INDUSTRY PULSE | MARCH 2024

Australian Retailing: Q1 2024

Discretionary sector rallying on overblown tailwinds.

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Table of Contents

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Key Takeaways and Valuation Snapshot

Sales momentum improving, but no repeat of boom.

Improving Sales Growth Unlikely to Reach Anywhere Near Recent Boom Years

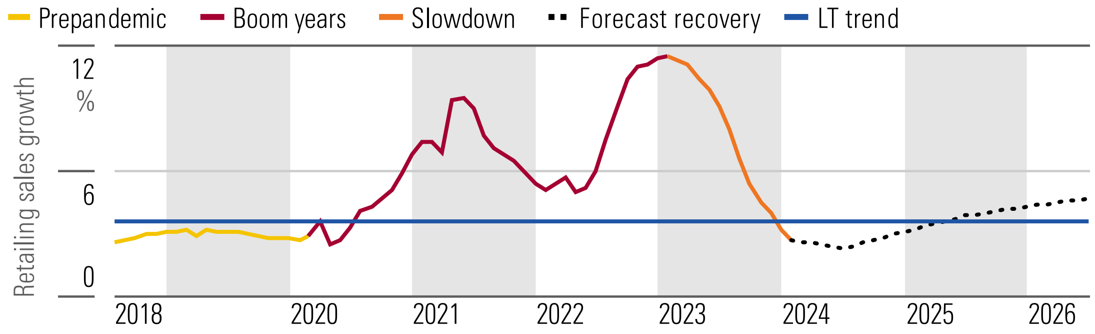
Talk of interest rate cuts and impeding tax cuts are sparking a rally in consumer cyclicals. We agree these factors improve the near-term outlook for consumer spending, with cyclical retailers more exposed. We expect the combined impact of fiscal and monetary tailwinds to underpin mid-single-digit growth in total retailing sales in the medium term—compared with our estimate of only 2% growth in fiscal 2024.

However, we suspect the market is expecting a much more pronounced recovery. Cyclicals currently trade at an average 17% premium to our fair values, with material downside if sales and earnings disappoint—although some appealing opportunities exist.

While we expect retail to recover through to fiscal 2026, we're not anticipating anything like the boom we saw after the pandemic. The postpandemic retail surge was underpinned by pent-up demand, unprecedented fiscal stimulus, and emergency monetary policy settings.

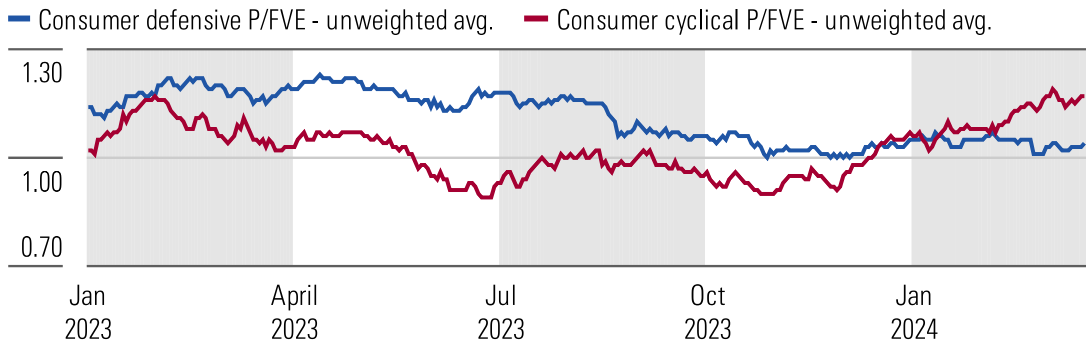
We think this rebound will look different. In contrast to the largesse during the pandemic, this government is concerned with fighting inflation and firming its economic management credentials, with the Treasurer warning we won't see "big cash splashes" in the upcoming budget. Stage 3 tax cuts will be supportive, but we estimate only a modest contribution to fiscal 2025 consumption growth. Monetary policy, too, will alleviate some of the pressure on households. But on current market forecasts, the cash rate in fiscal 2025 only returns to the still-elevated levels of early 2023, nowhere near the ultra-low emergency settings of the pandemic.

Retailing Sales Growth Returning to Normal After Pandemic-Related Volatility



Source: Australian Bureau of Statistics, Morningstar. Note: Long-term trend 10-year CAGR to June 2019.

Cyclicals Look Expensive After Recent Rally



Source: Morningstar. Data as of March 15, 2024. Note: P/FVE<1 is undervalued, and P/FVE>1 is overvalued.

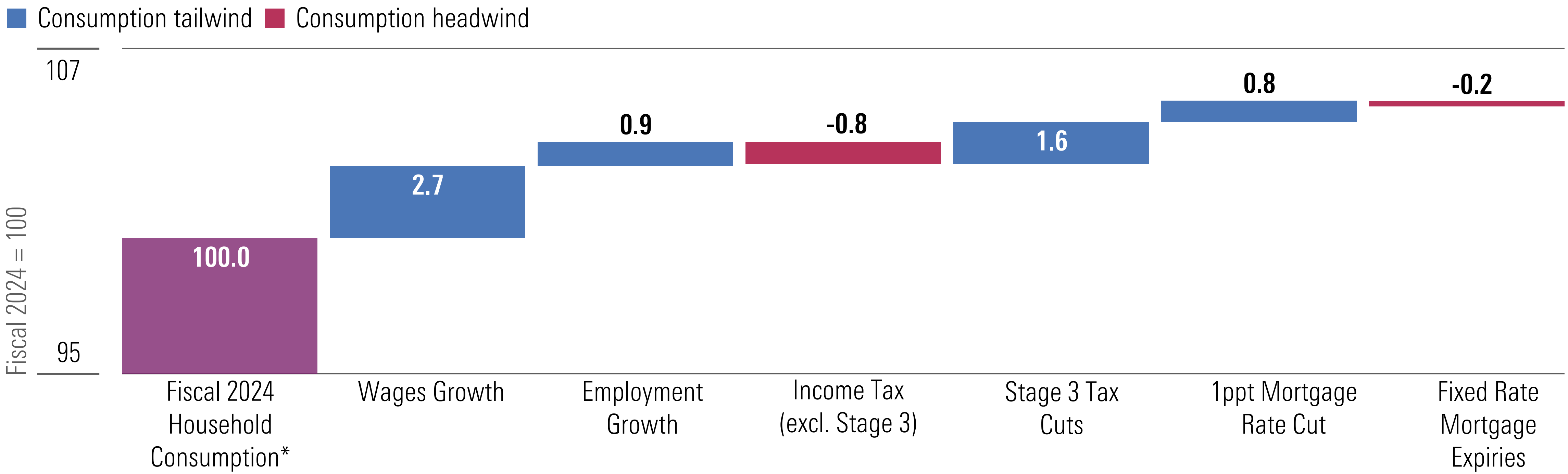
KEY TAKEAWAYS

Interest Rate and Tax Cuts Unlikely to Propel Retail Sales Growth

We don’t see the much-anticipated stage 3 tax cuts as a game changer for household spending in fiscal 2025. At a cost of AUD 21 billion in fiscal 2025, stage 3 could add up to 2% to consumption if households spend all the windfall. But for context, this is only one quarter of the size of JobKeeper, which underpinned the postpandemic retail boom. Meanwhile, 100 basis points of mortgage cuts—broadly in line with market expectations—adds less than 1% to spending on our calculations and will be partly offset by fixed-rate mortgage expiries.

Interest Rate and Tax Cuts Supportive, but Wages Are Main Driver of Consumption Growth

Estimated impact of select key consumption drivers in fiscal 2025.



Source: Australian Bureau of Statistics, Reserve Bank of Australia, The Commonwealth of Australia, Morningstar. *Based on Reserve Bank of Australia Forecasts.

VALUATION SNAPSHOT

We See Value in Domino's, Collins Foods, Kogan, and Accent

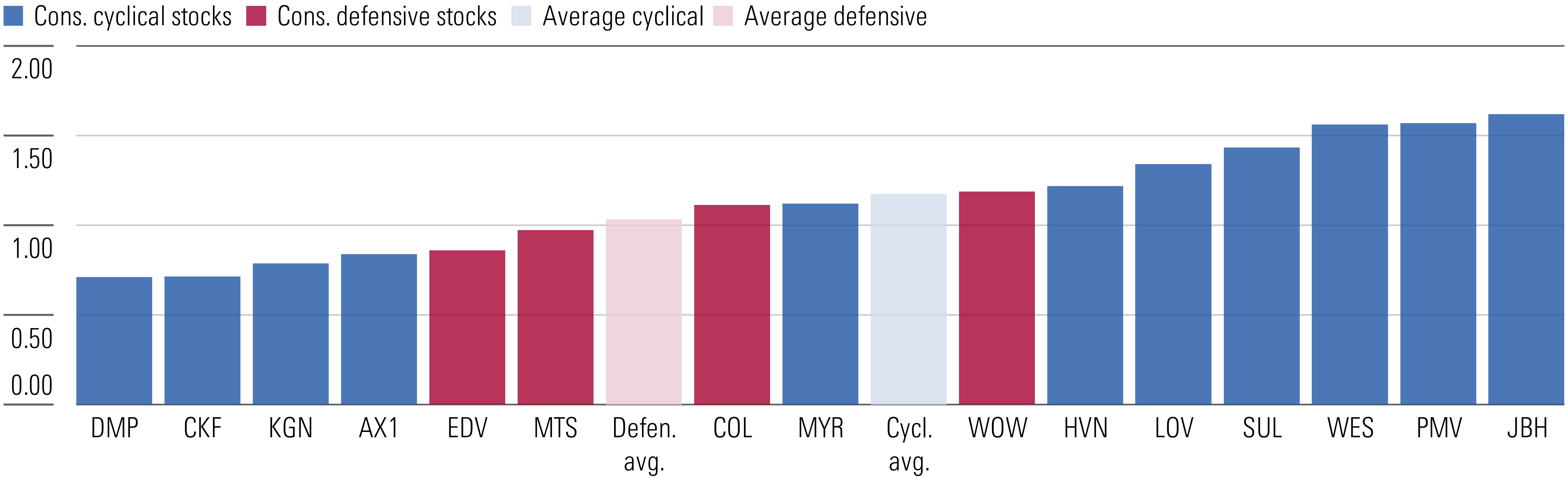
With an improving macroeconomic outlook, discretionary retail stocks are rallying. JB Hi-Fi, Premier, and Wesfarmers trade at significant premiums to our fair values.

However, we still see value in apparel retailer Accent, despite the near-term earnings headwinds from slower sales and a growing wage bill.

We think trading down will insulate value-focused Domino's Pizza and Collins Foods, the two cheapest names in our retailing coverage.

On Balance, Smaller Discretionary Retail Stocks Most Appealing

Price/fair value estimate ranking, with P/FVE<1 undervalued, and P/FVE>1 overvalued.



Source: Morningstar. Data as of March 15, 2024. Note: Subsector averages are unweighted..

Macroeconomic Drivers and Indicators

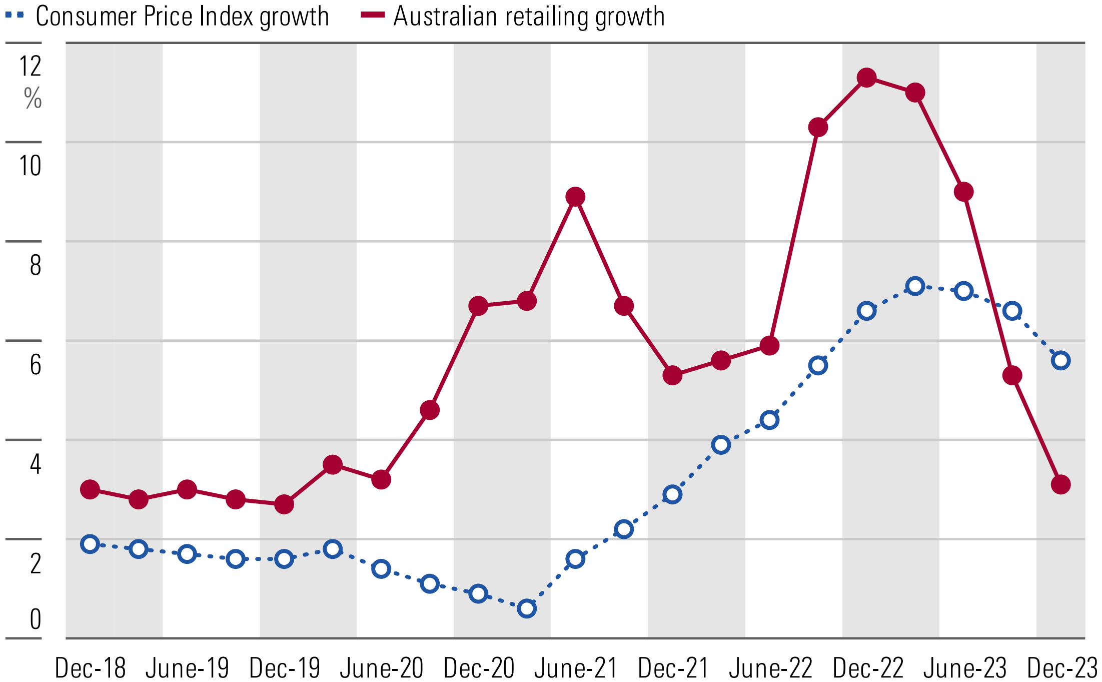
Expected rate cuts unlikely to result in retail surge.

Volumes Declining as Sales Growth Stays Below Inflation

Usually, inflation underpins retailing growth with a rising population further supporting sales. But this relationship has broken down in recent quarters. Inflation growth is outstripping retail sales, translating into negative volume growth in the 12 months to December 2023. With the supply bottlenecks now largely behind us, we think retailers will be forced to compete more on price. As shelf prices cool, and underlying demand remains soft, this should pressure revenue growth and gross profit margins over the rest of fiscal 2024.

Retail Sales Growth Crashes Below Inflation

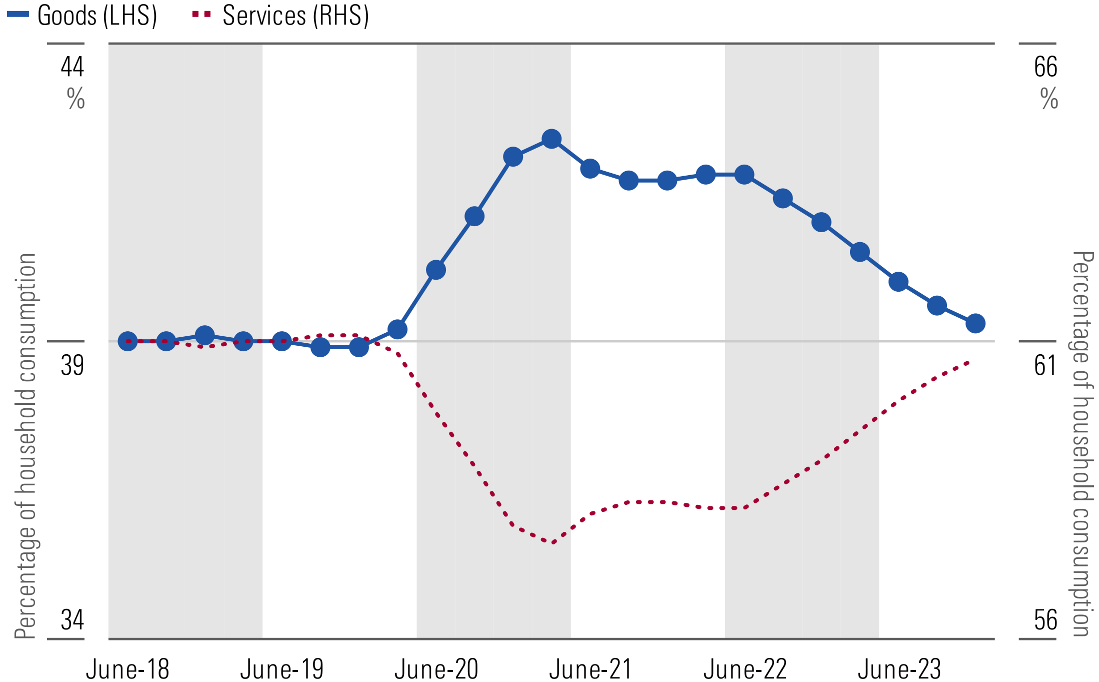
Annual Consumer Price Index growth. Rolling 12-month retail sales growth versus PCP.



Source: Australian Bureau of Statistics. Data as of Dec. 31, 2023.

Spending Split Back to Trend With Risk of Goods Undershooting

Consumption split of goods and services.



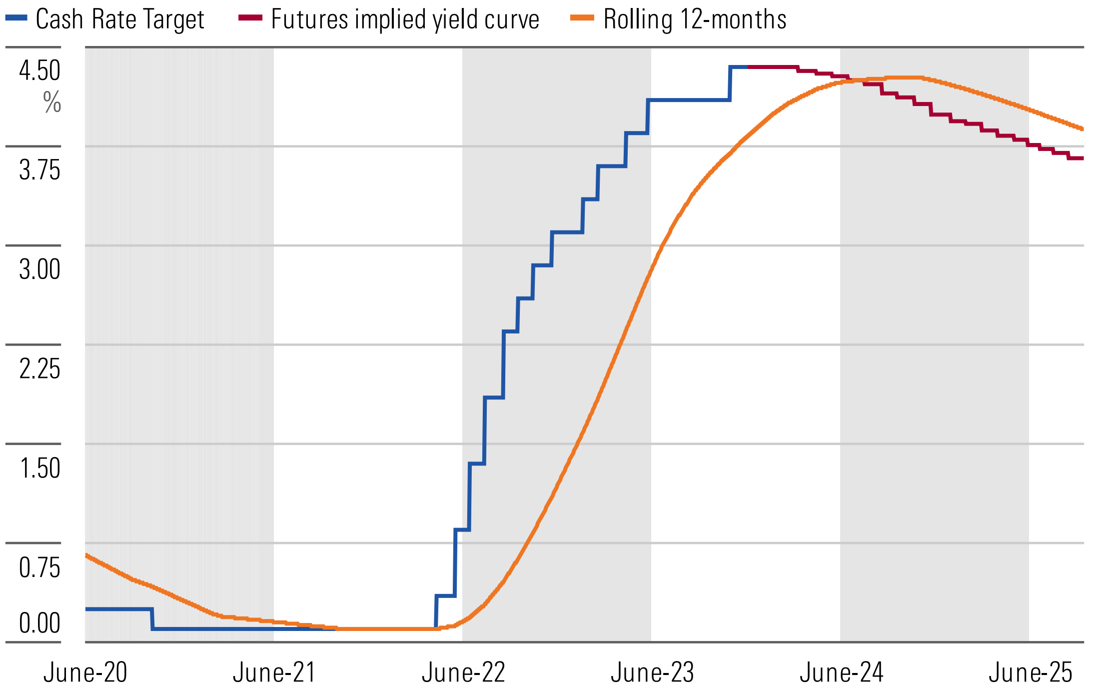
Source: Australian Bureau of Statistics. Data as of Dec. 31, 2023.

Global Inflation Battle Not Over Yet

Recent signs of sticky inflation, particularly in the US, are tempering market expectations around the timing of rate cuts. The futures market expects the Reserve Bank of Australia to deliver its first 25-basis-point cut in third-quarter 2024, with a cumulative 75 basis points by June 2025. This will alleviate some of the pressure on households, but even 100 basis points of rate cuts in fiscal 2025 only brings the cash rate back to levels of early 2023—only a relatively small one-off sugar hit to household consumption.

Stickier Inflation Delays Timing of Projected Rate Cuts

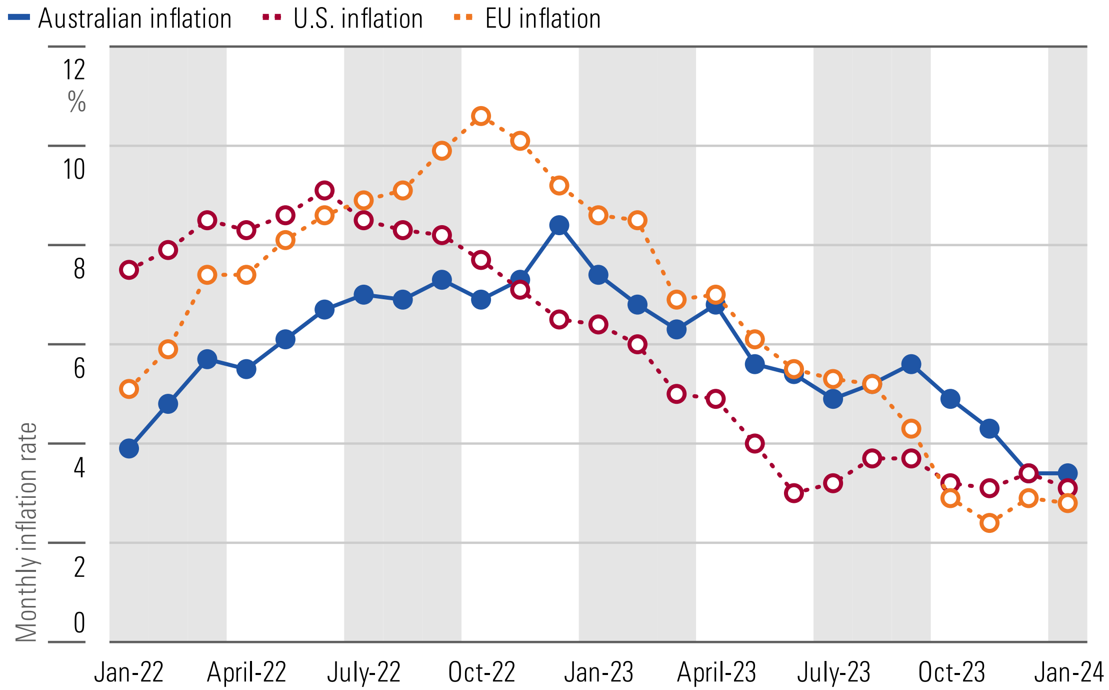
RBA cash rate and 30-day interbank cash rate futures implied yield curve.



Source: Reserve Bank of Australia. Data as of March 6, 2024.

Inflation Rates Converging of Global Peers but Still Outside of Respective Targets

Monthly Consumer Price Index versus the previous corresponding period, or PCP.



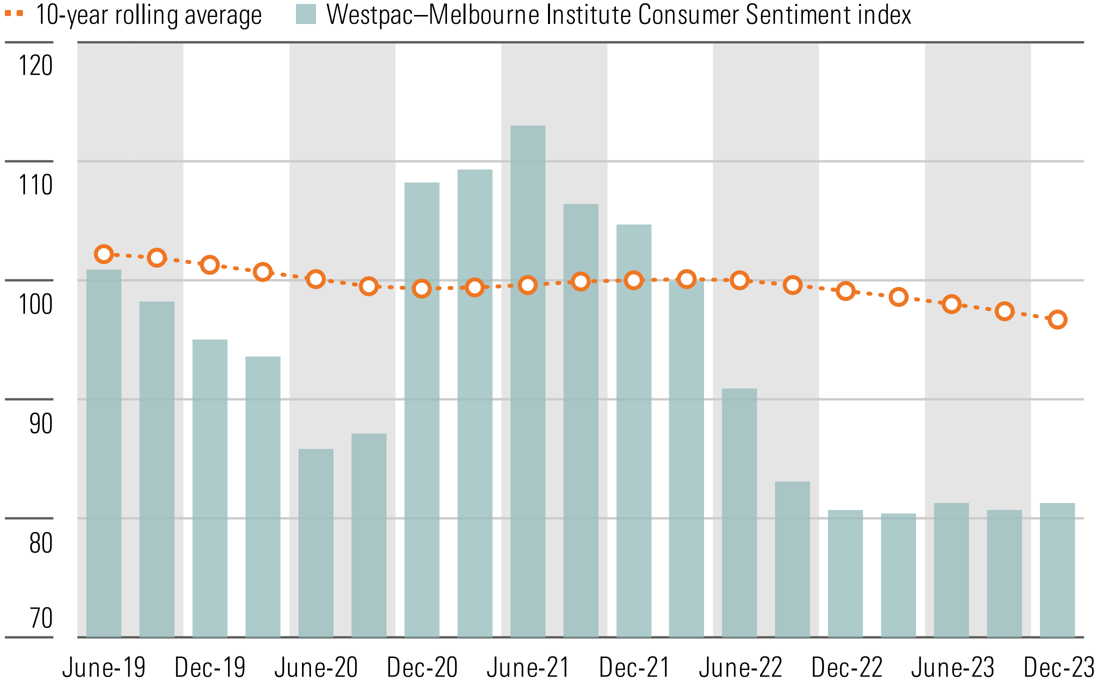
Source: Australian Bureau of Statistics, U.S. Department of Labor, European Central Bank.

Consumer Confidence Tentatively Lifting on More Positive Outlook

Consumer sentiment is recovering from its recent trough, showing a modest improvement in the final quarter of 2023. Cooling inflation and a lower perceived likelihood of further rate hikes are drivers. But sentiment remains in firmly pessimistic territory. This is keeping a lid on retail sales growth, particularly for big-ticket discretionary goods. In 2023, households paid almost 70% more in mortgage interest compared with 2022, and confidence appears to be closely tied to changes in commentary from the Reserve Bank.

Consumer Sentiment Still Very Pessimistic

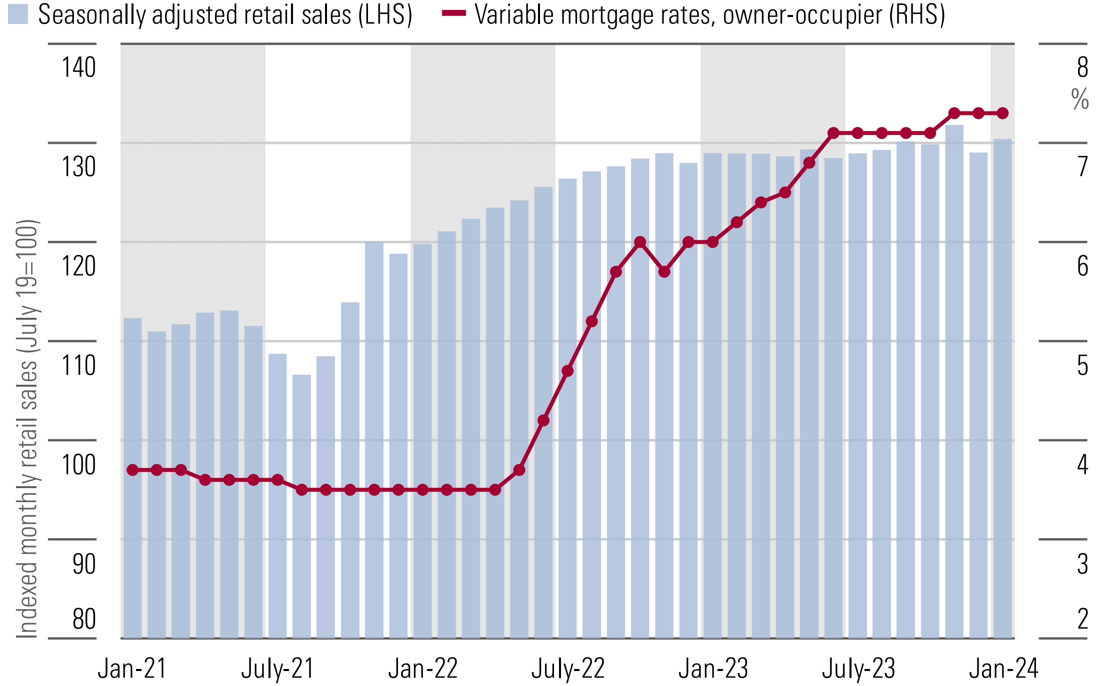
Quarterly average of the Australian Consumer Sentiment Index.



Source: Westpac–Melbourne Institute Survey of Consumer Sentiment.

Interest Repayments Still Building as Rate Hikes Pass Through to Mortgages

Indexed monthly retail sales (July 2019=100) and variable mortgage rates.



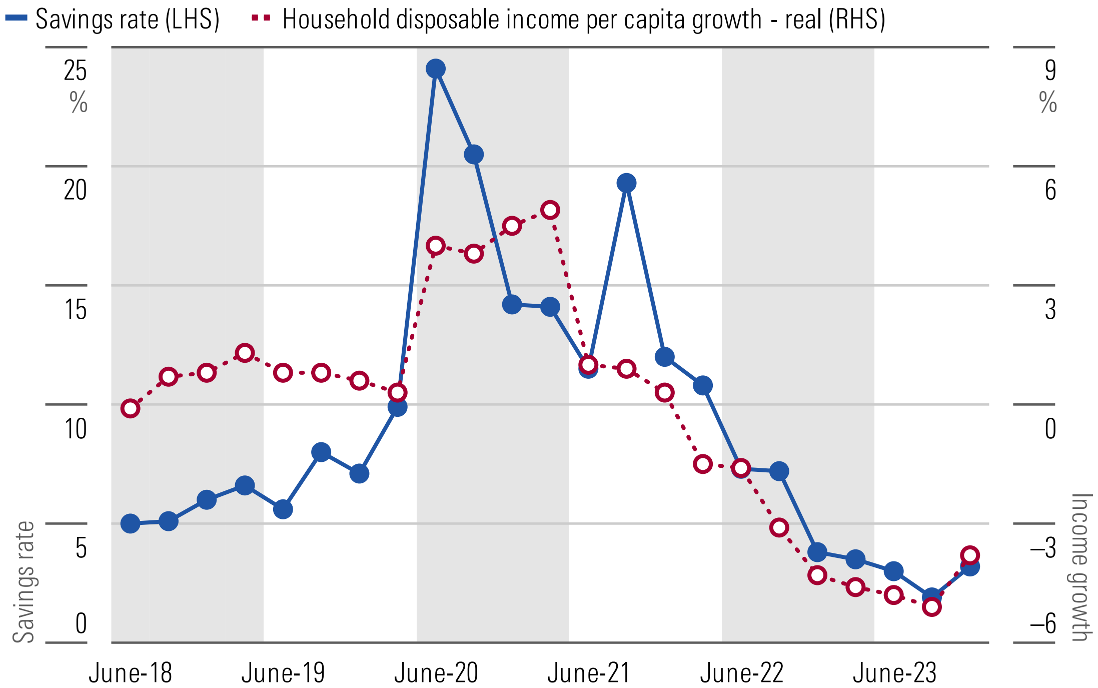
Source: Australian Bureau of Statistics, Reserve Bank of Australia.

Household Savings the Key Swing Factor in Spending

The savings rate ticked up in December 2023, breaking a streak of eight consecutive falls. However, at 3% of household income, savings are well below the long-run average of around 7%. We estimate households accumulated AUD 250 billion of excess savings during the pandemic and are drawing on these to prop up spending while maintaining a lower savings rate. We think around one quarter of this savings buffer has been exhausted. Any increase in the savings rate directly reduces consumption of goods and services, including retailing sales.

Savings Rate Well Below Long-Run Average

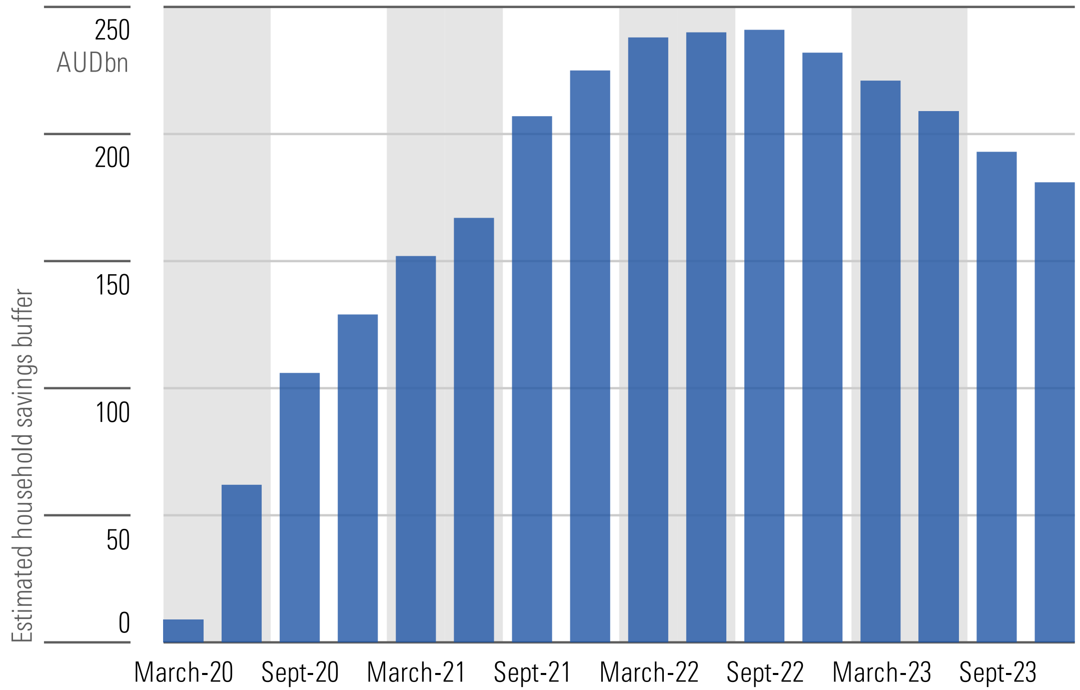
Quarterly savings rate. Rolling 12-month disposable income per capita versus the PCP.



Source: Australian Bureau of Statistics, Morningstar estimates.

Accumulated Savings Unwinding in Response to Cost-of-Living Pressure

Accumulated household savings above 10-year average prepandemic rate.



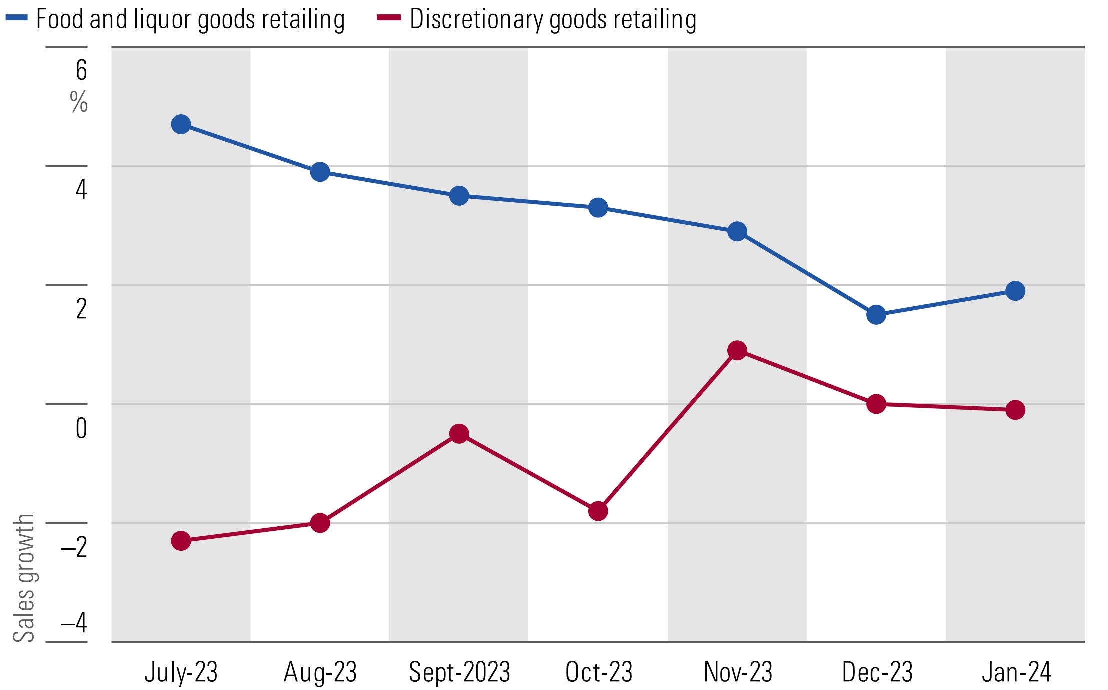
Source: Australian Bureau of Statistics, Morningstar estimates.

Defensives More Resilient as Cyclicals Struggles to Tread Water

We expect the Australian retailing industry to grow by 2% in fiscal 2024. But underlying this is a significant divergence across categories, with sales in cyclicals virtually flat and defensives up 4%. As we begin to get some support from fiscal policy in fiscal 2025, and possible monetary easing, discretionary sales momentum should improve. We think total retail sales will grow modestly above the 10-year trend rate in fiscal 2025 and 2026.

Defensives Growth Rate Remains Above Discretionary Spending

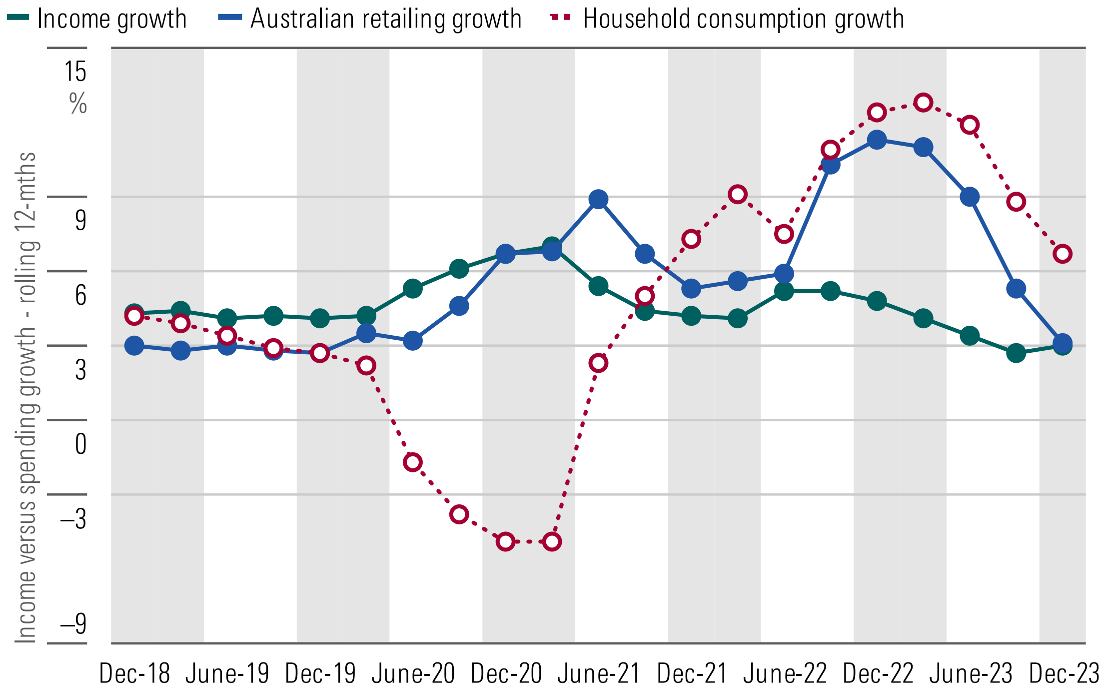
Monthly seasonally adjusted sales growth versus the PCP.



Source: Australian Bureau of Statistics. Note: Discretionary sales excluding cafes, restaurants, and takeaway.

Consumption Growing Ahead of Income, but This Can't Last

Quarterly rolling 12-month income, retail sales, and consumption versus the PCP.



Source: Australian Bureau of Statistics. Data as of Dec. 31, 2023.

Retailing Categories and E-Commerce

Apparel and dining out coming back to earth.

Above-Trend Apparel Spending at Risk of Correction

As a share of wallet, spending on apparel ballooned as the economy reopened. The category remained comfortably above long-term trend levels in the December 2023 quarter. But wardrobes are replenished, and apparel sales volumes are gradually normalizing, posing a near-term headwind for fashion retailers like Accent, Myer, and Premier. We expect apparel sales to contract 2% in fiscal 2024, and when met with mid-single-digit wage rises, this is set to put significant pressure on retailer profit margins and earnings.

Apparel and Dining Out the Big Winners of the Economic Reopening

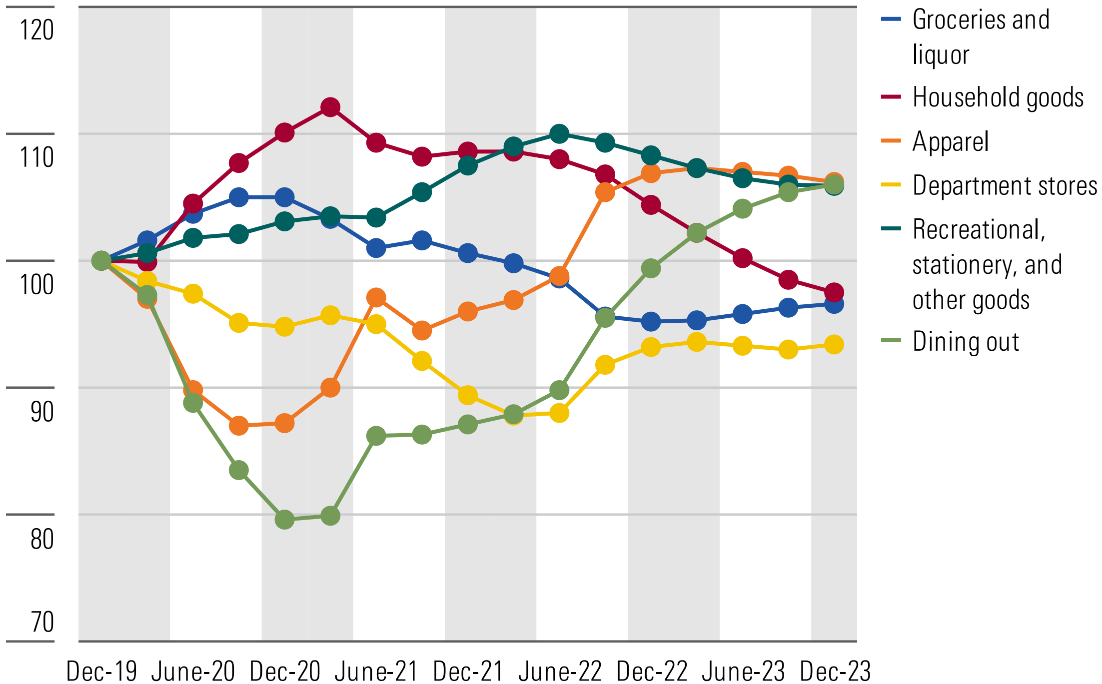
Retail sales split by category for the rolling 12 months to December-quarter 2023.

	%
Groceries and liquor	39.63
Dining out	15.05
Recreational and stationery goods	15.24
Household goods	16.36
Apparel	8.38
Department stores	5.34

Source: Australian Bureau of Statistics.

Apparel Looks Particularly Exposed to Spending Normalization

Indexed category share of retail spending on a rolling 12-month basis (Dec. 2019 = 100)



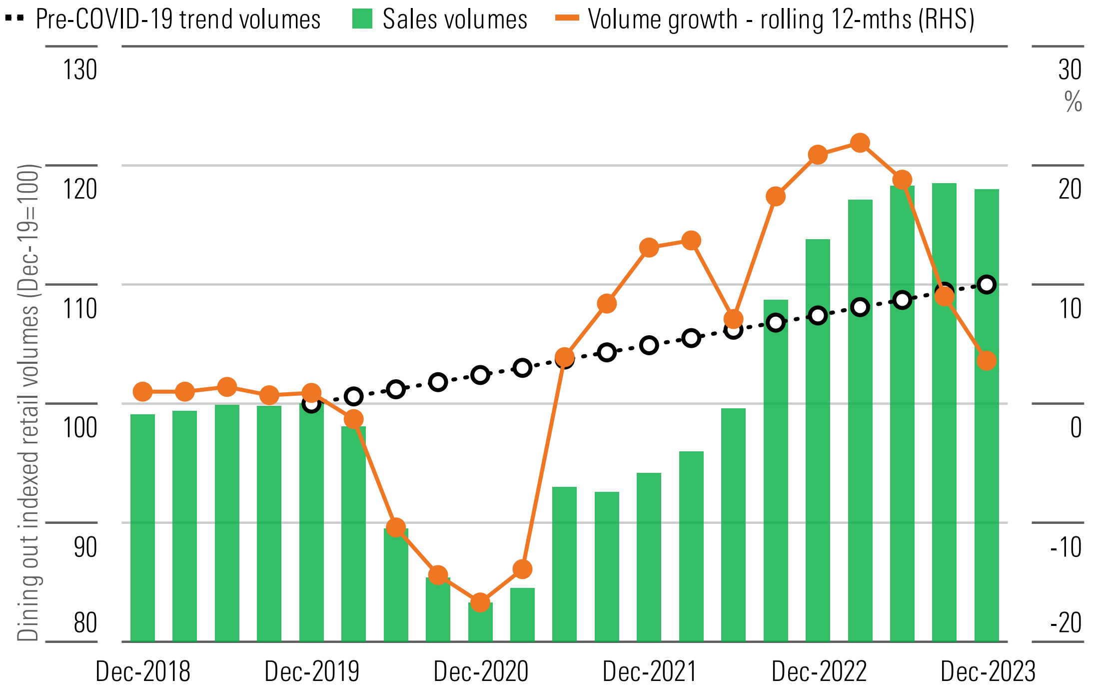
Source: Australian Bureau of Statistics.

Value-Focused Restaurateurs to Outperform Peers as Consumers Trade Down

The heat looks to be coming out of the dining out category following its postpandemic boom. In response to cost-of-living pressures, consumers are trading down, and supermarkets are likely to pick up share at the expense of restaurants and cafes. But within this category, we see quick service restaurants as the least exposed. With a focus on value, the networks of Domino's Pizza and Collins Foods' KFC restaurants should fare better than independent eateries.

Deceleration in Eating Out a Boon for Supermarket Volume Growth

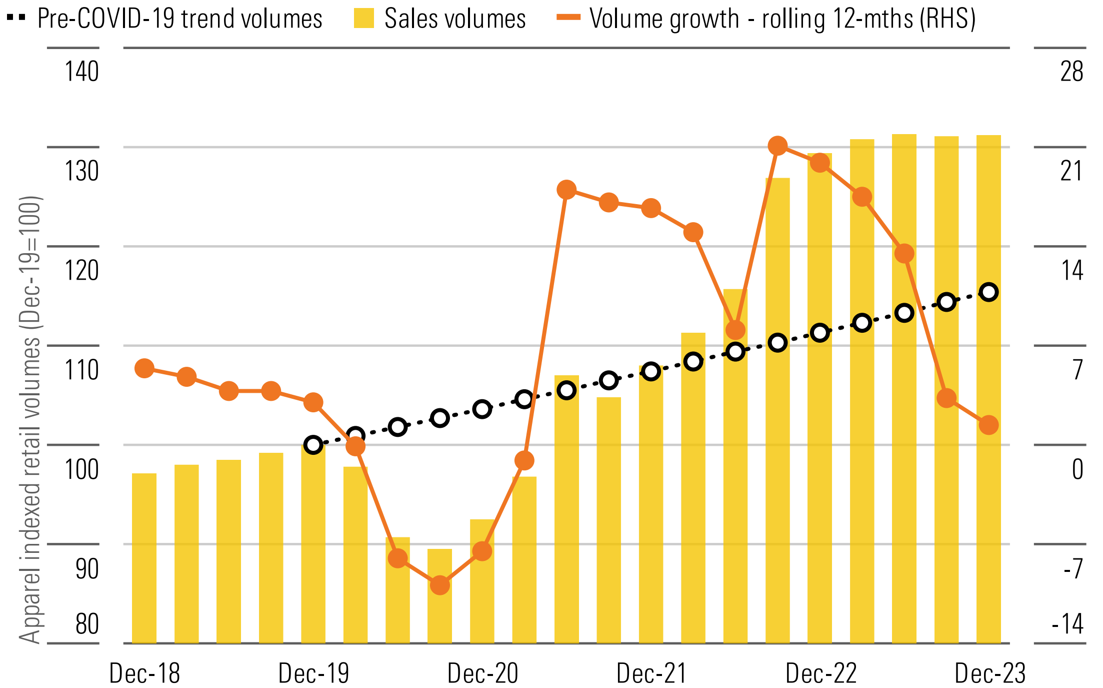
Indexed dining out sales volumes on a rolling 12-month basis.



Source: Australian Bureau of Statistics.

Fashion Sales Hovering at Elevated Levels but Unlikely to Defy Gravity for Long

Indexed fashion sales volumes on a rolling 12-month basis.



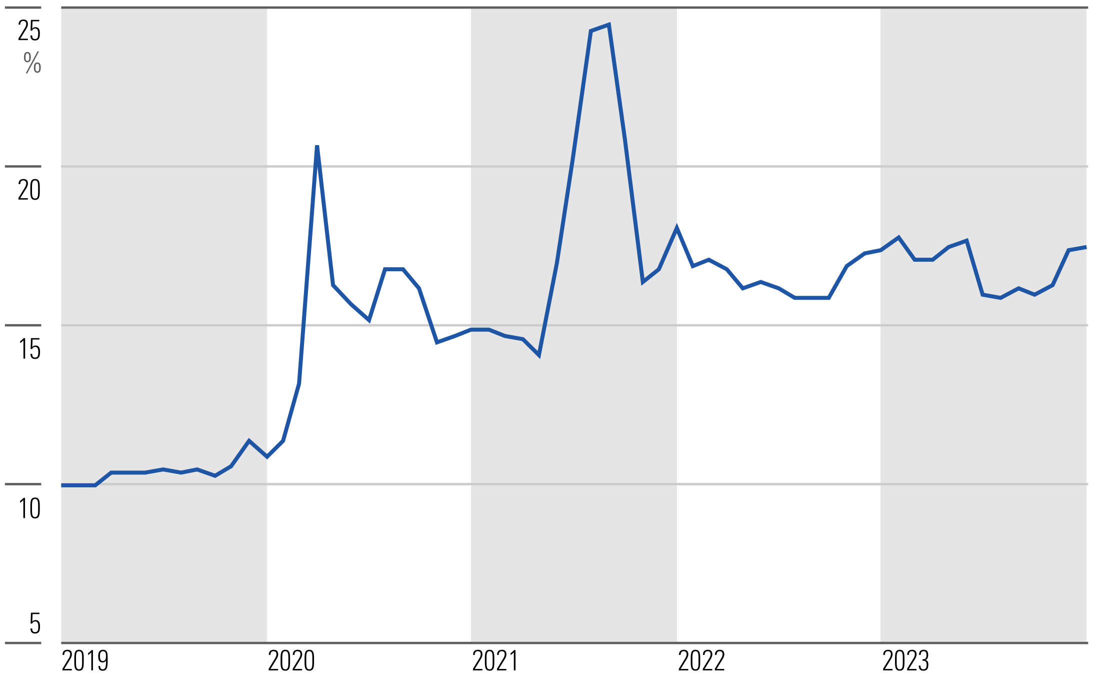
Source: Australian Bureau of Statistics.

Omnichannel Retailers See Online Outperforming Physical Sales Channel

We expect an underlying structural trend of more online shopping to persist over the long term. Online sales took a step back when the economy reopened and some shoppers chose to return to physical stores, but most omnichannel retail chains in our coverage are seeing e-commerce outperform store-originated sales. Retailers with greater online exposure are likely to take market share at the expense of retailers that rely more heavily on a brick-and-mortar network, like JB Hi-Fi and Harvey Norman, respectively.

After Postpandemic Consolidation, Online Penetration Is Gathering Momentum

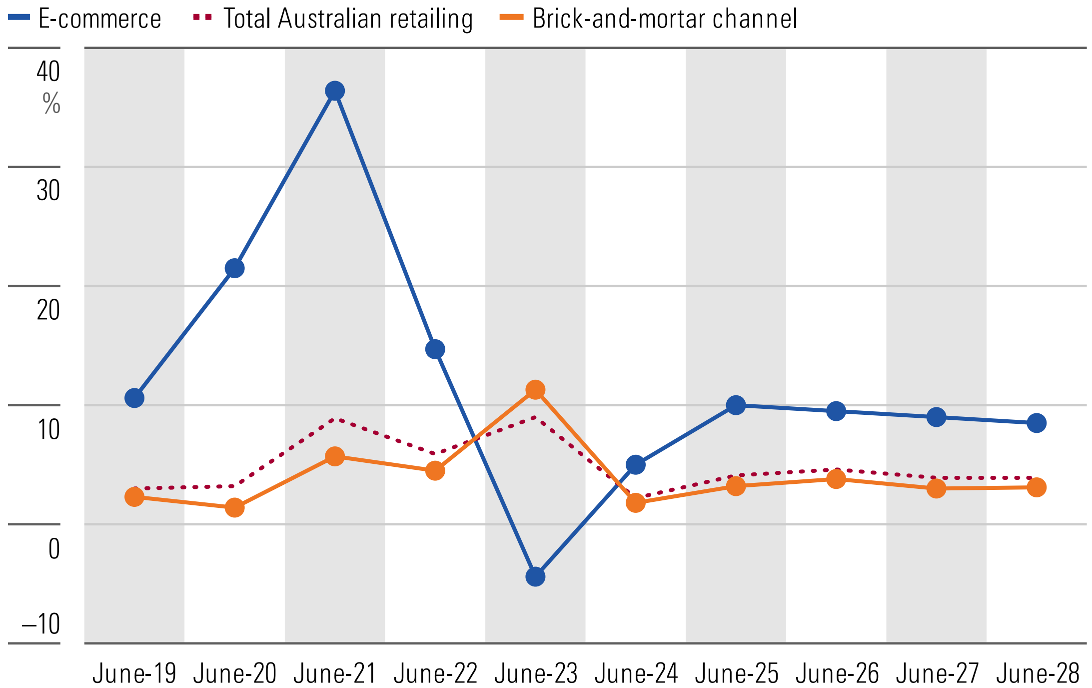
Online penetration of discretionary retailing sales.



Source: Australian Bureau of Statistics.

E-Commerce to Grow Ahead of Physical Sales

Annual channel growth rate versus the PCP.



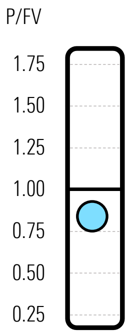
Source: Australian Bureau of Statistics, National Australia Bank, Morningstar estimates.

Top Picks and Industry Coverage

Quick service restaurants to benefit from trading down.

Short-Term Challenges Weigh Excessively on Strong Fast-Food Brands

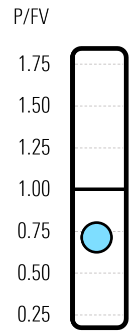
Australian Cyclical Retailer - Apparel Retailing



Company (Ticker)	Rating	P/FV	Moat	Uncertainty
Accent Group (ASX:AX1)	★★★★	0.84	Narrow	High

We think the market is caught up on the near-term cyclical headwinds facing Accent. Granted, fiscal 2024 is shaping up to be tough. The postlockdown boom in apparel sales looks to be running out of steam, and wage costs will pressure margins. But Accent's narrow moat, sourced from long-standing relationships with global footwear brands and a vast store network, positions it well for a cyclical upturn. We anticipate a strong earnings recovery from fiscal 2025, with mid-single-digit same-store sales growth compounded by a brisk store rollout. We anticipate operating leverage to drive EBIT margins to our midcycle assumption of 11%, from a forecast trough of 7% in fiscal 2024.

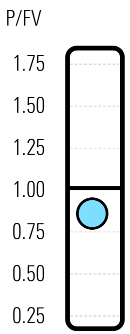
Australian Cyclical Retailer - Quick Service Restaurant



Company (Ticker)	Rating	P/FV	Moat	Uncertainty
Domino's Pizza Enterprises (ASX:DMP)	★★★★	0.71	Narrow	High

Domino's Pizza is a high-quality company with a long growth runway. We forecast a 24% earnings CAGR for the next five years, underpinned by its global store rollout. Domino's sales growth is volatile, and the share price tends to reflect near-term trading conditions rather than longer-term potential. The near-term outlook is uncertain and hinges on a moderation in elevated inflation. However, we believe Domino's growth potential is unaffected by near-term woes. We forecast the network to grow to 6,200 stores by fiscal 2033, below management's long-term target of 7,100. Hitting management's target would lift our valuation by 11%.

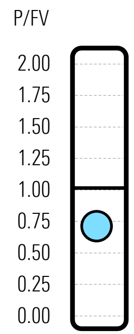
Australian Defensive Retailer - Liquor Retailing and Hospitality



Company (Ticker)	Rating	P/FV	Moat	Uncertainty
Endeavour Group (ASX:EDV)	★★★★	0.86	Wide	Low

We think the market's concerns regarding regulatory risk are overdone. Liquor demand is defensive and likely underpinned by inflation and population growth. The premiumization trend also likely counterbalances the structural decline in per capita liquor consumption. We forecast gaming restrictions proposed by the Victorian government to weigh on Endeavour's earnings, and we expect New South Wales to follow suit. But we estimate the combined impact to be moderate with EPS declining by 1% in fiscal 2025. From fiscal 2026, we expect group profit to grow at an average rate of 6% to fiscal 2033.

Australian Cyclical Retailer - Quick Service Restaurant



Company (Ticker)	Rating	P/FV	Moat	Uncertainty
Collins Foods (ASX:CKF)	★★★★	0.71	None	High

Consumers are tightening their belts and gross profit margins are compressed. We anticipate KFC will prioritize customer value and long-term brand health over restaurant economics, while consumers remain under pressure in the near term. Hence, we estimate relaitvely low gross margins in fiscal 2024, despite gradually easing input cost inflation. Longer term, however, we expect consumer demand to eventually normalize as interest rates are cut and cost-of-living pressures abate and gross margins revert to historical averages of around 52.5% from fiscal 2025.

Source: Morningstar. Data as of March 15, 2024.

Endeavour Most Appealing Defensive Play

Company (Ticker)	Industry	Mcap (AUD bn)	Moat Rating	Uncertainty Rating	Last Close	Fair Value Estimate	Star Rating	P/FVE	P/E*	Yield	1-Year Return
Domino's Pizza Enterprises (ASX:DMP)	Restaurants	3.89	Narrow	High	43.36	61.00	★★★★	0.71	27.7x	2.6%	-2.1%
Collins Foods (ASX:CKF)	Restaurants	1.21	None	High	10.26	14.40	★★★★	0.71	17.7x	2.4%	+33.0%
Kogan.com (ASX:KGN)	Internet Retail	0.85	None	Very High	8.41	10.70	★★★★	0.79	41.8x	1.8%	+98.3%
Accent Group (Acquirer) (ASX:AX1)	Apparel Retail	1.13	Narrow	High	2.01	2.40	★★★★	0.84	15.5x	8.5%	-3.2%
Myer (ASX:MYR)	Department Stores	0.70	None	Very High	0.84	0.75	★★★	1.12	14.1x	7.1%	-5.1%
Harvey Norman (ASX:HVN)	Specialty Retail	6.07	None	Medium	4.87	4.00	★★	1.22	15.3x	5.1%	+34.7%
Lovisa (ASX:LOV)	Specialty Retail	3.46	None	High	31.54	23.50	★★	1.34	36.1x	2.6%	+37.7%
Super Retail Group (ASX:SUL)	Specialty Retail	3.40	None	Medium	15.05	10.50	★	1.43	13.9x	5.0%	+29.0%
Wesfarmers (ASX:WES)	Home Improvement Retail	76.17	Wide	Medium	67.12	43.00	★	1.56	28.4x	2.7%	+41.3%
Premier Investments (ASX:PMV)	Apparel Retail	4.88	None	Medium	30.62	19.50	★	1.57	18.7x	3.9%	+18.9%
JB Hi-Fi (ASX:JBH)	Specialty Retail	6.64	None	Medium	60.73	37.50	★	1.62	15.8x	5.2%	+48.5%
Australia Retail - Cyclical (unweighted average)								**1.17**	**22.3x**	**4.3%**	**+30.1%**
Endeavour Group (ASX:EDV)	Beverages - Wineries & Distilleries	9.38	Wide	Low	5.24	6.10	★★★★	0.86	17.8x	4.2%	-18.4%
Metcash (ASX:MTS)	Food Distribution	4.18	None	Medium	3.89	4.00	★★★	0.97	13.6x	5.7%	+7.6%
Coles Group (ASX:COL)	Grocery Stores	22.35	None	Low	16.70	15.00	★★	1.11	20.5x	4.0%	-0.9%
Woolworths Group (ASX:WOW)	Grocery Stores	39.88	Narrow	Low	32.65	27.50	★★	1.19	21.9x	2.9%	-8.0%
Australia Retail - Defensive (unweighted average)								**1.03**	**18.5x**	**4.2%**	**-4.9%**

Source: *PitchBook consensus, Morningstar estimates. Data as of March 15, 2024.

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