Shopping for retail stocks – 3 to watch

by Roger Montgomery

Employing nearly 11% of Australia's workforce, the retail industry is the second largest employer behind Healthcare and Social Services. The retail sector in Australia is made up of almost 140,000 different businesses, covering everything from corner convenience stores to big box hardware and supermarkets.

There is also a great deal of wealth that can be made from retailing. According to the *Forbes* rich list, 221 billionaires in retailing and fashion make up 12% of the worldwide total of billionaires from Home Depot's Bernard Marcus and Arthur Blank to Aldi's Beate Heister and Karl Albrecht, Jr and Ralph Lauren and Giorgio Armani. Indeed, retailing has produced the second largest number of billionaires after finance and investing.

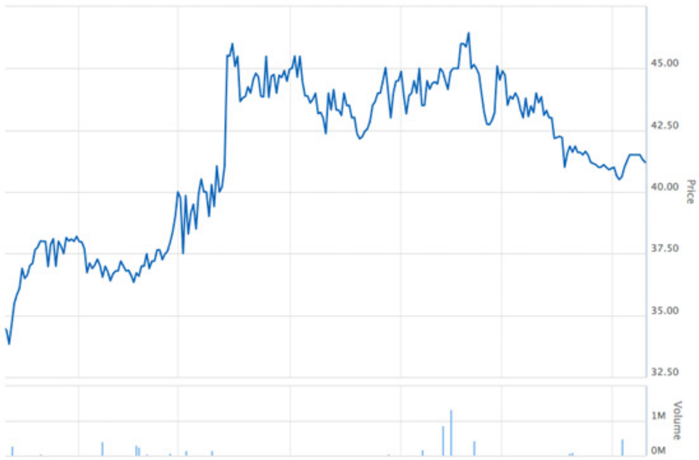
The one great challenge in retailing is, of course, change itself. Not only do tastes change, requiring adaptation to both the products being sold and the environment and platforms through which they are sold, but competition is intense – sometimes even driving the changes to tastes and preferences. Today online 'disruption' and the emergence of global bricks & mortar entrants, such as Uniqlo, Topshop and Zara are simply the latest changes the Australian retail sector faces. That challenges are ever-present ensures only the very best merchants survive and prosper.

In large part because of deflation – retailers must continue to lower their prices in order to compete effectively – the retail industry's share of GDP has been declining. While record low interest rates are providing some cushioning, they won't stay low forever. The two most oft-cited variables impacting retail sentiment is interest rates and petrol prices. If the future holds higher interest rates and fuel prices, one would expect retailers will face another challenge beyond their control.

Three we look at:

Reece (REH) – BUY/HOLD

Reece remains the gold standard in terms of quality and its share price is up 20% in the last 12 months. It remains the case that without a dollar of additional capital over the last 16 years, this hot water and plumbing company grew profits from $38m in 2000 to $192m in 2016. Since 2000, growth in total equity has come solely from retained profits and returns on equity have been maintained. EPS of $1.96 in 2016 was forecast a year ago to grow to $2.17 by 2018. That EPS estimate is now $2.21 and has been raised amid a continuing renovation boom for hot water and bathroom supplies.



Source: ASX

BWX Limited (BWX) – BUY

A little-known company held by Montgomery is BWX Limited. While not a direct retailer, it depends on retail sales activity. This small Melbourne-based company owns a range of skin and hair care brands and manufactures cosmetics for third parties. Shares in BWX began trading on the ASX in November 2015 at

$2.12. They have doubled since then, and we think there's more good news ahead.

BWX derives most of its earnings from its flagship Sukin range of 'natural' skin care products. Australia was an early adopter of natural skin care, and Sukin was an early mover into this market. It is a product sold in pharmacies but not supermarkets. Following several years of strong growth, Sukin is the No. 1 selling 'natural' skin care brand in Australian pharmacies, having displaced globally-recognised brands for the title.

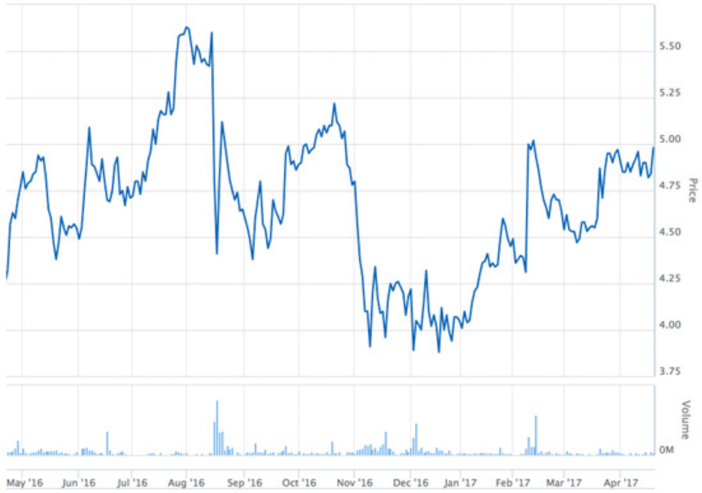
This market segment continues to grow strongly, as consumers become more attuned to the merits of natural products, and BWX has worked to extend the Sukin range, add new outlets and improve sales execution. The first half of FY17 this saw Sukin's domestic sales grow by an extraordinary 48%.

While BWX manufactures the Sukin range itself, the capital intensity of the business is surprisingly low, and these very strong growth rates have been achieved with minimal investment in new capital.

BWX has the opportunity to replicate some of its Australian success in much larger overseas markets. They are working to have the Sukin range distributed in several overseas markets, and the early signs are encouraging. In the UK, the leading health retailer, Holland and Barrett, has retailed a small selection of Sukin products in 142 stores, and recently decided to offer a wider range of products throughout their 765 store retail network. Similarly, Boots UK sells Sukin in over 220 stores, and there is potential to extend into its 2,500 strong retail network.

It is clearly difficult at this stage to gauge the ultimate success of Sukin in these markets, so any valuation analysis needs to contemplate a wide range of possible outcomes.

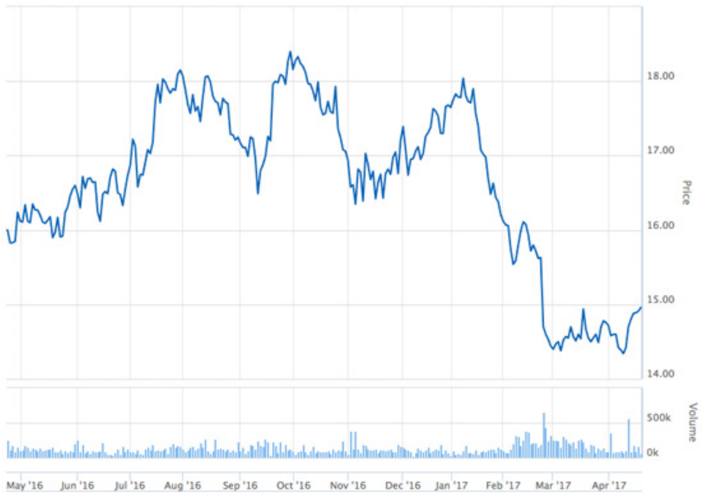
(*Tony Featherstone included BWX in his article earlier this month:* [3 stocks that can rally further](). *)*



Source: ASX

ARB (ARB) – HOLD

ARB is the manufacturer and distributor of aftermarket 4X4 accessories including winches, vehicle lighting and bull bars. The company has tripled profits over the last decade and has maintained a relatively high rate of return on equity of near 20% per annum. The company is currently trading above our estimate of its intrinsic value which suggests the shares aren't cheap. However, the company also enjoys strong cash flows, which combined with a high rate of profitability has, over time, lead to consistently growing dividend income.



Source: ASX

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