STONEHAGE FLEMING

EQUITY MANAGEMENT (SOUTH AFRICA)

EQUITY INSIGHTS

Woolworths: Deteriorating Quality

Issue date: 19 March 2018

COMPANY DESCRIPTION

Woolworths is a Southern hemisphere retailer that is headquartered in South Africa and has operations in Australasia and the rest of Africa. Woolworths listed on the JSE in 1997. Today the company employs more than 43,000 people and has more than 1,300 stores. The Group consists of Woolworths Clothing and General Merchandise, Woolworths Foods, Country Road and the recently-acquired David Jones.

RECENT DEVELOPMENTS & OUTLOOK

We have recently been exiting client positions in Woolworths. We view the approximate R7bn impairment to David Jones as a significant mark against management's credibility and capital allocation track record. In addition to the black mark against management, we are concerned about a deterioration in the structural competitive advantage that has allowed Woolworths to enjoy sustainably high and stable historical returns on capital. Woolworths' cash flow return on invested capital has declined from a 10-year average of approximately 40% prior to FY17, to around 15% in in FY17. Structural shifts and technological advancement in the global retail environment have seen competition intensify immensely, increasing the threat of new entrants and weakening the pricing power of traditional retailers. This has effectively made growth more difficult to come by and has arguably increased the risk of irresponsible capital allocation decisions at traditional retailers as growth is pursued at the expense of profitability and returns.

Looking back, Woolworths' sales and margin performance together with their aggressive expansion into Australia is indicative of the structural nature of these developments, suggesting they are less transitory than initially anticipated. Looking forward we view Woolworths' ability to deliver consistent, long-term shareholder value creation as highly vulnerable given the i) highly competitive and structural industry dynamics at play in global retail and ii) the fact that Woolworths is in a capital-intensive phase of the capital cycle (investing heavily to both transform Australian operations and streamline the group from an IT/operational perspective) with iii) a balance sheet that is arguably more stretched than normal (net debt is at approximately R11.5bn in FY17 whereas the business operated in a net cash position prior to the acquisition of David Jones).

RECOMMENDATION

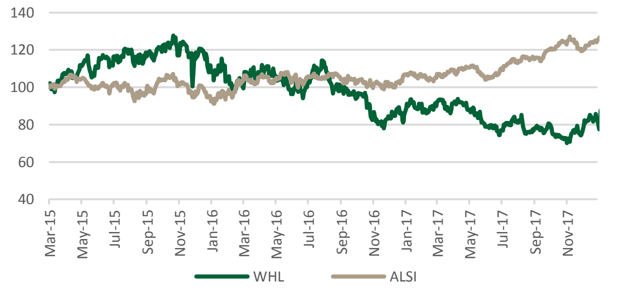
Our 12-month price target of R61.38 is derived using a discounted cash flow methodology with a weighted average cost of capital of 12.2% and a terminal growth rate of 5.5%. This price target translates into an estimated 12-month return of 1.1% from the closing price level as at 16 March 2018. **REDUCE.**

Industry
Retail
Industry View
Cautious
Current Recommendation
REDUCE

	WHL
Market Capitalisation	R63,617.4m
Share Price	R60.70
12m Target Price	R61.38
52w Low-High Range	R52.26 – R74.45
Estimated Forward PE	14.3x
Estimated Forward DY	4.9%
Next Financial Year End	June '18

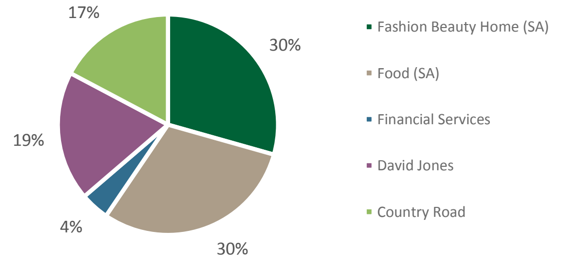
Sources: Factset 16/03/18, SFEMSA

INDEXED PERFORMANCE (3 YRS)



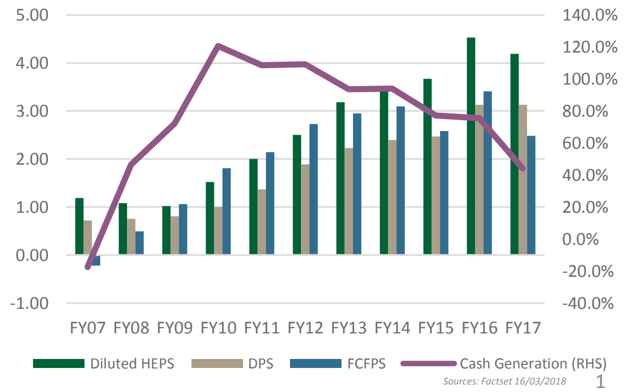
Sources: Factset 16/03/18

OPERATING PROFIT SPLIT – 1H18 (R3.5b)



Sources: Woolworths Interim Results 2018

FINANCIALS (ZAR)



Sources: Factset 16/03/2018

FOR MORE INFORMATION PLEASE CONTACT:

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