

Value Line: Woolworths



By Roger Montgomery

PORTFOLIO POINT: The retailer has competitive advantage, high return on equity and no debt, all of which leads to the enviable “profit loop”.

Australia, we are told, is the envy of the world, the only OECD country not in a recession. So far, the country has navigated a relatively injury-free course through the global financial crisis. Government spending has been a significant factor but, of course, sustaining confidence and upholding these conditions requires the private sector to replace the public purse at some point, lest the debt rises to absurd levels and inflation and higher interest rates follow.

The main beneficiaries of this country’s surprise resilience have been the retailers, and you’ll be happy to note three are listed in the Value Line portfolio. This is not the result of some strategic or tactical asset allocation decision. I make no claim to an ability to predict the future performance of asset classes, the share prices of individual companies or even the economy. I will leave that to those poor souls who, given the ability to

read, believe they are global economics strategists.

The inclusion of three retailers happens to coincide with the fact they represent easy-to-understand businesses, with bright prospects and a demonstrated record of true earning power.

And when it comes to earning power, Woolworth’s record is the longest. With 200,000 employees and revenue of almost \$50 billion, Woolworths is the largest retailer in Australia and – according to Deloitte – one of the 20 largest in the world.

Return on equity for Woolworths has exceeded 20% for the past 10 years and, with the exception of 2006 when the company raised an additional \$2 billion and made a number of purchases, the figure has been rising. A chart of earnings per share since 2000 looks like a ski jump.

As an investor, what you are after is “big” equity and high rates of return. Woolworths has this in spades. Witness the rise in equity for the company, from less than \$2 billion in the year 2000 to almost \$7 billion in 2009. While a substantial contributor to this increase is new capital raised from shareholders, this is offset by the maintenance and increase in the return on that equity, which is about 20% higher than a decade ago.

When investing using the approach I advocate in Value Line, investors need to find companies with, among other things, little or no debt and generating high rates of return on equity. But high rates of return on equity, if being displayed by

The Value Line portfolio, as at September 8, 2009

Company	July 1 price	Price today	Est value	Margin of safety	Bought	Invest-ed (\$)	Capital value (\$)	Divs rec	Total return	Total return
JB Hi-Fi	14.8	18.37	21.7	15.3%	845	\$12,500	\$15,515	0.29	\$3,260	26.08%
Cochlear	56.36	61.96	58.7	-5.6%	102	\$5,744	\$6,315	0.95	\$668	11.62%
CSL	31.81	33.69	28.99	-16.2%	163	\$5,197	\$5,504	0.4	\$373	7.17%
The Reject Shop	11.62	13.86	11.27	-23.0%	513	\$5,959	\$7,107	0.23	\$1,267	21.26%
Woolworths	26.16	28.19	26.7	-5.6%	206	\$5,377	\$5,795	0.56	\$532	9.90%
Westpac	19.68	24.54	18.13	-35.4%	295	\$5,811	\$7,246	0	\$1,435	24.70%
Reece	17.8	21.85	13.7	-59.5%	236	\$4,209	\$5,167	0.33	\$1,036	24.61%
Platinum Asset Mgt	4.06	5.22	2.84	-83.8%	854	\$3,467	\$4,457	0.12	\$1,093	31.53%

Since July 1

Security Value										\$57,927
Cash Value										\$51,736
Total Value										\$109,663
Total Return (\$)										\$9,663.00
Return Invested (%)										20.02%
Total Return (%)										9.66%
All Ordinaries change										14.70%
* Outperformance (I): Outperformance of Invested Portion										5.32%
* Outperformance (T): Outperformance of total portfolio										-5.04%

Under observation

ISOFT	0.635	0.86	0.19	-352.6%						-35.43%
Amcor	4.79	5.72	2.84	-101.4%						

companies devoid of competitive advantages, are unlikely to be sustainable.

Sustainable competitive advantages, economic goodwill or economic moats are needed to sustain high returns on equity, and Woolworths has several. Woolworths also benefits from scale and the lower prices that are a direct result of this. It's what we call the "profit loop".

Woolworths' large size allows it to command volume discounts from its suppliers. This means a higher margin, which Woolworths then reinvests in improvements to processes and systems, which help to reduce costs and allows margins to rise.

The additional margin is then reinvested in lower prices, which increases traffic to Woolworths, increasing stock turns, improving efficiency and raising volumes that in turn allow Woolworths to demand further price reductions from suppliers. Suppliers I have spoken to in the past, portray Woolworths' buyers as adversaries that go to extraordinary lengths to extract a few extra cents.

Saving money is an entrenched culture at Woolworths, something Coles must surely find difficult to match when its new owners are willing to pay more than \$20 billion for a business that was worth half that at best.

Woolworths' scale also provides a network benefit. Better margins means greater range and better looking stores. Better looking stores and wider range, means more customers. More customers means more profit to be invested into better looking stores and so the competitive advantage is entrenched.

Woolworths' efforts to claim an ever-increasing share of the customer's wallet through fuel vouchers and credit cards may also begin to see it increase the switching costs of consumers, eventually making it more challenging for customers to shop elsewhere and generating another source of competitive advantage. And we haven't even touched on the 50:50 joint venture with Caltex or the liquor business or the fact that Woolworths is the largest poker machine operator in Australia.

The historical financial performance of this company is remarkable. Its cash flow is exceptional, its balance sheet tank-like, and profitability the envy of its global peers with both operating and net profit margins more than doubling in 10 years. But it is the future and the presence or otherwise of discount to intrinsic value that will determine the return of the new investor in Woolworths.

Woolworths' competitive prospects are favourable and its current share price of about \$28 compares favourably to my estimate of the company's intrinsic value of between \$26.70 and \$28.80. Indeed, historically the shares have only rarely traded below their value. The absence of a significant discount

to intrinsic value today or even proximity to the lower end of the range of values, however, must necessarily temper Value Line's enthusiasm to buy more shares. ◆

Roger Montgomery is an independent analyst and investor, having previously founded and listed a boutique funds management investment firm.

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