What's Next for Australia's Retailers?

Chief Investment Officer, Steve Johnson, is joined by Alex Shevelev, Senior Analyst on the Australian Shares Fund, as they discuss the factors contributing to a strong start to the year for Australian retailers including JB Hi-Fi and Super Retail.

https://youtu.be/0zjYuJ1cCKU

Transcript:

Steve

Hi everyone and welcome. It's Steve Johnson here, Chief Investment Officer at Forager Funds, bringing you our first video for 2021. I'm joined by Alex Shevelev, Senior Analyst on the Forager Australian Shares Fund. Hi Alex, how are you?

Alex

Hi Steve, hello everybody.

Steve

It's been a bumper start to the year for Australian retailers, lots of them out early in 2021 talking about some very buoyant Christmas trading. We saw JB Hi-Fi, Super Retail, a couple of stocks that we own small positions in our portfolios such as Shaver Shop and Michael Hill pretty consistent across the retail industry, making lots of money.

Alex

It's been a great time to be a retailer. All that money that we saw that's not going towards international travel and a lot of the money that's coming from government stimulus is ending up in the coffers of some of these businesses and the revenue growth has been absolutely staggering for what are already some pretty large businesses. Supercheap and JB Hi-Fi group grew 23% and 24% in total revenue and that's including the fact that some of these stores were shut down for a period during that half.

Steve

I remember doing an analysis of JB Hi-Fi probably 10 years ago, questioning whether it could ever get to $10 billion of sales given the amount they Australians spend on electronics. But we've seen through this past period, they just keep taking market share and also the market keeps growing. The big thing though, has been profit. You talk about sales up 20%, but profit numbers are up a lot more than that.

Alex

In some cases they're up 80% plus and the reason here is twofold. Firstly, we've got increasing gross margins. So the retailers have managed to tick up the sales prices of their products ever so slightly relative to their costs. That might only be a couple of percentage points and you may not see it necessarily in your purchases but for a retailer that makes maybe a high single digit margin that is a really big change.

Secondary to that, you've then got all those extra sales, all that extra gross margin coming through and the operating costs of these businesses have stayed largely similar. So you're getting a double benefit there.

Steve

I think as a well-run retailer, you might be talking sort of 6% to 8% margins at the bottom line. So as you can add 2% at the gross margin level, that's having a fairly dramatic impact on your profit. Maybe a bit counter-intuitively retailers are talking about it being difficult to get goods into the country, from China in particular, with lots of capacity constraints in shipping. It’s probably been a good thing net for them because there's less competition and lots of demand and it's enabled them to put those gross margins up a little bit. Now the share price reactions have been muted using profit here up 80% and 90% on stocks that were not trading on crazy multiples to start with.

Yet we've seen share prices, maybe up 5% or a bit more on the day and retracting a bit over the days after that. What's going on with the bumper results coming out way above everyone's expectations and share prices not really moving?

Alex

These retailers had run up to some extent already. There was already an expectation that there was going to be more revenue flowing in. However, it is higher than people expected, but that increase is limited, or appears to be limited in investor's minds, to this first half of the year and potentially subsequent couple of months. These businesses are not necessarily getting credit for this level of profitability continuing.

We're going to really get to see that in the first half of next financial year, how these businesses end up relative to the half they've just had.

Steve

I'd probably say we agree with that. That's a sensible reaction from the market to say this is clearly unsustainable, both at a sales level, people are going to start spending money on travel and other things again, towards the back end of next year. Probably most importantly, you would assume these to come back to something more normal eventually.

Alex

That's right. There are some things that have changed though for some of these retailers and Shaver Shop is a good example of this. There has been a transition to online and the

businesses that have really been able to seize the opportunity in online and transition some of their offline sales to online should be better positioned for that come next year.

Shaver Shop for example, has seen its online sales percentage tick up from 10%, two years ago, closer to 30%. Now that's a big change for a business like that.

Steve

Yeah and I think you've seen some of these businesses manage that transition well. Shaver Shop is up to more than a third of its sales through its own website online. They're delivering those through the store network. But it says to me that all of that brand awareness they have, when you think I want to buy a shaver, where do you go? The money that's been spent on that over all these years is worth something. As long as you can get your offering right online, you're not actually seeing the likes of Amazon kill these businesses. In fact, they're doing quite well online.

Alex

That's not the only thing that's happening though. There's a secondary aspect of it and that is that this period has really been a shake up for a lot of these industries.

So you've got, for example in the jewellery space, some competitors that might struggle more than the listed player Michael Hill. In that situation you might be taking sales off competitors. Eventually, like we had seen with someone like Baby Bunting, over a long period of time those competitors might fold and you might capture more of those sales.

In other situations that shake up has really been a COVID affected shakeup, but with implication over a long period. So personal travel on motorcycles for example, is likely to be a bigger feature going forward as people remain a little bit hesitant of public transport, and that's really feeding into a Motorcycle Holdings result, which probably is not going to be quite as good as our bumper first half of 2021, but has a good chance of being better than the prior years as that industry is really shaken up.

Steve

I think people are actually underestimating how difficult the environment was for the three years leading into this COVID meltdown. Retail in Australia has been really hard. You've had costs marching up slowly while revenue has not been growing at all across the whole sector and this leakage to online going on at the same time. I think you've seen some of those businesses do a great job of consolidating in their industries and I don't think we're going back to 2019 levels of profitability.

There's no doubt that this year is going to be an anomaly on the high side. But I think people are looking back and saying, well I'm going to apply a multiple of 2019 earnings. In my view, that might be a bit too conservative given where share prices are at the moment. So still some really interesting opportunities out there in the space and still a meaningful part of our portfolio.

We're looking forward to hearing those and other companies give us further updates through February as our Australian portfolio reports results. Thanks for tuning in, and we'll be back with

some regular updates over the next month as we get all of those results.