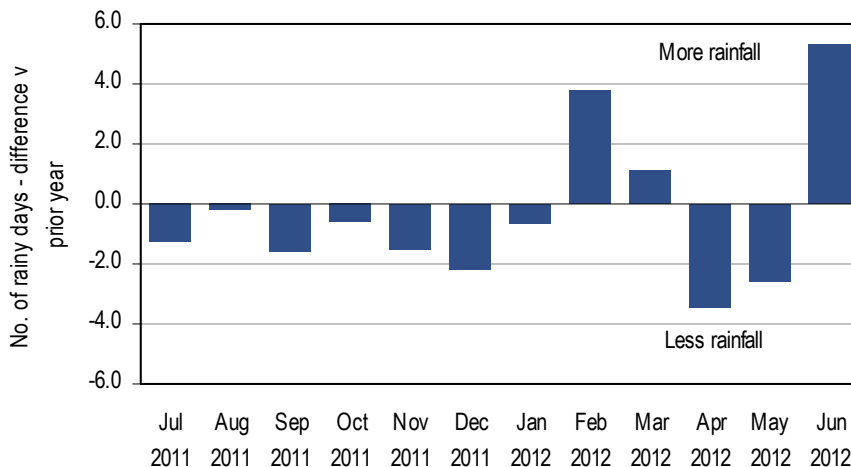
Figure 30. Temperature change - weighted national average



Source: BOM, Citi Research

Figure 31 shows the weighted average difference in rainfall days to last year.

Figure 31. Rainfall change – weighted national average

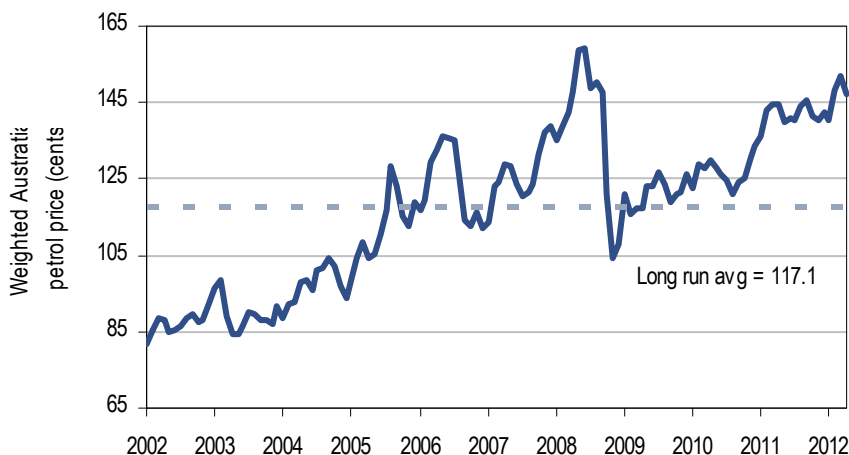


Source: BOM, Citi Research

## Petrol prices

Petrol prices averaged 147.0 cents per/litre in May 2012. Prices are 1.5% higher compared to the last year. Continued rises in the price of petrol are draining the available household income for retail purchases.

Figure 32. Australian petrol prices



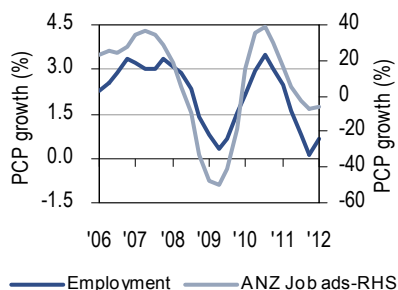
Source: Aust. Automobile Association

## Employment

The jobs market recovered in 2010 and 2011 after a sharp decline during the 2008-09 global financial crisis. However, the job ads growth has become lumpy since November 2011, with the latest reading at -0.4% for April 2012. While the overall

employment is still in growth, we note that the rate of increase is below 1.0% now. The mining boom is being offset by weakness in other sectors. The unemployment rate has however remained relatively stable at 5.0% during April and May 2012.

Figure 33. Employment and job ads growth



Source: ABS, ANZ

Figure 34. Unemployment rate

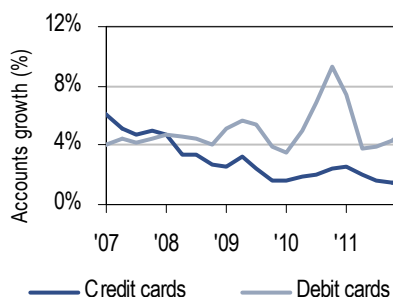


Source: ABS

## Credit and debit card spending growth

We show in Figure 35 to Figure 38, 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. This contrasts with credit card accounts that have had slowing spending growth per credit card.

Figure 35. Credit and debit card accounts



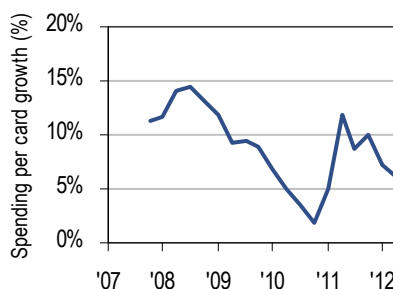
Source: RBA

Figure 36. Spending per credit card holder



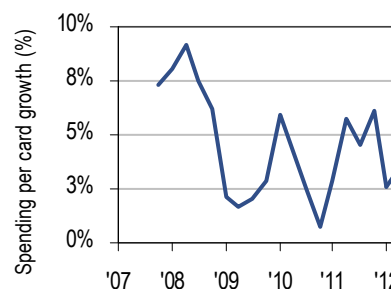
Source: RBA

Figure 37. Spending per debit card holder



Source: RBA

Figure 38. Spending per all card holders



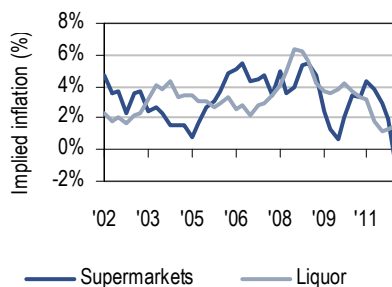
Source: RBA

## 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 the competitive landscape is an offset.
- **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.

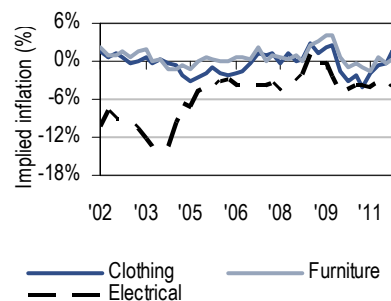
We show implied retail price inflation for a number of key categories in Figure 39 and Figure 40 below.

Figure 39. Food and Liquor inflation



Source: ABS, Citi Research

Figure 40. Non-food sector inflation



Source: ABS, Citi Research

## Input cost pressures

- **Food & Liquor** – Input prices declined 6.5% on pcp, in the three months to June 2012 mainly driven by lower coffee, dairy, sugar and meat partly offset by inflation in rice, soy and canola oil. The weaker AUD was a partial offset to the overall deflationary trend.
- **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 deflation continued in the 3-month period to June 2012.
- **Electronics** – Deflation in monitor and NAND more than offset the slight inflation in DRAM. Our input basket declined by 2% in the 3-months to June 2012.

We show our Citi input cost monitor for June 2012 on a monthly and rolling-three month basis in Figure 41 and Figure 42 below.

Figure 41. Citi input cost monitor (1 mth)

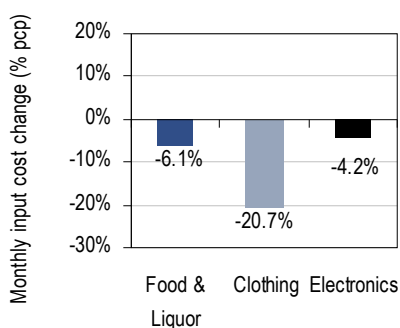
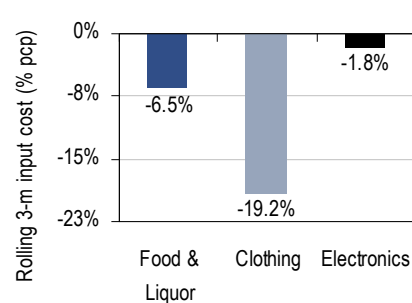


Figure 42. Citi input cost monitor (3 mths)

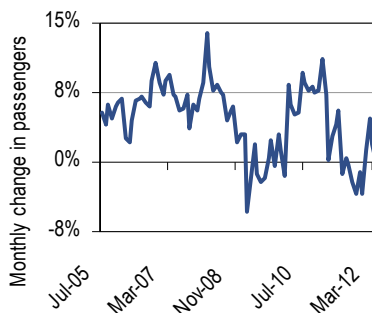


Source: Citi Research

## On the move – transport indicators

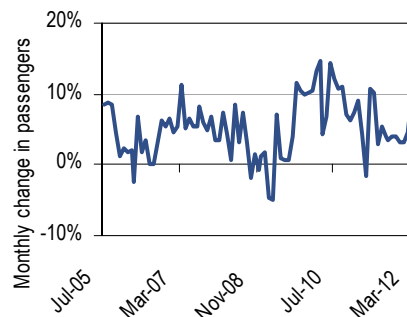
In Figure 43 to Figure 46 we show areas where consumers are “on the move”. We include air and road transport indicators as a guide to business and consumer activity. International travel remains strong, while domestic road-traffic has slowed, a sign of weaker domestic activity.

**Figure 43. Change in domestic air passenger traffic (monthly)**



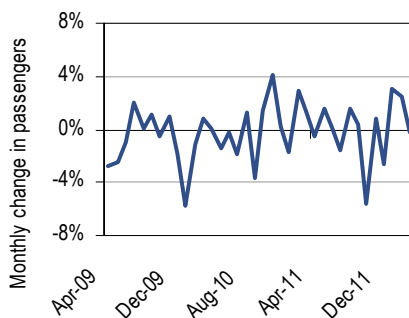
Source: Statistics New Zealand, Citi Research

**Figure 44. Change in international air passenger traffic (monthly)**



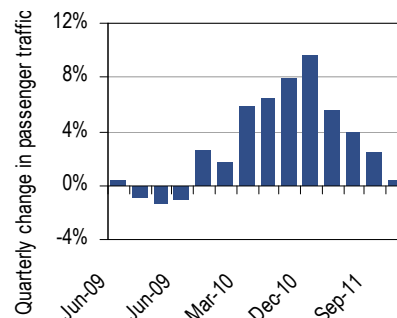
Source: Statistics New Zealand, Citi Research

**Figure 45. Automotive fuel sales change against pcg**



Source: Statistics New Zealand, Citi Research

**Figure 46. Change in quarterly road traffic volume at tolled roads**



Source: Transurban, Citi Research

## Kiwi corner

In Figure 47 we show Citi forecasts for New Zealand's key economic variables.

**Figure 47. Citi economic forecasts for New Zealand**

Calendar year	2011	2012	2013
GDP growth	1.30%	2.30%	2.80%
CPI	2.60%	2.20%	2.40%
Unemployment rate (end of period)	6.50%	6.40%	5.60%

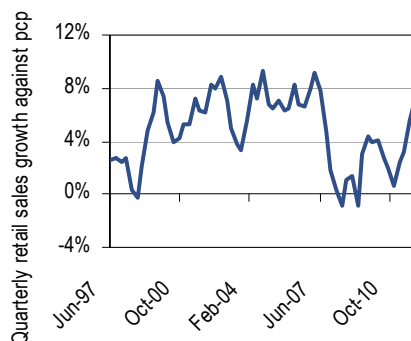
  

Period	06-Jul-12	Jun-12	Jun-13
Cash rate	2.50%	2.50%	3.00%
NZD/USD	0.80	0.77	0.73

Note: Forecast data as of 6<sup>th</sup> July 2012; Source: Citi Research

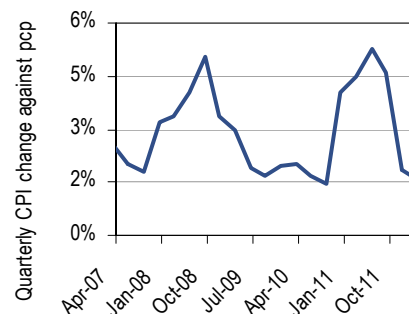
In Figure 48 to Figure 51 we show New Zealand's retail sales growth, CPI growth, unemployment rate and electronics cards transaction growth. In Figure 52 and Figure 53, we show the stock performance chart for selected New Zealand stocks in retail.

**Figure 48. Retail sales growth**



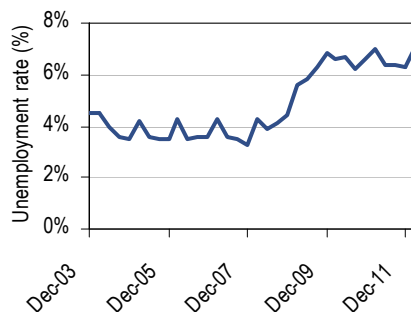
Source: Statistics New Zealand, Citi Research

**Figure 49. CPI growth**



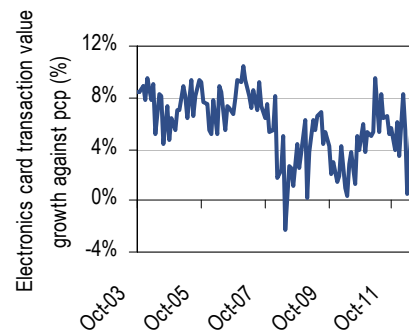
Source: Statistics New Zealand, Citi Research

**Figure 50. Unemployment rate**



Source: Statistics New Zealand, Citi Research

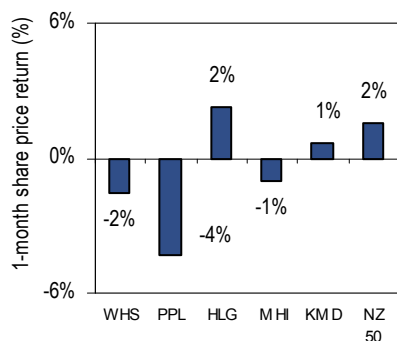
**Figure 51. Electronic card transaction value growth**



Source: Statistics New Zealand, Citi Research

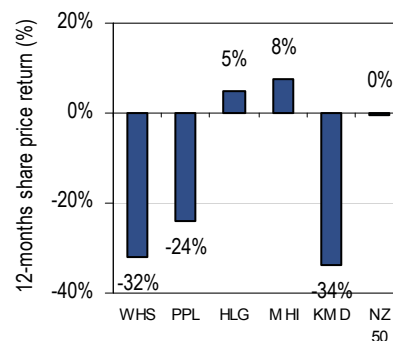


Figure 52. Stock performance chart - 1 month return



Note: Market data as of 10<sup>th</sup> July 2012; Source: Citi Research

Figure 53. Stock performance chart - 12 months return

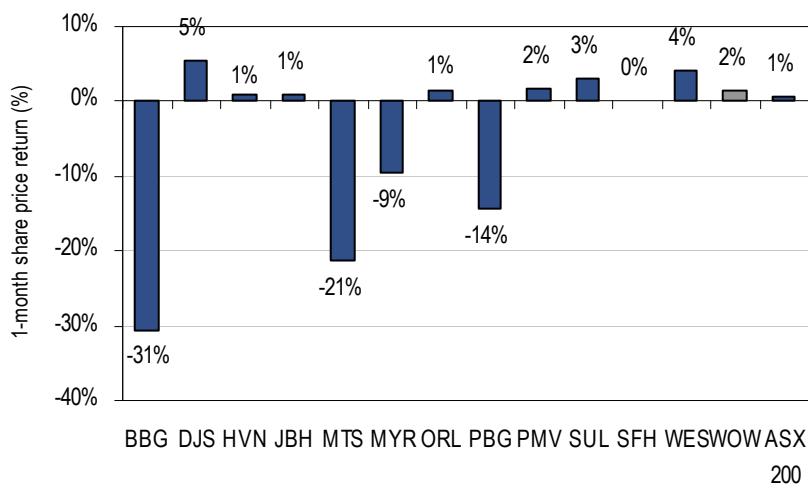


Note: Market data as of 10<sup>th</sup> July 2012; Source: Citi Research

## Share price performance

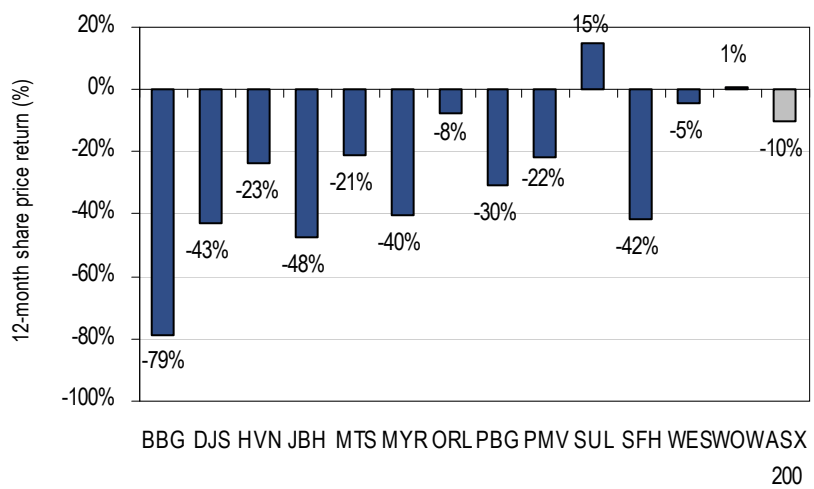
In Figure 54 and Figure 55 we show the 1-month and 12-month share price performance of listed Australian retailers and the ASX 200 Index.

Figure 54. 1-month share price return for Australian retailers



Note: Market data as of 10<sup>th</sup> July ; Source: Citi Research

Figure 55. 12-month share price return for Australian retailers

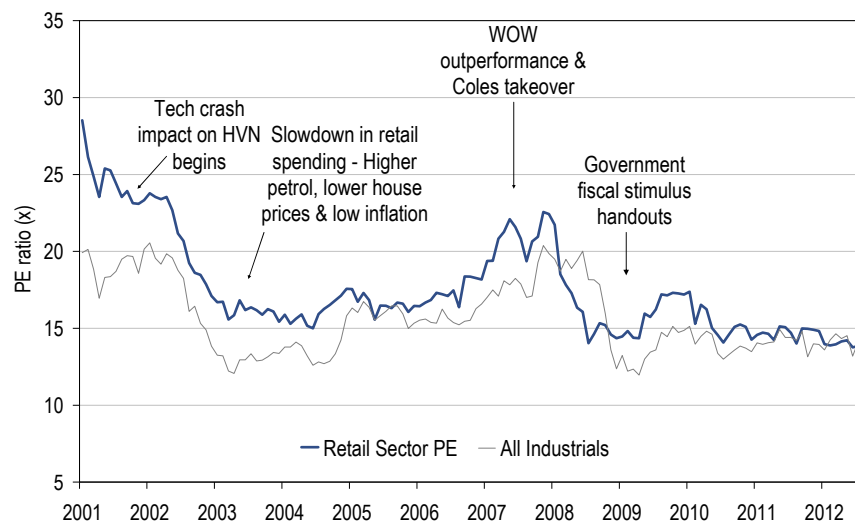


Note: Market data as of 10<sup>th</sup> July 2012; Source: Citi Research

## Valuation and financial performance

Figure 56 shows that the retail sector PE is currently trading at a 17% discount to its five year average. The discount reflects concern for discretionary retailers due to the uncertain recovery in retail spending activity.

Figure 56. Retail sector PE ratio



Note: Market data as of 10<sup>th</sup> July 2012; Source: Citi Research

## Retail Sector Valuation

Figure 57. 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
<b>Supermarkets</b>											
Woolworths Ltd (WOW.AX)	2	27.55	27.00	11.2	10.4	15.2	14.2	4.7%	5.1%	2.0%	4.2%
Wesfarmers Ltd (WES.AX)	2	29.40	30.28	12.0	11.4	16.2	14.8	5.4%	6.1%	1.7%	3.3%
Metcash Ltd (MTS.AX)	1	4.25	3.19	8.2	7.7	9.4	9.3	8.8%	8.8%	8.8%	9.1%
<b>Global comparable</b>				<b>7.6</b>	<b>7.3</b>	<b>10.9</b>	<b>10.1</b>	<b>4.4%</b>	<b>4.8%</b>		
<b>Department Stores</b>											
David Jones Ltd (DJS.AX)	2	2.30	2.35	7.9	8.2	10.8	11.4	8.6%	8.5%	10.1%	6.9%
Myer Holdings Ltd (MYR.AX)	2	1.80	1.68	5.9	6.0	6.9	7.4	11.8%	10.8%	16.2%	12.2%
<b>Global comparable</b>				<b>8.7</b>	<b>9.0</b>	<b>12.1</b>	<b>9.8</b>	<b>2.3%</b>	<b>2.5%</b>		
<b>Electrical Retailers</b>											
Harvey Norman Holdings Ltd (HVN.AX)	3	1.75	1.92	7.9	9.5	11.2	10.6	4.7%	5.2%	3.7%	2.6%
JB Hi-Fi Ltd (JBH.AX)	3	8.05	8.82	6.5	6.4	8.4	8.6	7.5%	8.2%	11.3%	10.3%
<b>Global comparable</b>				<b>4.1</b>	<b>4.5</b>	<b>13.8</b>	<b>9.0</b>	<b>0.4%</b>	<b>2.0%</b>		
<b>Surf/Street wear</b>											
Billabong International Ltd (BBG.AX)	1	1.45	1.05	9.5	9.5	6.3	9.9	2.3%	1.9%	1.3%	12.7%
<b>Global comparable</b>				<b>10.9</b>	<b>9.0</b>	<b>15.7</b>	<b>13.3</b>	<b>1.8%</b>	<b>1.9%</b>		
<b>Wholesaler</b>											
Pacific Brands Ltd (PBG.AX)	1H	0.75	0.48	5.2	4.6	6.4	5.5	8.3%	10.4%	12.6%	20.6%
<b>Global comparable</b>				<b>10.6</b>	<b>8.9</b>	<b>14.4</b>	<b>13.9</b>	<b>0.7%</b>	<b>0.9%</b>		
<b>Clothing retailing</b>											
Premier Investments Ltd (PMV.AX)	2	4.50	4.73	6.2	6.2	13.0	12.8	7.6%	7.6%	9.2%	8.3%
Specialty Fashion Group Ltd (SFH.AX)	1H	0.60	0.52	59.2	9.6	2099.0	13.3	0.0%	1.9%	9.2%	5.4%
<b>Global comparable</b>				<b>16.1</b>	<b>14.3</b>	<b>21.4</b>	<b>19.3</b>	<b>3.0%</b>	<b>3.3%</b>		
<b>Luxury Goods</b>											
OrotonGroup Ltd (ORL.AX)	2	7.50	7.35	8.3	7.8	12.0	11.2	6.9%	7.3%	8.4%	9.8%
<b>Global comparable</b>				<b>11.5</b>	<b>10.0</b>	<b>17.0</b>	<b>14.7</b>	<b>2.4%</b>	<b>2.7%</b>		
<b>Auto-parts retail</b>											
Super Retail Group Ltd (SUL.AX)	2	7.50	7.27	10.3	8.9	14.2	12.4	4.5%	4.9%	5.8%	4.8%
<b>Global comparable</b>				<b>9.0</b>	<b>8.1</b>	<b>14.4</b>	<b>12.7</b>	<b>0.2%</b>	<b>0.2%</b>		

Note: Market data as of 10<sup>th</sup> July 2012; Source: Citi Research

## Retail Sector Financial Forecasts

Figure 58. 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
<b>Sales (\$m)</b>													
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	56,543	57,207	12,255	1,873	3,142	5,797	3,116	1,653	1,362	836	562	181	1,649
FY13e	59,699	59,827	12,489	1,897	3,172	5,741	3,224	1,514	1,338	856	556	187	1,960
<b>Sales growth (%)</b>													
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	4.4%	4.9%	-0.9%	-4.5%	-0.5%	-6.1%	5.3%	-1.9%	-15.6%	-4.5%	-1.3%	9.9%	51.0%
FY13e	5.6%	4.6%	1.9%	1.3%	0.9%	-1.0%	3.4%	-8.4%	-1.8%	2.4%	-1.1%	3.7%	18.8%
<b>EBIT margin (%)</b>													
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%	3.6%	8.8%	7.5%	21.8%	5.2%	5.3%	9.4%	8.9%	0.4%	20.9%	9.6%
FY13e	6.1%	6.2%	3.7%	8.9%	7.1%	18.7%	5.0%	4.1%	10.4%	8.5%	2.2%	21.2%	10.1%
<b>Core EPS (cents)</b>													
FY11a	173.6	166.3	33.3	32.4	27.8	22.4	124.0	37.4	11.1	33.0	7.6	60.6	40.1
FY12e	177.4	187.4	34.0	20.7	23.8	17.1	105.4	16.8	7.5	36.7	0.0	61.4	51.3
FY13e	189.5	204.2	33.8	20.6	22.5	18.1	102.9	10.6	8.8	36.9	3.9	65.8	58.8
<b>EPS growth (%)</b>													
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	2.2%	12.7%	2.0%	-36.0%	-14.1%	-24.0%	-14.9%	-55.2%	-32.1%	11.2%	-99.7%	1.4%	28.1%
FY13e	6.9%	9.0%	-0.4%	-0.9%	-5.6%	6.2%	-2.4%	-36.8%	16.4%	0.6%	n.m	7.1%	14.5%
<b>DPS (cents)</b>													
FY11a	122.0	150.0	27.0	28.0	22.5	12.0	77.0	23.1	6.2	36.0	4.0	50.0	27.3
FY12e	126.0	165.0	28.0	19.5	19.5	9.0	66.0	2.4	4.0	36.0	0.0	51.0	32.5
FY13e	138.0	185.0	28.0	20.0	18.0	10.0	72.0	2.0	5.0	36.0	1.0	54.0	35.5
<b>ROE (%)</b>													
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	24.6%	8.2%	6.8%	13.9%	16.2%	9.1%	56.8%	5.1%	-35.0%	4.8%	0.1%	79.9%	17.1%
FY13e	27.2%	9.3%	19.2%	14.0%	14.9%	6.4%	44.2%	4.5%	10.0%	4.8%	12.8%	75.3%	16.4%
<b>Working cap to sales (%)</b>													
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%	3.6%	2.5%	-0.4%	8.8%	5.2%	19.1%	21.2%	3.2%	0.2%	16.0%	14.9%
FY13e	-1.3%	3.0%	3.6%	2.5%	-0.6%	9.3%	4.6%	17.6%	20.9%	2.3%	0.9%	15.4%	14.1%
<b>Capex to sales (%)</b>													
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%	4.6%	0.6%	4.1%	1.9%	3.8%	1.7%	5.6%	1.6%	1.9%	2.4%	2.6%	2.8%
FY13e	3.5%	4.1%	0.7%	4.2%	3.5%	2.5%	1.6%	4.6%	1.5%	2.7%	2.7%	2.3%	2.8%
<b>EBITDA interest cover (x)</b>													
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	14.3	11.4	7.3	21.0	9.4	8.9	14.9	4.5	5.2	nm	12.3	37.6	7.9
FY13e	15.8	12.7	10.2	17.4	9.2	7.3	14.8	13.5	6.6	nm	21.2	42.2	7.3

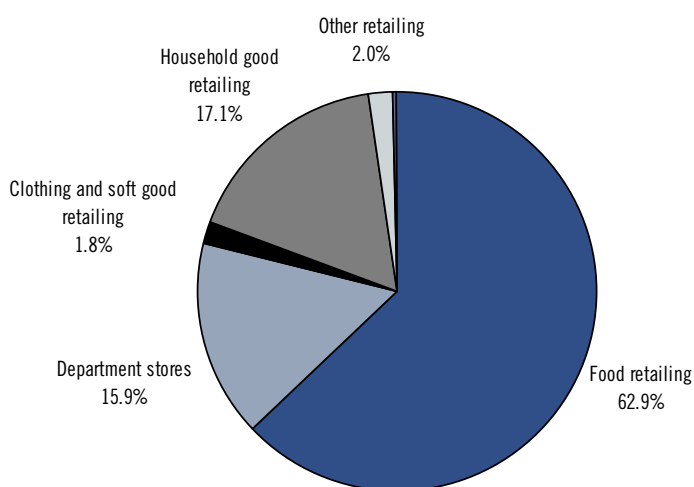
Note: Market data as of 10<sup>th</sup> July 2012; Source: Citi Research

## Appendix 2 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 59. Listed company sales base assumption



Source: Citi Research

### 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 3 Previous Issues

### 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.

url: [Demystifying Retail Leases](#)

### 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.

url: [Retailers addicted to discounts](#)

### 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.

url: [FY11 Retail Results: Trying to Protect Margins](#)

### 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.

url: [An Age Old Question for Retailers](#)

**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 March 2012)**

**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>

**Issue 48 (9 May 2012)**

**Focusing on Shrinkage To Grow Profit**

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

**Issue 48: Focusing on Shrinkage To Grow Profit**

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.

<https://www.citivelocity.com/geo/pdf/SAU2BQGI.pdf>

**Issue 49 (6 June 2012)**

**The Wardrobe Is Full – The Replacement Cycle in Retailing**

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

**Issue 49: The Wardrobe Is Full – The Replacement Cycle in Retailing**

Retailing in Australia and overseas has relied on consumers more frequently updating their wardrobes and upgrading their electronics and furniture over the past ten years. In this issue of What's In Store?, we look at the shopper's replacement cycle as an influence on retail spending. In non-food categories, like clothing and electronics, more than three-quarters of the volume growth has been driven by a shorter replacement cycle. Price is the biggest influence. Bigger homes and innovation have also been large drivers. We expect a lack of replacement cycle compression to lead to softer retail sales trends over the next decade. We estimate 3%-5% growth in non-food retailing versus 5% in the past ten years. Food retailing is much better placed with stronger pricing power. We have Buy ratings on Metcash and Woolworths.

<https://www.citivelocity.com/geo/pdf/SAU4JUXO.pdf>





## Appendix A-1

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