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## A Montgomery White Paper

SEPTEMBER 2013

Double edition

## ARB On Track Through Tricky Terrain

4WD parts provider puts in another solid performance – but value is not quite there.

## Dressed To Weather The Retail Storm

Retail is a tricky sector for investors at the moment. But amidst the harsh conditions, there are some glimmers of opportunity.

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# ARB On Track Through Tricky Terrain

**When it comes to consistency, four-wheel-drive parts provider ARB Corporation is like a classic LandCruiser: a no-nonsense performer in all sharemarket terrains. By small-cap standards, it has had remarkably consistent – almost unbreakable – profit growth in the past decade.**

But ARB's record presents two investment challenges. Firstly, buying it below intrinsic value, given the market knows it is exceptional and has priced it accordingly. Secondly, being blinded by ARB's impressive past and overlooking a possibly more challenging future.

ARB had every right to disappoint the market with its FY13 earnings. Low consumer confidence and sluggish retail sales growth were obstacles, the high Australian dollar hurt its exports, and the slowing mining investment boom weakened demand for 4WDs and parts.

While ARB's result was slightly below expectations, revenues rose 8.3 per cent to \$294.5 million and after-tax net profit increased by 10 per cent to \$42.3 million for the year ended June 30 2013. The result wasn't spectacular, but showed ARB's capacity to grow profits in weaker trading conditions.

As ARB noted: "The result was achieved in a very challenging year, particularly in relation to the changing economic drivers in Australia, but also in terms of the economic difficulties faced by many countries in which the company's export customers operate."

The market imagined worse. ARB has fallen 10 per cent from \$13.75 in mid-July to \$12.34, putting it closer to value territory and strengthening the case for a spot on portfolio watchlists. A share price below \$10.30 could entice value investors and ARB would approach bargain territory if it retests its 52-week low.

Investors need to watch and wait for better value. ARB's main headwinds, resource-sector weakness, and a sluggish domestic and global economy may not ease for some time. If they intensify, the company's first-quarter trading update, due at the annual general meeting in October, could be a catalyst for selling.

There will be no shortage of buyers – at the right price. ARB has a 10-year compound average annual return (including dividend reinvestment) of almost 20 per cent, and its intrinsic value has risen by a similar quantum. Net profit after tax has grown at an average compound rate of 14.9 per cent over 10 years and dividends have risen consecutively in that period, with special dividends in FY05 and FY10.

Return on equity (ROE) has averaged 28.5 per cent over 10 years, there is no debt, and ARB had a net cash balance of \$43.8 million at the end of FY13 – up from \$33.2 million a year earlier. Plenty of surplus cash gives it scope for earnings-accretive acquisitions or capital projects, or another special dividend (FY15 would have a nice ring to it, given five-year gaps between the last two).



In some ways, you should be surprised by ARB's strong record. It doesn't do anything sexy – designing, manufacturing, and distributing 4WD accessories in Australia and overseas. It's a good business, but doesn't have an immediately obvious sustainable competitive advantage that underpins high rates of returns for long periods. But clearly it must have one.

Many of the company's steel products can be copied or commoditised. Sceptics contend that ARB has benefited from a lack of competition due to a small Australian market, and that low barriers to entry in a commoditised market eventually kill even exceptional companies.

However, ARB may have a much a stronger, more valuable long-term competitive advantage than the market realises. Its products are loved by 4WD enthusiasts – many of whom have ARB stickers plastered over their vehicles – making its position in that community, built over many years, difficult for a new industry entrant to usurp. More importantly, overseas



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### Returns to 31 August 2013

Code		Change	Outperformance
<b>MPF</b>	<b>The Montgomery [Private] Fund</b>	<b>40.79%</b>	<b>-</b>
XNAJI	ASX 200 Industrials Accumulation Index	10.90%	29.89%
XTOAI	ASX 100 Accumulation Index	23.59%	17.20%
XJOAI	ASX 200 Accumulation Index	20.97%	19.82%
XAOAI	All Ordinaries Accumulation Index	17.93%	22.86%
XK0AI	ASX 300 Accumulation Index	19.53%	21.26%
XTLAI	ASX 20 Accumulation Index	28.33%	12.46%
XMDAI	ASX Midcap 50 Accumulation Index	2.82%	37.97%
XSOAI	ASX Small Ordinaries Accumulation Index	-17.24%	58.03%

Benchmarked returns are since inception (23 Dec, 2010) of the Montgomery [Private] Fund and assumes distributions are reinvested. Past performance is not indicative of future performance.

**Minimum investment \$1,000,000**

# MONTGOMERY

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the company's products are so popular that copycats stick copycat stickers on their copycat bullbars. One suspects safety concerns might limit the reach of cheap knockoffs.

Being close to its customers has helped ARB respond quickly to changing trends and new 4WD launches and model upgrades. Speed is a great asset in manufacturing, and the company has consistently been able to target new markets to seize opportunities, or offset slower growth elsewhere.

Also, an examination of ARB's financial accounts over 10 years shows it is strongly committed to research and development. It must have been tempting to slash R&D when sales growth slowed, but consistent innovation has been another critical source of competitive advantage.

With innovation comes a stronger brand, and with that comes greater customer loyalty and potential for higher profit margins. The result: enhanced ability to scale a business domestically and overseas, and maintain high rates of growth as innovations are pushed through a bigger customer network.

Of course, it takes great skill to deeply understand customers, build and maintain an organisational culture that supports rapid-fire product innovation, and ensure the benefits flow through to high profit growth and ROE. ARB's management is arguably its most valuable competitive advantage.

The executive team will need all its skills to ensure the growth record is not blemished in the next few years. It's no overstatement to say ARB's outlook is the most challenging in a decade, given the slowing resource investment boom and weakening Australian economy. Even after the GFC in 2008, ARB could look forward to the mining-sector boom.

Sales growth in FY13 was surprisingly patchy: Australian aftermarket sales rose a solid 15 per cent and although export sales were flat, that was a pleasing result given a high Australian dollar for most of the period. However, sales to original equipment manufacturers (OEM) in Australia fell by 10 per cent due to less mining-sector demand.

Sales to OEM also look problematic in FY14. Lower commodity prices mean even more cutbacks in the mining sector, smaller 4WD fleets and less demand for accessories. The mining sector was an important source of growth for ARB during the sector's boom years up to 2010.

The company's best hope is continued strong growth in aftermarket sales (worth 69 per cent of total FY13 sales) as more Australians buy 4WDs, either the traditional variety or smaller cross-over versions designed for urban users. The 4WD segment been the fast-growing of the local car market, which had record sales this year thanks to aggressive price discounting and zero-interest finance deals.

A falling Australian dollar could be a significant problem if it leads to sharply higher petrol prices. Demand for gas-guzzling 4WDs, and thus accessories, would take a hit if petrol prices climbed.

Other potential positives in FY14 and beyond are new facilities in Thailand, as well as new ARB store openings, both of which should aid growth. ARB has just 47 stores globally, 19 of which are company owned, and there is considerable scope to expand the network given ARB is still under-represented in some key 4WD geographies.

Consensus analyst estimates suggest ARB's ROE will hover around 26 per cent during the next three years – slightly down on the long-term average. Still, most retailers, manufacturers and small-cap companies would kill for such a high ROE in this market. If ARB can deliver that type of ROE in challenged markets, what will it provide when conditions improve?

We reckon ARB's intrinsic value is somewhere around \$10.00 a share, rising to \$11.40 or so a year later. The current \$12.38 share price offers no margin of safety.

In addition to the share price, prospective investors in ARB should watch 4WD sales, the Australian dollar, and resource-sector trends. A recovery in consumer confidence after the election would support growth in 4WD sales, a stabilisation in the Australian dollar is on balance good for ARB, and signs that the worst for the resource sector is over would boost sentiment. The trouble is, those trends may move against ARB in FY14.

Clearly, the hills are getting steeper for ARB to climb and a \$12.38 price is heavy cargo. But old LandCruisers have a habit of grinding to the top in a lower gear.



# Dressed To Weather The Retail Storm

**It takes nerves of steel to buy small fashion retailers in this market. Weak consumer confidence, sluggish retail sales growth, price discounting and the online sales threat are pounding the sector. But within the carnage are potential opportunities such as Speciality Fashion Group (SFH).**

The turnaround play is in the eye of the retail storm. With 892 stores across the Millers, Katies, Crossroads, Autograph, City Chic and La Senza brands, and around 180 million interactions with Australian shoppers each year, SFH is incredibly leveraged to discretionary spending conditions.

Apparel is a tricky business at the best of times; fashion-fickle consumers and seasonal disruptions such as a warmer-than-expected winter can crunch sales. It takes great skill to sell more clothes when so many headwinds conspire to stop consumers spending.

The list of retail problems is long and growing. In the short term, interest-rate cuts are having less effect as consumers remain concerned about job security and prefer to pay down debt (or buy investment properties!) and spend less. Retail sales grew just 0.1 per cent in May, compared with market expectations of 0.3 per cent.

The lead-up to elections is rarely good for retailers and online sales continue to eat into traditional retail sales channels, albeit off a low base. Rampant price discounting has conditioned consumers to expect ever-lower prices for basic items such as cheap clothing, which the likes of K-Mart almost seem to give away.

These trends are taking a heavy toll. One of SFH's nearest listed rivals, Noni-B, saw its share price tumble this year after reporting deteriorating conditions within and without.

Among large apparel sellers, Target has been a basket case. Parent company Wesfarmers issued a profit warning for its troubled discount store in May, blaming lower sales, shrinking profit margins, excess inventory and a late start to the winter season. Target's woes put chills through the apparel sector as analysts feared higher-than-expected unsold inventory.

The apparel sector, it seems, can't take a trick this year. The

tragic factory collapse in Bangladesh this year, which killed more than 1,000 garment workers, has put the spotlight on Australian importers such as K-Mart, which source garments, directly or indirectly, from third-world countries.

But despite these problems, some retail stocks have rallied in 2013. JB Hi-Fi, for example, has a one-year shareholder return of 105 per cent (including dividends) after touching a 52-week low of \$8.34. Kathmandu Holdings is up 89 per cent over one year, and Myer Holdings is up 46 per cent.

These are remarkable performances in the context of such a weak retail market. They show how investors can badly misprice stocks when market noise peaks and everybody is focused on backward-looking newspaper headlines rather than looking forward. The market was too negative towards some high-quality retailers in late 2012, and investors, as is their wont, confused price and value.

This was true of SFH when its shares plumbed 47 cents in 2012 at the peak of the retail-gloom hysteria. Following a surprisingly strong interim profit report in February, the company soared to a 52-week high of \$1.20 before retreating to a low of 78 cents in the past few months.

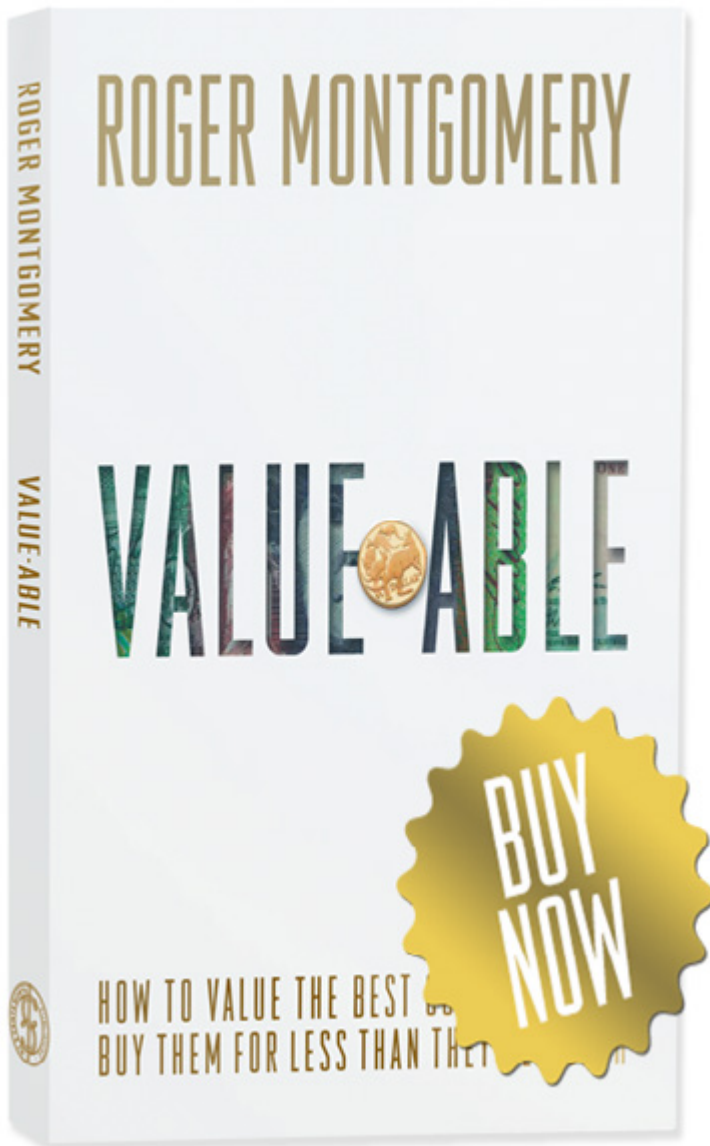
SFH was an easy stock to sell in 2012. As retail sales growth slowed, fewer women would buy dresses at its shops, or would seek lower-priced substitutes at the discount department stores, or so the theory went. And SFH has been a volatile, arguably lower-quality retailer at times over the past decade.

*The list of retail problems is long and growing... sales grew just 0.1 per cent in May*

It posted a \$2.8 million loss in FY12, partly from higher depreciation charges due to a store rationalisation program, did not declare a final dividend, and gave a cautious view of its outlook. But beneath the gloom were good signs of improving operational performance.

Supply-chain enhancements bolstered the company's gross profit margin, more goods were being sold online, and operating cash flows were higher due to much better

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management of working capital. Simply put, SFH was rapidly improving the business to combat retail headwinds.

Those initiatives underpinned sharply improved performance in the first half of FY13. Revenue rose 1.3 per cent to \$311.1 million on the same half year earlier, net profit soared from \$6.1 million to \$17.9 million, and basic earnings per share almost tripled to 9.3 cents.

A 62.4 per cent gross margin was the highest in the company's history, up a whopping 477 basis points over the half. Higher selling prices, lower product and freight costs, and the benefits of investments in moving to a design and direct sourcing model are transforming SFH's margins, with another 150 basis points in margin gains targeted for the second half of FY13.

Other cost controls also impressed. It limited cost increases to 1.2 per cent for the half despite annual wage inflation of 3 per cent. Lower base rentals on renewed store leases and the exit of underperforming stores helped contain cost increases.

Although it has done an excellent job in becoming more productive and efficient, those gains alone will not drive SFH sharply higher in the next 3-5 years. The company needs to better leverage its great, under-recognised strength – a database of 7 million customers built over decades.



Notwithstanding the inevitable 'returns to senders' and 'email address not recognised', the power of this database, and SFH's retail reach, usually gets scant consideration in analyst reports, even though it is the key to the company's long-term fortunes. It is not well known that 55 per cent of Australia's female adult population are on SFH databases, according to SFH figures.

Long-time market watchers will remember the work of Miller's Retail Group, once a standalone ASX-listed company, in

building a huge database of fashion devotees through a "club format" long before the internet made such channels a critical part of retailing.

SFH is doing a much better job mining this database and improving its customer communication and touchpoints. Its email-valid membership, 2.5 million and rising, is a huge platform for targeted marketing for deal-hungry consumers.

A strong 'omnichannel' distribution platform – across physical stores and online – is critical in retailing these days, and a significant source of sustainable competitive advantage and value for SFH. The challenge now is to turn that database into sharply higher, sustained sales growth.

For all its recent achievements, SFH does not appear to have received the recognition it deserves. Although it has a volatile record, it's starting to look like a more consistent, high-quality company that ticks key boxes for long-term value investors.

It had net cash of \$38.6 million on the balance sheet at June 30, 2013 – down from \$45.6 million on the balance sheet at December 31, 2012, which was the highest in seven years. The company repaid \$6.5 million of debt in the first half, and has no outstanding debt. A 27.9 per cent Return on Equity (ROE) for FY13 also impressed, given the retail malaise.

SFH has plenty of cash for a circa \$150-million company (probably too much) and firepower to make acquisitions as the troubled retail sector inevitably throws up opportunities. It has been touted as a takeover target for the fast-growing Cotton On Group, which has a 20 per cent stake and two directors on the SFH board. Cotton On emerged on the SFH register in 2010.

The key question, of course, is does value exist now?

Another interest-rate cut, a stabilisation of the Australian dollar, and the resolution of the Federal election could spur confidence and give cash registers a slightly stronger ring in the next 12 months, and also create more market focus on the retail sector.

But if conditions remain exceedingly tough, as seems likely, SFH has at least shown it has the right formula, management skill and balance sheet to weather the retail storm.

*Roger Montgomery is the founder and Chief Investment Officer at The Montgomery Fund, [www.montinvest.com](http://www.montinvest.com). He is also the author of *Value.able*, *My 2 Cents Worth Publishing*, 2010.*



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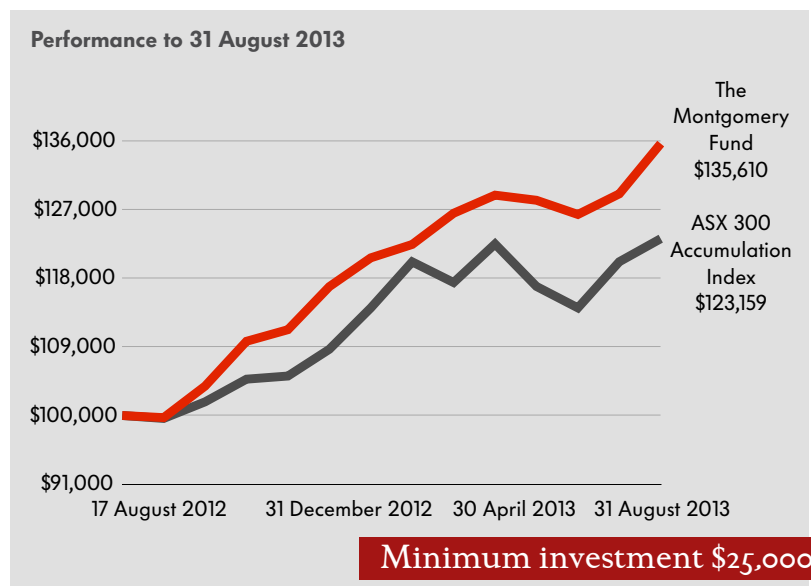
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