SECTOR **SUPERMARKETS**

It's tough at the top as Aldi advances through the aisles

The no-frills model puts the focus on price and has grabbed market share from the two big chains and is eating into their profitability, writes Roger Montgomery

RESEARCHER ROY MORGAN SAYS that, in 2015, more than 12 million shoppers in Australia visited a supermarket at least once in seven days on average. Their revenue is projected to reach $88.1 billion this year, so owning a supermarket should be a winner.

The truth, however, is that it's arguably the most fiercely competitive industry here and consumers seem to care only about price. That means they're effectively selling a commodity and there will always be pressure on profit margins.

Citing Roy Morgan again, in 2014 55.8% of Australian grocery buyers said "high standards of food safety" were the factor that mattered most to them when supermarket shopping. A similar proportion of those surveyed also cited location, while 54% nominated "good value", 52.6% said convenient trading hours and just 5% said "a good range of financial services" (the banks can relax!).

What people say, however, and what they do are often two entirely different things and the growth of Aldi, the privately owned German supermarket chain, here demonstrates price trumps almost all else.

Competition is getting tougher. Aldi's unstoppable growth of over the past five years has significantly and permanently changed the industry and the level of achievable profits.

Aldi only enters countries where wages are high because its operating model requires fewer staff. Where a Coles or Woolworths supermarket might have 30 staff, Aldi can operate with as few as a 10th of that number for a given store footprint because it offers a smaller range. If Coles and Woolies stock 30 SKU (stock-keeping units) of tomato sauce, Aldi stocks just one. An SKU might be a different brand, size or shape. In the UK, where Aldi has been operating for more than 25 years, it sells 1500 product lines, while a UK Tesco supermarket can sell 40,000 lines or SKUs.

And because Aldi focuses its buying on one line of sauce, it can buy that line more cheaply than Coles and Woolies and it is satisfied with profits from much lower margins. Any incumbent supermarket must discount prices to preserve market share. So on lower margins, its profits will grow more slowly or even go into reverse as Aldi becomes more popular.

Experience elsewhere in the world suggests there is little incumbent supermarkets can do to thwart the advance of Aldi and its rival, Lidl.

Here, Woolworths and Coles are following the script Aldi has written for them – cutting prices and expanding their ranges of private-label, lower-profit products. But despite the lower prices, they aren't hanging on to their market shares.

Woolies and Coles appear to be merely playing catch-up but Aldi is one step ahead. Once Aldi reaches a predetermined number of stores and a predetermined revenue figure, the company reduces its reliance on importing foreign goods and localises the supply chain. This simply means it starts selling Australian-made goods. By doing this, it reduces its freight costs – meaning it can reduce prices even more – and can simultaneously promote the local provenance of its products.

And Aldi is believed to have reached that point during 2014's Christmas period.

Unsurprisingly Aldi's market share continues to rise. In fact, it has more than tripled from 3.1% to 11.6% over the past 10 years, reports Roy Morgan, at the expense of Woolworths and Coles. Of course, Woolworths still commands the largest market share with just more than 38% – a fall from just over 40% 10 years ago. Coles's market share has also declined from 37% to 31.8%.

In a relatively short time, Aldi has secured third position with its 11% share. But how you measure share can easily disguise just how powerful the Aldi threat is. In an average four weeks, more than a third of Australian grocery buyers shop at Aldi, and in NSW and Victoria that number is nearly half of all grocery buyers.

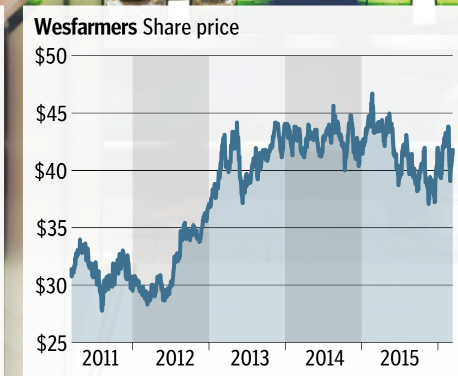
As it continues to open stores and expand its hard discount offering, it is unlikely the market shares of Coles and Woolies will stop falling any time soon.

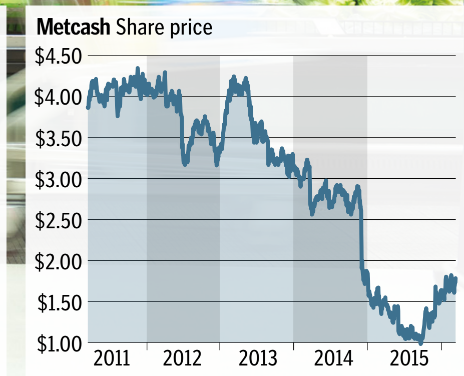
And lest you still believe that the fall in Woolies share price represents good value, it is instructive to look at the UK experience, where Aldi landed in 1990. Since then margins and market share have declined materially for the incumbents (Sainsbury, Tesco, Asda and Morrisons) while, after 26 years, Aldi is still building its market share.

In this fiercely competitive industry, if there was one supermarket chain we might consider buying shares in it would be Aldi. But as it remains privately owned, that simply isn't an option. For Australian investors, considering current prices, there isn't, in our view, an attractive investment case to be made at current prices.

Roger Montgomery is the founder and CIO at The Montgomery Fund. For his book, Value.Able, *see rogermontgomery.com.*

SHARE INFORMATION AS AT CLOSE OF BUSINESS 11-MAR-16





1 Woolworths

ASX code WOW
Price $23.34
52wk ▲ $29.96
52wk ▼ $20.50
Mkt cap $29.5b
Dividend $1.16
Dividend yield 4.97%
PE ratio NAv
SELL

Woolworths is Australia's largest supermarket chain, with 961 stores. It also operates more than 600 co-branded Caltex petrol stations, 177 Countdown supermarkets in New Zealand, the Thomas Dux providore chain, liquor store chains BWS (1100 stores) and Dan Murphys and online Cellarmasters. It also owns ALH, which operates 323 hospitality and wagering venues and 537 retail liquor outlets.

Woolworths' profitability has been declining for a decade. In 2006, return on equity was 34%; in 2015 it was 24%. Forecasts are that return on equity will fall to 16% in 2018 and it appears the failed Masters venture is symptomatic of an organisation in disarray.

But change is in the air. One suspects a repeat of new Big W head Sally Macdonald's performance at Oroton will lead to rapid improvements in structures and margins.

But it is be far too early to consider buying Woolworths – the share price is still above our estimate of intrinsic value. More importantly, intrinsic value has been declining, suggesting the rout for shareholders may not be over yet.

2 Wesfarmers

ASX code WES
Price $41.79
52wk ▲ $45.00
52wk ▼ $36.65
Mkt cap $47b
Dividend $2.02
Dividend yield 4.83%
PE ratio 19.1
SELL

Wesfarmers operations cover supermarkets, liquor, hotels, convenience stores, home improvement, office supplies, department stores and an industrials division with businesses in chemicals, energy and fertilisers, industrial and safety products and coal. Its retail businesses are operated under the Coles, Bi-Lo, Vintage Cellars, Liquorland, Bunnings, Kmart, Officeworks and Target brands.

Wesfarmers is partly insulated by its successful Bunnings hardware franchise but its acquisition of Coles caused returns on equity for the conglomerate to fall from 30.5% in 2006 (during the commodities boom) to 7.59% in 2009. Since the bottom of the GFC, returns have improved but they aren't expected by analysts to be much higher than 10% by 2018.

Wesfarmers' share price remains above our estimates of intrinsic value and, given our expectation of further declines in supermarket market share and profit margins, we don't believe that an investment in this blue chip will become attractive any time soon.

3 Metcash

ASX code MTS
Price $1.79
52wk ▲ $1.87
52wk ▼ $0.96
Mkt cap $1.7b
Dividend 6.5¢
Dividend yield 3.64%
PE ratio NAv
SELL

Metcash operates a very different business model from those of Coles and Woolworths. As a wholesale distribution and marketing company, Metcash uses its buying power to offer attractive supply and logistic solutions to independent supermarket operators under the IGA brand. Metcash also owns the Mitre 10 hardware chain and the Campbells Wholesale stores and the Cellarbrations chain of liquor stores.

The company might be under pressure financially: it sold the Metcash Automotive Holdings business, which included the Autobarn and Midas brands, to Burson in 2015.

Very little growth in equity over a decade combined with a net decline in returns on equity suggest the value of this business has at best tracked sideways. Unsurprisingly, the Metcash share price has fallen over the same period and is trading at just a third of its peak price in 2007.

With little or no change in intrinsic value over 10 years, even a substantial discount to current value may not be enough to offset the risk of further business disruption.