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## Wesfarmers to win hardware battle

**Woolworths thinks the hardware market is ripe for the picking. But there's a big bad scarecrow in this orchard, and it goes by the name of Bunnings.**

With all the [glowing media commentary](#) surrounding [Woolworths'](#) entry into the hardware and home improvement market, you'd be forgiven for thinking success was a foregone conclusion. But, for what it's worth, I'm about to make a bold prediction: Woolworths' long-awaited and much-vaunted expansion into home improvement will *never* displace [Wesfarmers'](#) Bunnings as the market leader.

But wait a minute, maybe this isn't a bold prediction at all. Let's take a look at the facts. Bunnings has a huge lead over Woolworths, with almost 160 large format, 'big box' stores already trading in Australia (and more than 30 small format stores). Woolworths has only secured 12 sites thus far, with a further 15 'under negotiation'.

Woolworths' first home improvement store won't open for business until 2011. It has taken Bunnings more than a decade to secure 160 large sites, and then open stores. And it also had the benefit of a free kick from the 2001 takeover of Howard Smith, which owned the BBC Hardware chain. It seems a particularly ambitious target for Woolworths to secure 150 suitable sites in less than half the time, especially given the difficulty Costco, [Bunnings Warehouse Property Trust](#), and Woolworths itself have had finding and developing sites in recent years.

### Fragmented Market

Rather, Woolworths' entry is likely to accelerate the decline of the smaller independent hardware stores and banner groups. Indeed, Woolworths' takeover of the Danks distribution business, which supplies the independently-owned Home Timber & Hardware, Thrifty-Link and Plants Plus retailers is bad news for these banner groups, however reassuring Woolies might be about them remaining the 'lifeblood of the business'. It's also no secret that Mitre 10, the most significant hardware brand after Bunnings, has been struggling for some time. Lights out time for some of these players, perhaps?

Another fact is that Bunnings, as the 'first mover' and strongest player, is in the fortunate position of being able to meet any competition easily. Its 2009 earnings before interest and tax margin was an impressive 11.3%, which is no doubt what attracted Woolworths to this market segment in the first place. Anyone who has visited a Bunnings store will know that its prices are indeed lower than the independents, so there is room to move here.

Bunnings, then, could make life extremely tough for Woolworths' new venture over the next five years. It can afford to lower prices to undercut the new venture and still remain extremely profitable at a time when Woolworths will be incurring enormous costs. Time and again, history has shown that new entrants struggle to gain traction against an entrenched player. Woolworths will need those famously deep pockets.

A counterbid for Danks?

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This also presumes that Woolworths' bid for Danks is successful. It's possible that Wesfarmers will make a counterbid. While that wouldn't stop Woolworths from entering the sector, it would certainly frustrate its plans and show that Bunnings means business.

Of course, if new competition comes, it won't be good news for Bunnings' margins. But the adulation the market had for Woolworths' expansion into the home improvement market seems more than a little misplaced. While there's no doubt Woolworths is a smartly run company – and the tie-up with Lowes improves the venture's chance of success – this move also has a whiff of desperation about it. Woolworths' Michael Luscombe has spent the past few years trying to buy various businesses, including Kmart, Target, and Officeworks from Coles/Wesfarmers, JB Hi-Fi, Warehouse Group, Mitre 10, Corporate Express and Reece. He also has a team of investment bankers scouring the US for deals. None have yet come off, and he needs something, anything, to maintain that hallowed double-digit growth.

Five years hence, there's a good chance Wesfarmers' shareholders will look back on Woolworths' home improvement plans and wonder 'What were we worried about?'. Unfortunately for Woolworths' shareholders, there's a much greater chance that they'll be asking: 'What on earth was Michael Luscombe thinking?'

Wesfarmers' share price has fallen slightly since 20 Aug 09 (Hold – \$25.40). We remain hopeful of an opportunity to buy if the Woolworths spin machine ramps up its attack on Wesfarmers. For now, HOLD.

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