

## Investment Newsletter

Market Performance (As at 30 <sup>th</sup> June 2017)	Month To Date (%)	Calendar YTD (%)	1 Year Rolling (%)
S&P - All Ords Accum. Index	0.28	2.89	13.12

### Month in Review – A review of events that influenced the share market in June

The All Ordinaries Accumulation Index rose 0.28% in June, with the market down 1.6% on the final day of the month after a weak lead from foreign markets. The yield trade stumbled in June with REIT, Utilities and Telecommunications sectors amongst the worst performers, declining 7.8%, 3.8% and 3.1% respectively. Even after adjusting for many REIT stocks that went ex-dividend late in the month, as did APA Group within the Utilities, the sector was still hit hard. Ongoing rises in global interest rates will no doubt see these yields unwind further. While the timing of global rate increases appears to be in the latter part of this year, we still doubt they will be significant in magnitude without substantial improvement in economic growth across major developed economies. The Energy sector was also hit hard in June, falling 6.7%, with West Texas Intermediate Oil down over 7% and Brent down over 4% in the month. Iron ore took another fall in June – having dropped from US\$87/t to US\$70/t in April, it fell to around US\$60/t in May and into the low US\$50/t range during June before recovering into the mid US\$50/t range by month end.

After some post-budget turmoil across the major banks in May, the Financial sector excluding REITs increased 1.6% in June with Commonwealth Bank +4.0% and ANZ +2.5% providing strong leads for the sector. The rally came despite a proposal from the South Australian state government for a bank levy. The opposition however stated they would vote it down, with assistance from crossbench MPs, arguing it would limit financial sector employment opportunities in the state if it were introduced. It would also send a very poor signal to business in relation to future investment in the state.

During the month, we introduced Super Retail Group and Select Harvests into our Australian Equities portfolios following recent share price weakness, exited Transurban and Sydney Airports, added to holdings in BHP Billiton and Rio Tinto, and reduced positions in GUD Holdings and Base Resources following share price strength. The estimated Market PE multiple for the next 12 months for the ASX All Ordinaries now stands at 15.7x and is expected to yield 4.2% in FY18, with around 70% franked.

### Chart/Table of the Month – Global Economic Factors

Region Economic Summary					
	Real GDP	CPI	Unemploy-	Current Account	Govt Debt
	%	%	ment rate %	% of GDP	% of GDP
China	6.9	1.2	4.0	0.7	16.6
European Union	2.1	1.6	7.8	–	83.4
Euro Zone	1.9	1.4	9.3	2.4	88.3
France	1.1	0.7	9.3	-1.6	97.9
Germany	1.7	1.5	3.9	6.0	67.7
India	6.1	1.1	5.0	-0.6	41.8
Italy	1.2	1.2	11.1	2.6	131.7
Japan	1.3	0.4	3.1	4.1	205.5
United Kingdom	2.0	2.9	4.6	-3.4	90.6
United States	2.1	1.9	4.3	-2.5	104.4

Source: FactSet Economics Standardized Database

Australia is entering an unusual phase where global growth is accelerating but not having its typical impact on Australia's rate of growth. Since we last looked at a table of economic growth factors in January there have been some interesting, albeit modest, improvements particularly in Europe. Real GDP growth in China has improved marginally from 6.8% to 6.9% but growth in the European Union has increased from 1.9% to 2.1%. In addition, stronger growth in the U.S. which has risen from 1.9% to 2.1%, and Japan from 1.0% to 1.3%, more than offset weaker growth from India, which has moderated from 7.3% to 6.1%.

The improved growth has understandably been reflected in lower unemployment levels. While there have been mixed changes in inflation rates, it is encouraging to see the CPI rise from 1.2% to 1.6% in the European Union – although a significant reversal in China (2.3% to 1.2%) is a concern and could become a risk to asset inflation, an important requirement for consumer confidence.

Government debt as a % of GDP was stable in Europe but rose from ~13.8% to 16.6% in China.

## Due Diligence – Super Retail Group (SRG or ASX:SUL) and the Amazon risk.

Retail stocks, both discretionary and staples, have been in the media spotlight over recent months. A number have experienced sharp declines and there has been much talk about the impact Amazon could have, once established in Australia.

Amazon will no doubt keep the pressure on Australian retailers but it will not be the end of retailing as we know it. Bricks & mortar retailers will protect their domains. We believe Super Retail Group (SUL) is well positioned to protect its franchises through a combination of exclusive product arrangements, private label, larger ticket and at times bulky items, immediate demand, tactile purchase requirements and development of their own online strategies. By specialising and engaging with customers, we believe SUL will continue to have a competitive advantage.

SUL recently released research showing that only 2% of Amazon sales are in the combined Auto, Sports and Leisure categories. On that basis if Amazon ultimately achieved \$10-\$15b of sales in Australia, it would amount to \$200-\$300m of sales across the Super Retail's categories. To put this in perspective SUL has annual sales of \$2.5b. On that basis if SUL represented 25% of total category sales, it might be at risk of losing \$75m of its sales to Amazon over a number of years. The bottom line is that we don't see Amazon as a major risk to SUL but it will continue to have a competitive impact on the Australian retail landscape. Within SUL's categories it is also worth pointing out that many of its major specialist peers in the US, UK and Canada have achieved solid sales growth, profit growth and margin improvement over the last four years despite Amazon growing its revenue base.

Comparison of Top 100 selling lines in SRG Divisions					
		Item count – Amazon cheaper	Item count – SRG cheaper	Item count – Not available	Basket RRP comparison *
Auto	Amazon US	27	18	55	Amazon and SCA equivalent
Leisure	Amazon US	28	28	44	Leisure circa 5% cheaper
Sports	Amazon US	42	36	22	Amazon circa 3% cheaper (excluding fitness equipment)

## The 'Big Five' – And how Amazon Compares

The 'Big Five' Nasdaq stocks each have market valuations between \$560b and \$980b, with Apple the largest but trading on the smallest multiple at 16.1x – presumably its business is more mature, and more at risk in terms of product cycle replacement with many competitors developing new smartphone products. Even Nokia recently launched a smartphone product, having been a global leader on the now antiquated pre-“smart” phone technologies. Outside of Apple, the PER multiples of the remaining 'Big Five' all imply above market growth rates, but of varying degrees. For Google and Facebook, growth in advertising and search should provide growth well beyond GDP.

Whether or not that is enough to justify current pricing, or even higher pricing, will be determined over time. If they do prove to be expensive, their multiples are not so outrageous that disappointment would lead to major share price reductions. However that could be different in the case of Amazon – at a multiple of 142x forecast FY17 earnings, Amazon needs to achieve substantial revenue and earnings growth. As a reseller of goods, it is understandable that Amazon operates at a much lower margin than its major Nasdaq peers.

However, to justify its large multiple it does ultimately need to lift profitability from US\$4b to around US\$30b. Given the competitive retailing environment, US\$30b NPAT would require both a significant increase in revenues and margin. We don't think 10+% margins are achievable in retailing on a long-term basis, whether online or bricks and mortar, when selling a broad range of goods. Comparable NPAT margins across major retailers in the US and Europe are typically sub 7%. For example: latest actual NPAT margins amongst general retailers include Wal-Mart 2.7%, Target US 4.5%, Debenhams 3.7%, and Kroger 1.7%; and amongst specialist retailers, NPAT margins include JD Sports Fashion 7.5%, Auto Zone 11.7%, Super Retail Group 4.5%, Dick's Sporting Goods 3.6%. So the long term question is whether an online-only retailer can turn retailing on its head and generate such efficiencies that it can achieve super margins or alternatively become such a dominant global retailer that it can drive sales to many hundreds of billions of dollars.

We can't answer that question with any degree of confidence but what we can say is that the market is factoring in a large price for the possibility that Amazon will lift its profit from US\$4b estimated in FY17 to nearer US\$30b over time.

What is interesting is that Amazon announced mid-June that it plans to acquire Whole Foods in the U.S., an organic grocery chain, for US\$13.7b. Whole Foods is a bricks and mortar business with over 450 stores across the U.S. as well as an online offering. This purchase may well highlight the need for a certain amount of store distribution to maximise the value of an online offering.

### The Big Five

FY17 estimates	Price US\$	Market Value US\$b	Revenue US\$b	EBIT US\$b	NPAT US\$b	PER (x)
Microsoft	\$68	\$688	\$126	\$38	\$31	22.5
Apple	\$144	\$978	\$296	\$79	\$61	16.1
Google	\$919	\$822	\$115	\$48	\$39	27.1
Facebook	\$148	\$563	\$50	\$22	\$19	30.7
Amazon	\$954	\$596	\$217	\$7	\$4	142.0

Source: FactSet