A Montgomery Thought Piece
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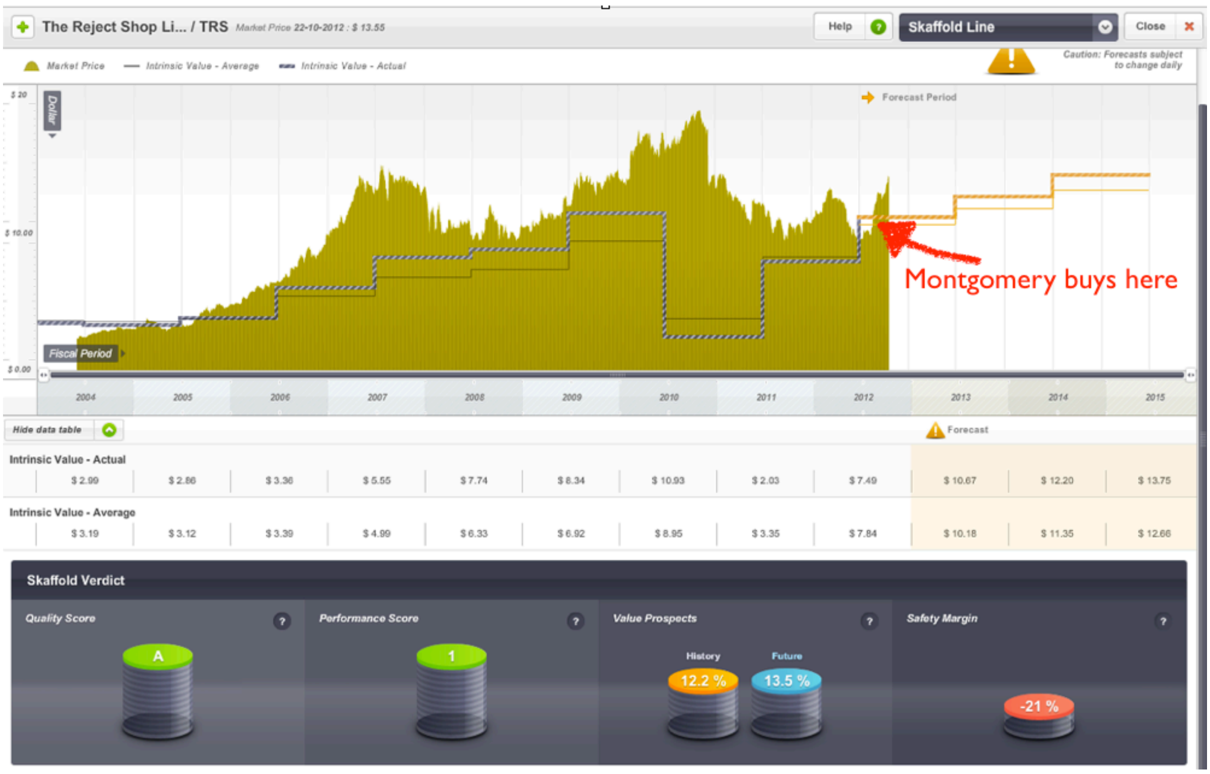
Don’t Reject the Reject Shop



Source: Skaffold.com

It has been easy for investors to reject The Reject Shop in the past two years. Sluggish retail sales growth, consumers saving more and the online threat are big headwinds for all retailers.

Compounding The Reject Shop's problems was the Queensland floods in late 2010 that badly damaged its Ipswich Distribution Centre. It serviced 90 stores, accounted for about half of all sales, and took nine months to fix. Diverting the Ipswich activities to Melbourne was hugely disruptive.

Longer term, the prospect of big discount stores such as Big W, Kmart and Target moving down the retail foodchain and selling even cheaper bulk-style goods, is a significant threat to The Reject Shop. More privately owned deep-discount stores are also moving into The Reject Shop's turf and some have made good inroads in recent years.

The Reject Shop did itself no favours by confusing its brand. Adding higher-priced items into its stores may have backfired if consumers saw The Reject Shop as the place for super-cheap everyday items such as toothpaste and detergent, rather than dearer outdoor furniture and the like. It was a good lesson: when you have a tried-and-tested retailing formula, stick to it.

As one semi-regular shopper at The Reject Shop noted (their young children love its cheap birthday cards, wrapping paper and stationery), they remain gob-smacked at its limited marketing. Apart from the odd product catalogue, they don't recall being asked to join a database or receiving any emails, even though digital marketing seems tailor-made for the store's low-price products.

These combined problems saw The Reject Shop tank from around $18 in late 2010 to below $10 this year, and plenty of newspaper talk that it had 'lost its mojo'. Skaffold spotted the problems early; between mid-2010 and mid-2012 The Reject Shop shares were badly overvalued, according its calculations.

It was only a few months ago that The Reject Shop's market price fell below Skaffold's intrinsic valuation, the first time in seven years. Skaffold members who picked up on the value opportunity and weren't swayed by the 'end-of-bricks-and-mortar-retailing' media tidal wave, have watched the shares rally since from $9.01 to $13.71 as the market re-rates the retailer's prospects.

Soaring share price gains have now put The Reject Shop in overvalued territory, according to Skaffold, but not by so much that long-term portfolio investors should drop it from watch lists. At $13.71, The Reject Shop is 23 per cent overvalued, shows Skaffold, so the plan should be to wait until better value emerges as the gap between market price and intrinsic value narrows. After the market's September and October rally, many other high-quality stocks are similarly overvalued.

For all its recent problems, The Reject Shop remains one of Australia's best-quality retailers. Latent value could be realised if it can strengthen its marketing, get the product mix right, expand faster in higher-growth states, and leverage what is still a terrific brand. Consumer sentiment is also stable and according to our conversation with Chris Bryce, 'possibly' improving.

Skaffold rates The Reject Shop an A1 company and its performance a '1' for excellence. These are the highest possible Skaffold rankings, and miles ahead of big retailers, such as Myer Holdings, David Jones and Harvey Norman. The Reject Shop is in good company; the star performers Breville Group and OrotonGroup are the only pure retailers to receive the cherished A1 Skaffold rating.

As an aside, the OrotonGroup is 7 per cent undervalued and Breville Group 13 per cent overvalued, shows Skaffold. Buying A1-rated companies when they are near or below their intrinsic value, and when they have rapidly rising intrinsic value over the next few years, has proven to be a smart move.

The Reject Shop's A1 rating is underpinned by its return on equity (ROE) averaging a whopping 37 per cent each year over the past decade. The return in 2012 was 27.5 per cent, and analysts as recorded by Skaffold currently forecast it to hover near 30 per cent over the next three years, which is an excellent return on shareholder funds.

But The Reject Shop has more risk than Breville Group and OrotonGroup. The Queensland floods distorted its financial performance and made year-on-year comparisons problematic. A significant insurance claim, now finalised, has also affected performance, and a 53-week trading period for the last financial year's results was highlighted by some nit-picking commentators.

This uncertainty means investors should demand a higher safety margin when buying The Reject Shop shares. Yes, it is a high-quality company, but much work is needed to get The Reject Shop running faster in what it still a tough retail climate as consumers spend cautiously. Further interest rate cuts this year are no certainty if the global economy improves.

Chief executive, and former CFO, Chris Bryce reaffirmed at the October 17 annual general meeting that The Reject Shop would not provide definitive earnings guidance for this financial year, given the retail and economic environment and consumer sentiment. He did say The Reject Shop had a 'pleasing start to the year with positive comparable sales year-to-date' - a comment that led to share price gains.

It seems momentum is picking up on FY12, which showed The Reject Shop sales rose 9.9 per cent, from $505 million to $555 million (over 53 weeks). Earnings before interest and tax (EBIT) rose 31.5 per cent from $26 million to $34.2 million, although on a pro-forma basis (a 52-week trading period), and stripping out a $2.9-milion insurance claim payment, EBIT growth was about 12 per cent.

Net debt fell from $39 million to $22.4 million and interest cover rose from 8 times to 11.5 times.

The strategic challenge now is to grow faster in a sluggish retail environment and overcome the online retailing threat.

In theory, more penny-pinching consumers seeking savings on everyday items should be good for The Reject Shop. But it also relies on impulse purchases from those who enter its stores to snap up their daily needs at bargain prices and end up buying half a dozen more products.

The Reject Shop is far less affected by the online threat than discretionary retailers that sell higher-priced goods. For them there seems little point in selling its cheap items online. To entrench the advantage there seems merit in TRS filling the space with its own online offering or at least a landing site for loyalty promotions and campaigns. The indirect threat is less impulse buying at The Reject Shop if more people buy other goods online and spend less time in shopping centres.

Like many retailers, its main growth option is rolling out more stores and achieving higher sales at comparable stores. It planned to open 20 stores in FY2013 and might do slightly better based on AGM commentary and even more recent discussions with us (see Post Script below). Should that happen, there would be 254 stores in FY2013, which means The Reject Shop still has plenty of room to grow to get to it saturation point of about 400 stores.

One AGM comment jumped out to us. CEO Chris Bryce said: '... Over the past few weeks we have received a number of enquiries from landlords of a major competitor. These landlords are concerned over the long-term viability of that business, and certain sites of theirs have been vacated mid-lease. Further activity in this area could present a real opportunity for us to substantially increase the store-opening program next half. Given we have invested significantly in our infrastructure to support a larger store footprint, we will actively pursue store opportunities that fit our model.'

The Reject Shop has the balance sheet, infrastructure and management capability to accelerate its store rollout faster than market expectations and boost earnings in FY14 and beyond. An opportunity to take sites over from a troubled competitor could coincide beautifully with the company's marketing and store investments, and improve economies of scale.

Higher comparable sales growth will not be easy in its mature stores. Opening stores in faster-growth states, such as Western Australia, where The Reject Shop has a relatively lower presence compared to other states, would boost growth. Greater focus on better in-store efficiencies through product sourcing and other store investments will also help.

The main upside will come from a reinvigorated marketing effort. One senses The Reject Shop spent so much time dealing with the fallout from the Queensland floods, and diverted so much capital, that its branding, marketing and customer 'experience' suffered. Our casual observation is that some stores look tired and are in need of a revamp to excite customers again.

The good news is that The Reject Shop still has a well-known, well-liked brand, which is a lot more than many retailers. A bigger, brighter brand campaign and a clever digital marketing effort could be key to getting cash registers ringing louder and the intrinsic value moving sharply higher in 2013 and 2014, when the main pieces of the company's strategic puzzle come together.

The Reject Shop is a major position in The Montgomery [Private] Fund and held in The Montgomery Fund.

Roger Montgomery
October 2012.

Post Script:
Jan Cameron (Jan Cameron founded Kathmandu and Retail Adventure Group) is closing all Chicken Feed stores in Tasmania and TRS is interested in many of those. Ms Cameron has already closed 20 stores Australia-wide and near term is expected to close at least another sixty.

About 50 sites are under consideration with a number of those of significant interest to TRS so a more aggressive expansion plan could be on the cards.

Each store costs $400k and with the right operations team in place (project mangers) the company could handle 100 new stores being opened within a 12-month period.

We get the feeling Chris Bryce might be more comfortable operationally with a number significantly less than this to make sure it doesn't become a blunder.

Two years ago, many businesses would have been jumping over each other to secure sites but today it seems that there is less in the way of near-term leasing pressure. Less pressure means rental increases are being negotiated and discounted heavily and TRS appears to have much more flexibility to up and move a store if they don't get their terms.

We think the market will know more in the next week or two about what strategy the board will take to increase from the current 20 store (normal) annual rollout.