SECTOR DEFENSIVE RETAILERS

Groceries in the firing line

Australia's big supermarkets will have to fight harder to resist Amazon's onslaught

Despite more than eight years of economic growth in the US, retailers there have been going out of business at a rate normally reserved for very deep recessions.

Until now the e-commerce apocalypse that has decimated retailers has largely been concentrated in apparel, which has also suffered from a growing share of spending on recreation such as restaurants and travel.

It seems the growing earnings power of millennials is simply driving more sales online. Amazon's sales have grown almost tenfold in the past decade, from $US15 billion ($19 billion) in 2007 to $US178 billion in 2017. Amazon was also responsible for about 44% of all US e-commerce sales in 2017, or about 4% of total retail sales, according to One Click Retail, a market researcher. In less than five years, 20% of the US's $US3.6 trillion retail market will have migrated online, and Amazon is expected to capture two-thirds of that trend.

While luxury retailers have beaten a retreat from expensive real estate sites, retail jobs are plunging even ahead of automation and retail real estate is being vacated at the highest rate since 2008, grocery has largely been untouched.

But it is only a matter of time before Amazon's purchase of upmarket grocer Whole Foods for $US13.7 billion is integrated with its logistics and delivery systems, including Dash Buttons, supporting a private label push whose wave could eventually hit Australia's shores.

According to the industry website Food Dive, grocery store openings in the US declined 28.8% as major chains shuttered stores. News website Curbed NY has reported and mapped New York's disappearing grocery stores, Convenience Store News has reported a decline of mid-size chains across the US, and Lidl's US expansion has slowed amid aggressive pricing by competitors.

The US, however, is behind many parts of the world when it comes to the penetration of online grocery shopping. While 4.3% of domestic grocery sales are conducted online in the US, that number is 19.7% for Korea, nearly 6% for China and over 7% in the UK. And in Australia, according to the discount coupon site CupoNation, Australia's online grocery sales are growing seven times faster than the total market.

The shift is already triggering brands to change their strategies. Retailers are looking to private labels to retain margin. Overseas, mega retailers such as Kroger

> **To reorder a favourite product, just press the Dash Button once**

are making private label growth a top priority in 2018, while Walmart's Jet.com rolled out its first private label, Uniquely J, while simultaneously purchasing Shoes.com, Bonobos and ModCloth to compete directly with Amazon.

In response, established brands, which have been removed from shelves and pressured on margins, now see grocery stores as their biggest competitors, not their biggest clients. They are taking control of their distribution channels either by building their own platforms using Magento and BigCommerce, or initially partnering through competitor Amazon until they launch their own strategy.

Meanwhile, tech start-ups are looking to serve brands in their attempts to regain share by offering assistance at every step of the supply chain, from subscription to packaging, delivery, search and social media.

In Australia, Woolies and Coles have all this ahead of them so they're not standing still. Already Woolworths serves more than 9 million visitors each month on its e-commerce platform and Coles 7 million.

Woolworths is expanding its click-and-collect service to more stores nationwide while Coles dominates social media with 1.2 million followers versus Woolworths' 1.05 million and Aldi with almost 600,000. In the US, Whole Foods is a case study in building a fan base through social media.

Australia's incumbent retailers will have to do more. In the US, Amazon Dash Buttons are product-branded, thumb-sized, wi-fi devices that can be attached to the door of the pantry or fridge. To reorder a favourite product, just press the button once, without ever looking at an app or searching on a website.

Trying to win back a customer who has a pantry full of these devices may be a challenge. Of course, the batteries will eventually go flat!

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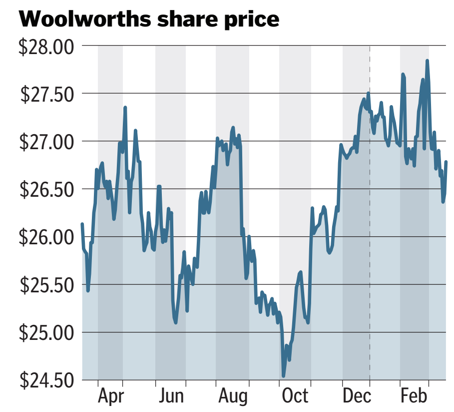

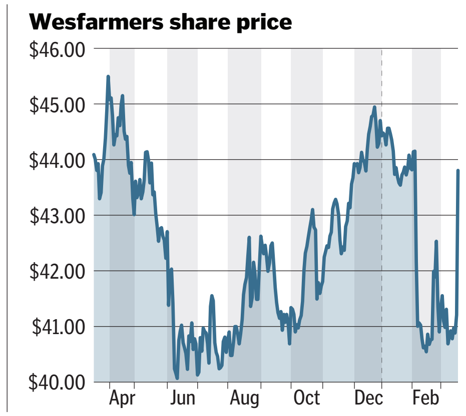

Prices as at close of business, 16-Mar-18.

1 Woolworths

ASX code WOW
Price $26.78
52wk ▲ $27.97
52wk ▼ $24.45
Mkt cap $35bn
Dividend 93¢
Dividend yield 3.47%
PE ratio 19.4
HOLD

While Woolworths' share price is virtually unchanged over the past year, perhaps the biggest news for Woolies was the ACCC's decision to block BP from buying the supermarket's chain of petrol stations, which would have grossed $1.785 billion in proceeds and reduced Woolworth's debt levels further.

Selling petrol stations is a curious strategy because one might assume the network provides an excellent additional channel for click-and-collect convenience, and the debt is easily supported by long-term cash flows generated from working capital.

The first-half underlying profits of just over $960 million were in line with the market's consensus expectations and were driven primarily by growth in Australian food (up 11% and like-for-like sales up nearly 5%) and hotels (up 17%) and slightly offset by New Zealand supermarkets (down 11%) and reducing losses at Big W.

Meanwhile, the share price reflects positive sentiment towards CEO Brad Banducci, who has done a solid job turning around the business sooner than many anticipated.

Nevertheless, management has indicated that sales growth in Australian food may moderate as research analysts compare sales stats with stronger numbers from comparative prior period.

While there is little to suggest the turnaround momentum won't continue, we note that the longer-term outlook for investors is somewhat clouded by the ever-present possibility of a derating associated with the eventual concentration of Amazon's focus on grocery in Australia.

2 Wesfarmers

ASX code WES
Price $43.80
52wk ▲ $45.60
52wk ▼ $39.52
Mkt cap $49.66bn
Dividend $2.23
Dividend yield 5.09%
PE ratio 32.9
BUY

The market saw the writedown of Wesfarmers' investment in its UK expansion as a negative, and the spin-off of Coles supermarkets from the Bunnings hardware chain as an even bigger one. But the first-half result was better than expected and the market quickly retraced the losses inspired by the UK writedown, which had been flagged.

Bunnings generates much higher returns on capital than Coles, which has probably inspired the spin-off. It has grown tremendously during Australia's two-and-a-half decade run without a recession. It is a case study in the power of monopoly and retail execution.

Until recently the major issue for supermarkets has been that EBIT was under pressure from "price investment", which is a euphemism for cutting prices to maintain market share. For as long as Aldi and Amazon remain on the doorstep of Australia, Coles and Woolworths may not be able to rest but the recent move by Coles away from its "Down, Down" advertising campaign suggests more rational competition between Coles and Woolworths may now prevail irrespective of whether Coles is part of Wesfarmers or not.

Before the proposed spin-off, Wesfarmers was not a company whose shares could be expected to double any time soon. At best a mature supermarket should be expected to grow no faster than the economy. Following the announcement, however, it is likely the market will focus on the much higher returns on capital being generated by Bunnings. Before the announcement Wesfarmers represented marginally better value than Woolworths but the gap has now narrowed.

3 Costa Group

ASX code CGC
Price $7.39
52wk ▲ $7.68
52wk ▼ $4.25
Mkt cap $2.36bn
Dividend 12¢
Dividend yield 1.62%
PE ratio 21.84
HOLD

Costa Group is not a supermarket but the largest grower, packer and marketer of fresh fruit and vegetables in Australia. It supplies supermarkets with a range of fruits and vegetables including berries, tomatoes, mushrooms, avocados, citrus, bananas and table grapes.

The company has invested significantly in production techniques and varietal developments that mitigate the adverse impacts of seasonality and bad weather. Without Costa, even Amazon may not be able to help someone who needs blueberries and avocados.

Costa's shares have risen 80% in the past 12 months.

For the first half of 2018, operating earnings were up about a quarter to $60.9 million, which was ahead of several analysts' expectations. EBITDA margins were also up materially by 1.40% year on year. The produce division was particularly encouraging, with citrus and snacking tomatoes offsetting a flat result from berries.

The company's growth runway remains long. Costa has invested more than $100 million in acquiring avocado producers and through geographical diversification seeks to be able to supply avocados 52 weeks of the year – currently it's 10 months.

Currently, the company produces 800,000 trays from 680 hectares and is forecasting 1.9 million trays from more than 1000 hectares within five years.

The share price implies that strong growth will be delivered so it is important for shareholders that these expectations are met without interruption.