

Shorts betting on another wardrobe malfunction for retailers

Retailers are characterised by intense competition and minimal switching costs. Products like home wares, clothing, televisions and cameras are often differentiated by price alone, making bricks and mortar retailers highly susceptible to online players. FY12 retail results were subdued. Like most discretionary retailers, **JB HI-FI (JBH)**, **David Jones (DJS)**, **Myer (MYR)** and **Harvey Norman (HVN)** face the challenges of deleveraging, more frugal consumers and surging competition from global online retailers who have the advantage of much lower overheads. Following our July shorts review ('A Short Warning' YMW 26) and a rally in equity markets from lows in early June, we review selective companies still suffering from heightened short interest post reporting season. Some of the more high profile cases belong to the retailers JBH, DJS, MYR and HVN. We review companies, and chart the performance of stock price against short position headwinds.

Stocks with a meaningful existing or increasing short position can provide an additional source of market intelligence for investors. On a backward looking basis starting in June 2010 and June 2011, the top 10 shorted stocks fell by an average 9.8% pa and 50.1% pa respectively. The only outlier was **Newcrest Mining (NCM)** in FY11 (which has subsequently fallen) – the stock returned 7.4%, beating the market return of 7.1%. Obviously past performance is no guarantee of future results, but the findings are certainly interesting and shorts can provide an early warning system for investors. Clearly weak market conditions or momentum have resulted in better returns for shorting activity. Table 1 lists the top five short companies by dollar value. This metric focuses on large caps and highlights deeper macro trends like slow credit growth and stagnant housing markets for the banks, or soft consumer confidence for retailers. The top three most shorted stocks by dollar value are **Wesfarmers (WES)**, **Commonwealth**

Bank (CBA) and **Rio Tinto (RIO)** – partly just reflecting the fact that they are larger companies.

Company analysis

JB HI-FI (JBH): JBH is Australia's sixth largest retailer, having built a strong brand within the consumer electronics industry after the demise of smaller fragmented groups like Retravision and Beta Electrical. JBH has no moat and sells commoditised products, it has struggled in recent times, a product of a higher A\$ and price deflation. Electronic retailers, in particular JBH, have borne the brunt of retail change. Following the FY12 result, shorts have remained above 20%, by far the largest short position in the market. Fair value estimate is \$9.40 and recommendation is Hold.

David Jones (DJS) and **Myer (MYR)** are department store chains selling many exclusive brands of clothing, accessories and homewares. The most glaring risk for these stores is the threat of market share loss to online competition, a trend that may continue for many years. Unlike Myer, DJS has substantial property assets that may curb losses. Following the FY12 result, DJS shorts have remained above 6%, making it a firm member of the top ten shorts in the market. Fair value estimate is \$1.70 and recommendation is Reduce. Following the FH12 result, shorts in MYR have trended upwards from 9% to 11%, finishing the week as the sixth most shorted stock in the country. Fair value estimate is \$2.00 and recommendation is Hold.

Harvey Norman (HVN): Gerry Harvey suggests the internet is a distraction representing only 1% of sales. We think there are two significant trends in play. The first is consumers remain in a deleveraging phase after a period of rapidly rising house values. The household budget is now redirected towards paying down debt. We expect the entire consumer discretionary sector to remain weak for a sustained period. The second is the structural shift online. Yes it is a relatively small percentage of sales but the pace of change is accelerating. The internet enables international operators to compete directly with domestic retailers. Beginning the year at 4%, shorts have trended upwards and recently peaked close to 10%. Fair value estimate is \$1.70 per share and recommendation is Reduce.

Current short positions

When examining the sector breakdown in Table 2, it's



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Table 1: Top 10 companies by dollar value

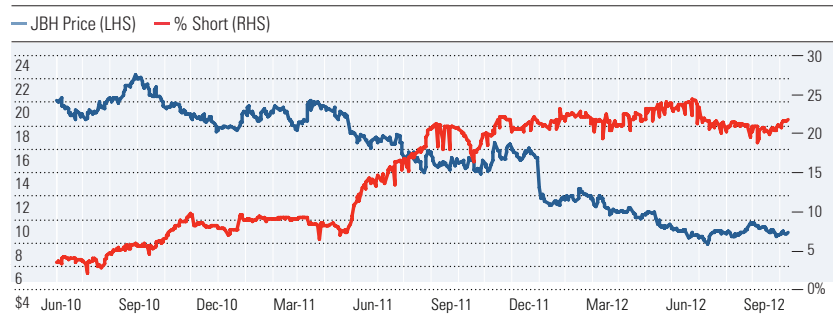
| 25/09/12 | \$m |
|----------|-------|
| WES | 1,015 |
| CBA | 1,003 |
| RIO | 878 |
| WBC | 813 |
| FMG | 770 |
| QBE | 720 |
| ILU | 491 |
| BHP | 353 |
| FLT | 322 |
| COH | 316 |

Source: ASIC/Morningstar

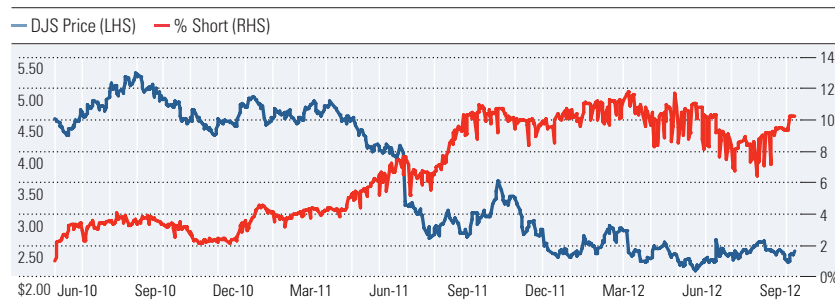
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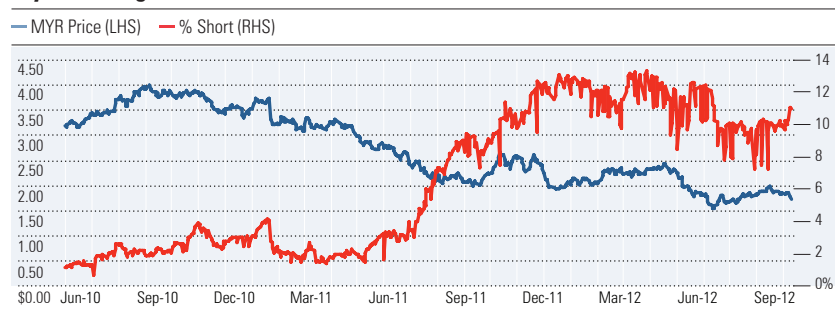
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JB Hi-Fi Limited (JBH)

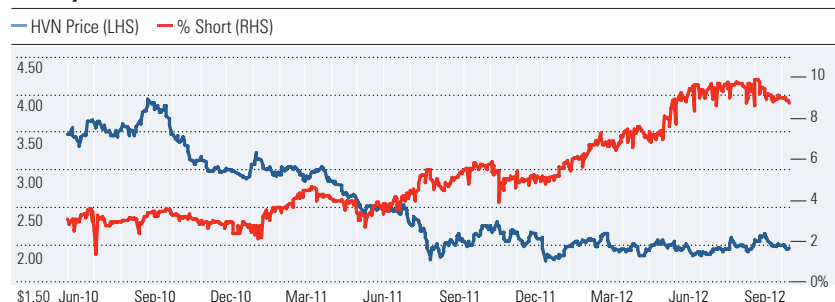
Source: ASIC/ Morningstar

David Jones Limited (DJS)

Source: ASIC/ Morningstar

Myer Holdings Limited (MYR)

Source: ASIC/ Morningstar

Harvey Norman (HVN)

Source: ASIC/ Morningstar

Table 3: Largest short positions categorised by Morningstar recommendations

| Buy | % | Accumulate | % | Hold | % | Reduce | % |
|-----|------|------------|-------|------|-------|--------|-------|
| AWC | 8.77 | ILU | 11.23 | JBH | 21.73 | DJS | 10.26 |
| QBE | 4.63 | WTF | 8.41 | FLT | 13.40 | HVN | 8.78 |
| SGM | 3.84 | TEN | 6.48 | FXJ | 11.53 | CRZ | 6.61 |
| RIO | 3.73 | MSB | 6.42 | MYR | 11.00 | MIN | 3.54 |
| SWM | 1.73 | MTS | 5.77 | TRS | 10.08 | SKI | 2.88 |

Source: ASIC/ Morningstar

easy to identify the market sector facing the strongest headwinds, Consumer Discretionary – where seven of the top 10 most shorted stocks reside. Interestingly, shorting Materials has risen sharply in popularity, with the top 10 averaging 7.6% in comparison to 2.2% recorded in our July report. Some interesting statistics:

- ▶ **Lynas Corporation (LYC)** has climbed 2.73 points in the past month to be 13.6% shorted.
- ▶ **JB HI-FI (JBH)** retains top spot, but shorts have risen sharply 1.36 points in the past month - 21.7% of outstanding stock is still short.
- ▶ **Flight Centre (FLT)** is the third most shorted stock in Australia, rising 0.7 points in the past month to be 13.4% shorted.
- ▶ Under pressure mineral sands miner **Iluka Resources (ILU)** has increased short position by 1.6 points in the past month, falling into 5th place at 11.2% shorted.
- ▶ **Perpetual (PPT)** is still the most shorted Financials stock, at 5.3% shorted.
- ▶ **Wotif.com (WTF)**, **Fortescue Metals (FMG)** & **Alumina (AWC)** aren't far off the top ten, sitting at 8.4%, 6.9% & 8.8% respectively. Fortescue's lower free float restricts the amount of shorts with a third of the shares tied up by Chairman Andrew Forrest. ■■

Table 2: Average short position per sector, and current top 10 short positions

| Sector | % Short | Top 10 | % Short |
|---------------------------|---------|--------|---------|
| Telecom | 2.18 | JBH | 21.73 |
| Materials | 7.63 | LYC | 13.61 |
| Industrials | 4.27 | FLT | 13.40 |
| Healthcare | 2.91 | FXJ | 11.53 |
| Financials x Property Tr. | 2.80 | ILU | 11.23 |
| Energy | 3.21 | MYR | 11.00 |
| Consumer Staples | 2.16 | DJS | 10.26 |
| Consumer Discr. | 10.55 | TRS | 10.08 |
| IT | 2.75 | CSR | 8.88 |
| Utilities | 1.45 | HVN | 8.78 |

Source: ASIC/ Morningstar

Table 4: Absolute change in short position – increases and decreases to 25/09/2012

| Increases | | | |
|-----------|------|---------|------|
| Weekly | (%) | Monthly | (%) |
| MYR | 1.02 | LYC | 2.73 |
| SLR | 0.88 | IDL | 2.12 |
| GNC | 0.57 | SLR | 2.07 |
| NWH | 0.56 | WTF | 1.95 |
| MIN | 0.55 | ILU | 1.64 |

| Decreases | | | |
|-----------|-------|---------|-------|
| Weekly | (%) | Monthly | (%) |
| LNC | -1.33 | SBM | -2.23 |
| SGT | -1.14 | LNC | -2.00 |
| WSA | -1.01 | COH | -1.74 |
| PAN | -0.99 | BBG | -1.51 |
| CSR | -0.72 | SGM | -1.01 |

Source: ASIC/ Morningstar