Are the retailers cashing in or out?

by Roger Montgomery

From the corner bakery and coffee shop to big box retailers, there are almost 140,000 retail businesses in Australia. Collectively, they account for more than 4% of GDP and just over 10% of employment. The retail sector employs 25% more people than the construction industry, 50% more than the Education and Training industry and 300% more than the Agriculture, Forestry and Fishing industry.

Challenges, however, constantly beset the sector and the ‘online disruption’ threat is just one of many befalling operators. The emergence, growth and change of ownership of department stores, electronics payments, obligations surrounding product safety and warranty, as well as government intervention, regulation and oversight – over everything from mergers and acquisitions to accounting and pricing – and the emergence of global bricks & mortar entrants, deep discounters and fast fashion are a few more of the very many challenges that must be navigated by those who choose to operate in this fiercely competitive sector.

Investors should be aware that from the removal of import tariffs to the failure to impose a lower limit on the levelling of GST on imports, legislation has almost always sided with the delivery of lower prices to consumers rather than support for the local industry. Of course, the fact that the local industry is such an important employer seems to have been missed by successive well-meaning governments.

Perhaps as a result of a short-sightedness, endemic to our system of three-year federal government terms, the retail industry’s share of GDP has been declining. The share of retail spending in overall consumer spending has fallen from over 35% in the early 1980s to just under 30% currently. Consumers are increasingly spending a greater share of their rising incomes on financial services, property and accommodation, education, travel and hospitality.

More recently online sales are taking some market share from traditional retailers. In 2016, online retail sales exceeded $20bn for the first time. This amounts to 6.8% of bricks and mortar retail sales and is growing at five times the rate of traditional retail sales. Of course, the declining Australian dollar has seen a significant shift to domestic online sales, which grew at 16.9% this year versus just 0.9% for overseas online sales.

Over the longer term however, the main drivers of retail sales growth are increasing disposable incomes and population growth.

Investors need to consider all of the above factors as well as those influencing the shorter-term business cycle for retailers. Over the last two years, for example, rising property prices and a surge in property construction has resulted in a spike in demand for household goods, furniture and electronics. It is no surprise then to find the share prices of retailers like the furniture chain Nick Scali near all time highs. Nick Scali has risen from a low of 38 cents in 2010 to $4.36 earlier this year. In 2003, the company was generating revenue of $36million from 10 stores and now generates $156 million from 48 stores.

So how are retail sales performing in aggregate? According to the Australian Bureau of Statistics, Australian retail sales rose just 0.1% in June and in NSW, Victoria, the ACT, the NT and Tasmania, retail sales fell.

Drilling deeper, one discovers spending on clothes and footwear was higher, and household goods retailers and department stores enjoyed an increase. Food retailing on the other hand declined and the ABS noted outings to cafes, restaurants and takeaway outlets declined.

Following ABS data each month however would have you jumping at far too many shadows. In the long run, the main driver of returns from retailing are low petrol prices and record low interest rates.

Of course, one day these tailwinds will become headwinds so investors considering buying today need to think about whether they are getting a bargain that offers a margin of safety.

The following table provides some insight into some of the major retailers, their profitability and their estimated intrinsic value. What becomes immediately apparent from this list is that valuations are stretched and the potential returns from investing in the sector do not support the risk that is being adopted by investing today.

Name	Market Cap	Est. Margin of Safety	P/E	Div Yield	EPS Growth(e)
Retail Food Group	950.22M	-3.12%	14.61	4.75%	31.80%
Super Retail	1.89B	-8.15%	15.2	4.26%	10.38%
Harvey Norman	5.23B	-22.06%	16.34	5.02%	17.57%
Breville Group	1.03B	-23.22%	20.67	3.61%	6.55%
Woolworths	29.88B	-23.99%	19.01	3.57%	-38.27%
Myer Holdings	1.06B	-46.14%	14.12	4.05%	-15.47%
Wesfarmers	54.24B	-47.44%	20.82	4.50%	-4.88%
Australian Pharmaceutical Industries	924.39M	-54.83%	18.64	2.92%	15.10%
Premier Investments	2.53B	-55.02%	23.59	2.94%	17.33%

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