Special Report

NZ Retail: No catalyst in sight

Sluggish retail environment and an onslaught from offshore websites make life difficult for domestic retailers.

Executive Summary

The NZ retail environment continues to remain lacklustre despite fairly low interest rates. Household spending, which surged from 2002–2008 on the back of a buoyant economy and high house prices, is now experiencing a period of tepid growth. High debt levels racked up by consumers during the boom phase stultified household balance sheets. As a result, consumers are now resorting to austerity measures like never before.

We expect continuing weakness in consumption over the next two years. House prices, the main driver of retail spending in NZ, will likely remain sluggish because of a weak jobs market and stagnant immigration. In addition, housing is incredibly expensive in NZ compared to incomes perspective, and consequently, any further interest rate reductions are unlikely to meaningfully improve housing affordability.

Against this economic backdrop, we expect discretionary retailers to struggle, while retailers exposed to food and other essentials (or consumer staples) might do relatively better because they are less susceptible to economic upheavals. Unfortunately, there aren't any listed consumer staple plays in NZ. Among discretionary retailers, our top pick is the **The Warehouse Group (WHS)** for valuation reasons. **Michael Hill International (MHI)** is the best positioned to withstand the downturn as its products, while discretionary in nature, cater mainly to affluent consumers who are less affected by economic cycles.

Competition remains fierce from domestic and online retailers

The challenging economic environment is forcing retailers in NZ to entice consumers with massive price discounts. This is especially true in categories like electronics, apparel and furniture. Moreover, the traditional bricks-and-mortar retailer is under threat from emerging internet channels, as Kiwis seek bargains on websites like Amazon.com. We understand the online new goods business, estimated to be around NZ$2.7bn, is growing at around 12% per annum. International websites account for NZ$940m or 35% of total new goods spend. The strength of the NZ$ is fuelling consumers' appetite to buy online and seek offshore bargains. Furthermore, shoppers aren't subjected to GST on goods below NZ$400, making online purchases that much more attractive. Several NZ retailers have voiced concerns about the unfair tax advantages being enjoyed by overseas retailers.

To be fair, some local retailers are also reaping the benefits of making their goods available online. They see this as a good long-term growth opportunity and a way of countering overseas competition. **WHS**, for instance, saw a 63% rise in online sales in the first half, albeit from a very low base. It has made more products available on the internet and is advertising heavily to promote its online offering. **Pumpkin Patch (PPL)** is another NZ retailer pushing online sales. In the first half, PPL witnessed 50% growth in internet sales, and within the next two years, it expects online earnings to exceed earnings from its New Zealand business. It recently inked a deal with Amazon.com to supply products to Amazon's websites in the UK, France and Germany. **Trade Me (TME)**, NZ's preeminent auction website, sees an opportunity to sell new goods in direct competition with NZ and international retailers. It recently inked a deal with ChannelAdvisor, which will allow Australian and international retail brands to sell products to Kiwis through the Trade Me website. We understand TME is looking at three to four such opportunities, which involves partnering directly with retailers or aggregators like ChannelAdvisor.

Margins should stabilise after seeing a significant decline

Margins in discretionary retail have moved south over the last four to five years. This is despite the

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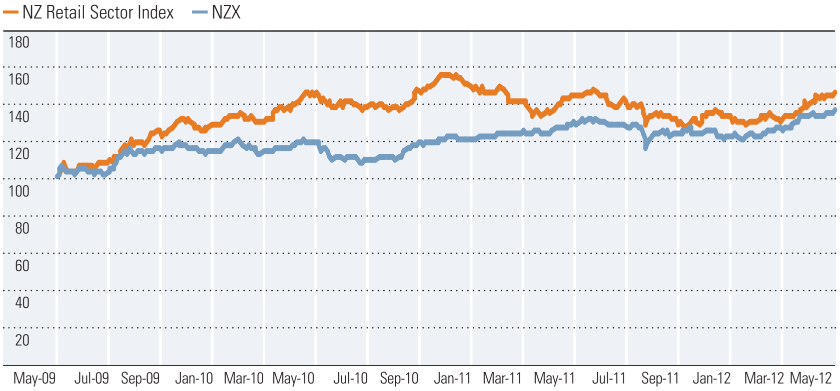
fact the NZ$ has appreciated against the US$ over a similar time period, making it cheaper for retail companies to import products. The key reasons behind the decline in margins are: a) the cutthroat competition as mentioned above b) overhead cost inflation, and c) raw material cost inflation in certain categories like apparel. WHS has borne the brunt of competition and cost inflation, with margins declining from around 9% in FY07 to an estimated 6.5% in FY12. In addition, WHS's margins were also impacted by anemic same-store sales because of market share losses. **Briscoe Group (BGR)** fared relatively better, with margins declining by approximately 140 basis points to 8.4%.

We don't expect any further deterioration in operating margins going forward, unless the currency sees a dramatic decline from current levels. Bigger NZ retailers have invested in systems and processes and have cut overhead costs in response to flagging demand. In addition, cotton prices have fallen dramatically, providing a reprieve to apparel retailers like **PPL** and **WHS**. In addition, most companies have set up operations in China and Asia to source their products, circumventing the need to buy from local wholesalers. Savings from these initiatives are likely to be invested back into price promotions in an attempt to drive sales and counter competitive threats.

Chart 1: NZX versus Retail Sector Index



Source: NZX

Our view on NZ retail stocks

The Warehouse Group (WHS)

WHS is one of our preferred stocks in the retail sector. At the current price, the stock provides a favourable risk-reward trade off. Also, the dividend yield of 7% is very attractive. We have assigned a narrow economic moat to the company, reflecting the firm's iconic brand, low-cost provider position, and unparalleled scale. Additionally, the company, by virtue of its first-mover advantage, has secured some very important and strategic sites, which are the envy of other large, big-box retailers. That said, we don't see any catalyst in the near term to drive the share price higher.

The company's first-half results were in line with our expectations. The Red Sheds business achieved revenue growth of 3.4% to NZ$835.7m, with same-store sales (SSS) increasing by 2.7%. The performance in the second quarter, which includes the all-important Christmas season, was pleasing, with the division achieving SSS growth of 3.1%. Sales at Blue Sheds rose 2.1%, with SSS increasing by 2.2%. It was a tale of two quarters, with a lacklustre first quarter and a relatively strong second quarter (with SSS growth of 3.9%.

The company is spending a significant amount of capital over the next three to five years, in an attempt to make the stores more appealing to would-be shoppers and reverse market share losses. Management confessed that a lack of investment back into the stores had led to a stale-looking environment, and one which was not inviting for customers. We believe the firm's earnings and valuation will receive a boost if management is able to successfully execute its strategic initiatives. CEO Mark Powell's track record of turning around the stationery division (while heading that business) gives us confidence that a turnaround of the core Red Sheds business can be achieved. However, in the mean time investors will take a wait and see approach.

Table 1: New Zealand Retail Sector Summary – Morningstar Forecasts

					EPS			PER			Dividend Yield		
Code	Recommendation	Price $	Fair Value $	Moat Rating	FY11	FY12	FY13 Forecast	FY11	FY12	FY13 Forecast	FY11	FY12	FY13 Forecast
WHS	Hold	2.74	3.00	Narrow	24.3	20.9	23.2	14.8	13.2	11.8	6.6	6.9	7.6
PPL	Hold	1.00	1.30	None	7.4	8.1	9.3	20.3	12.4	10.8	6.3	3.0	6.0
MHI	Hold	1.08	1.05	None	9.0	9.9	10.7	9.1	10.9	10.1	4.9	4.6	4.6
BGR	Hold	1.55	1.70	None	13.0	13.7	14.0	11.5	10.8	11.3	6.2	6.5	6.7

Source: Morningstar

Pumpkin Patch (PPL)
PPL is a leading provider of children´s apparel in Australasia. Its strong brand recognition, impressive store layout and attractive price points have underpinned growth in Australasia. However, its foray into the US and the UK was a big failure, prompting the company to exit those markets. Going forward, PPL intends to roll out new stores in NZ and Australia, and expand its wholesale and online operations. This is a good move as it will likely improve group margins. Management is particularly excited about the wholesale/franchise and online businesses. Not only does the wholesale/franchise business generate a higher margin (19.6% versus a group margin of 7.6%), it also makes better returns because the amount of capital needed is materially lower than rolling out new stores.

We view PPL as a high-risk company, (arguably, the risk to a great extent has abated following the closure of the UK and US stores) given the high level of competition and the fickle nature of the end consumer. We have a Hold recommendation on PPL with a fair value of NZ$1.30.

Michael Hill International (MHI)
MHI is a high-quality jewellery retailer with a strong position in the Australasian market. Store expansion in Australia and Canada offers good long-term growth potential, offsetting the more mature New Zealand market.

The company continues to be the best-performing retailer in terms of revenue and earnings growth among all the other NZ-listed retailers. In the first half, MHI posted operating revenues of NZ$288m, up 7.3% on the prior comparative period (pcp). Earnings before interest and tax (EBIT) grew 9.2% to NZ$34.8m and NPAT rose 11.5% to NZ$26.3m. This is a commendable performance considering the current choppy conditions in the retail sector.

We continue to assign no moat to MHI, as it remains highly susceptible to discretionary spending, has a plethora of competitors both locally and globally, and is also exposed to the growing online market. We maintain our high-risk assumption given the competitive landscape. Our recommendation on MHI is a Hold with a fair value of NZ$1.05.

Briscoe Group Ltd (BGR)
BGR is one of New Zealand's premier retail groups, operating the Rebel Sport (32 stores) and Briscoes and Living and Giving (eight stores) brands. BGR holds an enviable brand presence in New Zealand due to an aggressive promotional stance, a broad geographical presence, and an "everything under one roof" approach to its stores.

The company posted strong results in FY12, driven in part by the Rugby World Cup (RWC) in the third quarter. Underlying earnings increased 14% to NZ$27.5m on revenue growth of 4.5%. The homeware and the sporting goods businesses achieved solid SSS growth of 7.3% and 9.3%, respectively. EBIT lifted nearly 12% to NZ$32.8m. Importantly, margins increased 60 basis points to 8.4% – the highest level in five years.

BGR does not envisage any significant changes this year to the overall retail environment, although it expects to further strengthen its position in homeware and sporting goods. In our view, the big risk for BGR going forward might be the resurgence of WHS as the preferred homeware retailer. Arguably, BGR has benefited from WHS' poor execution over the last two to three years, but this might change if WHS' management is able to orchestrate a turnaround.