under the radar report

BIG VALUE

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Focussing on the big world events and how they impact your portfolio. Under the Radar hunts for undervalued Big Cap stocks on the ASX and abroad.

BUY OR SELL?

Myer (MYR) Wesfarmers (WES) Woolworths (WOW) Harvey Norman (HVN) JB Hi-Fi (JBH) Super Retail (SUL) Bapcor (BAP) Metcash (MTS).

International Stocks:

Amazon.com Inc (AMZN:US)
Wal-Mart Stores Inc. (WMT:US).

BIG VALUE PORTFOLIO KICKS OFF!

TAKING ADVANTAGE OF AMAZONOPHIA

Under the Radar's team has pulled out all stops to inform you about the effect of Amazon on the ASX.

First up, it's important to know that Amazon has not always been successful with its offshore rollouts. In the UK it has won a 27% online share but French sales have been less impressive. Its Canadian business is losing market share and losing money. The management consultancy ATKearney expects the Australian experience to be somewhere in between a 10% share of online retail and a 1% share of the total Australian retail market in the next three to five years.

But this is the thing that really scares bricks and mortar retailers and their investors: currently in Australia around 6% of retail purchases are done online, compared with 9% in the US and 13% in the UK.

So there is some reason to be afraid. But other facts need to be considered, such as the consolidation in the sector that has already taken place. And most important, the big discounts that are on offer for buyers of some of the big ASX retailers, which are selling for double the discount they have traditionally traded at in relation to industrial companies.

Under the Radar's Big Value portfolio manager Sam Ferraro kicks off the portfolio with a lesson on diversification, which is essential reading for anyone managing their own money. You will be able to manage your portfolio like the professionals.

In this month's Big Value issue we also cover off on Amazon.com Inc itself and compare it to its giant bricks and mortar competitor Wal-Mart Stores Inc. We also look in depth at eight ASX listed retailers at the big end of town, which includes our tip of the month.

We're flying high on Qantas (QAN) and Telstra (TLS) that are both up on our tip prices. We are confident we can do the same with Myer (MYR). ■

Richard Hemming
Editor

Talking Big

"Currently in Australia around 6% of retail purchases are done online, compared with 9% in the US and 13% in the UK."

ATKEARNEY, MANAGEMENT CONSULTANT

ASX BIG VALUE STOCK

MYER

The share price is factoring in the end of the world, so the benchmark for outperformance isn't high. Simply paying dividends should see investors re-rate this stock upwards. This stock is on sale.

WHY WE LIKE IT

Despite the various headwinds from increasing competition and low wages growth, investors have become too pessimistic about the prospects for Myer. Interest rates are likely to remain low for a period of time, which provides support for consumers' willingness to spend on discretionary items. The Myer brand is well known and has tremendous intangible value. Clearly the company must monetise it more effectively than it has in the past.

WHAT'S NEW?

Brokers have been downgrading their profit expectations for Myer on the basis of Amazon's entry into the Australian market. We would comment that this belies how hard it is to quantify what effect it will have on Australian retail, let alone on Myer, considering we don't know when Amazon is coming and in what form. The company is one of the most heavily shorted stocks in the market, adding to downward pressure on the stock. In late March, the listed retailer Premier Investments, which is controlled by retail veteran Solomon Lew, took a 10.8% stake in Myer, making it a potential takeover target.

MYER IS ON SALE

According to the brokers, Myer is right in the firing line when the Amazon juggernaut comes to town. For example, JPMorgan has cut its forecasts for the department store retailer by almost 15% in FY18 and just over 30% in the following year.

We think that this is an over-reaction because Myer is a key beneficiary of low interest rates and as we have shown earlier, retail sales are actually trending up! Department store sales have been in trouble, but the key here is expectations. Put another way, the market is looking at this industry and saying that it's gone.

Our call is clearly contrarian, but we're happy to make it because this stock is so cheap AND it's producing an abundance of cash. Subscribers need to discriminate between the negative news flow and what is reflected in the share price.

$3.2BN OF SALES INDICATES MYER ISN'T GOING AWAY

Currently Myer is in a "cost out" program, which simply means they're cutting costs and getting rid of the unprofitable stores among its 67-strong network. In the current year to 31 July (FY17) Myer is expected to generate some $3.232bn of total sales to deliver earnings before interest, tax, depreciation and amortisation (EBITDA) of $210m. This

RADAR RATING **BUY**

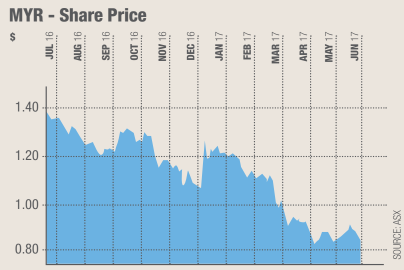
ASX CODE **MYR**

SHARE PRICE **$0.885**

MARKET CAP **$727M**

NET CASH **$7.1M**

DIVIDEND YIELD **5.6%**



BULL POINTS

- THIS STOCK IS ON SALE
- LOW INTEREST RATES
- RETAIL TRADE DATA IMPROVING
- POTENTIAL TAKEOVER TARGET

BEAR POINTS

- LOW WAGES GROWTH
- POOR SENTIMENT
- AMAZON

is slightly above last year's EBITDA. Myer will also spend about $120m in capital expenditure and pay close to $45m in dividends to pay out 5c a share from earnings per share of 7c a share.

We're confident this performance will be achieved because Myer earns about 80% of its profits in the first (Christmas) half and thus $142m of EBITDA has already been banked. As for the balance sheet, the company has close to $106m of cash so gearing is hardly a problem.

PRICED AT 30% OF SALES

Crucially, the company is valued by investors at only 30% of its sales, which gives the company big opportunities to grow profits from cutting costs, which Richard Umbers' management team appears to be doing successfully.

The composition of sales is also crucial, with 80% of turnover derived from brands exclusive to Myer, as well as non-exclusive brands. The remaining 20% derives from concession stores operated by the brands themselves. While Myer takes only a small margin, it incurs no inventory risk. Because of this, the retailer has been keen to increase concession numbers to reduce the danger of being left with unwanted inventory.

FINANCIALLY SECURE, YET PRICED LIKE A DINOSAUR

Myer is a financially secure group, yet the market is giving it no credit. Myer's current price puts it on a dividend yield of 5.6% (plus franking credits) and on a one-year forward PE of between 8-9 times, while the broader market is trading at 15-16 times. This puts the stock on a 40% discount to the market and compares to an average discount over the past 10 years of 20%, as can be seen from our graphic.

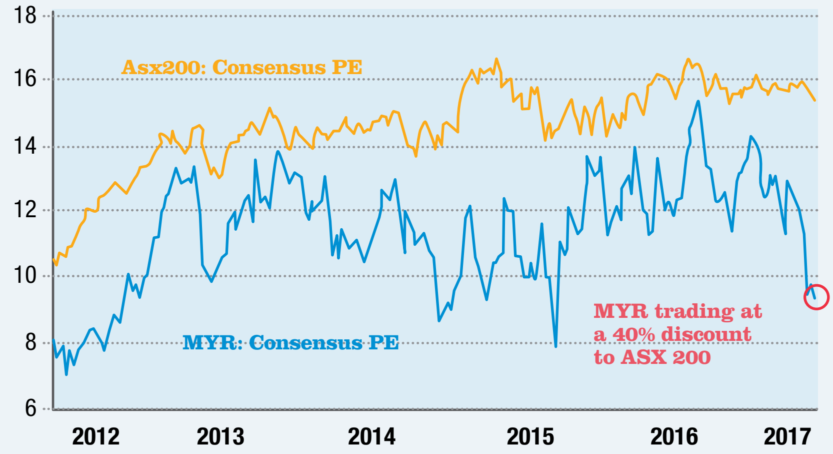
HISTORY

Since Sidney Myer founded the first store in Bendigo in 1900, Myer has continually

MYER ON SALE

Myer-PE relative: Consensus PE for Myer relative to the consensus PE for the ASX 200 Index

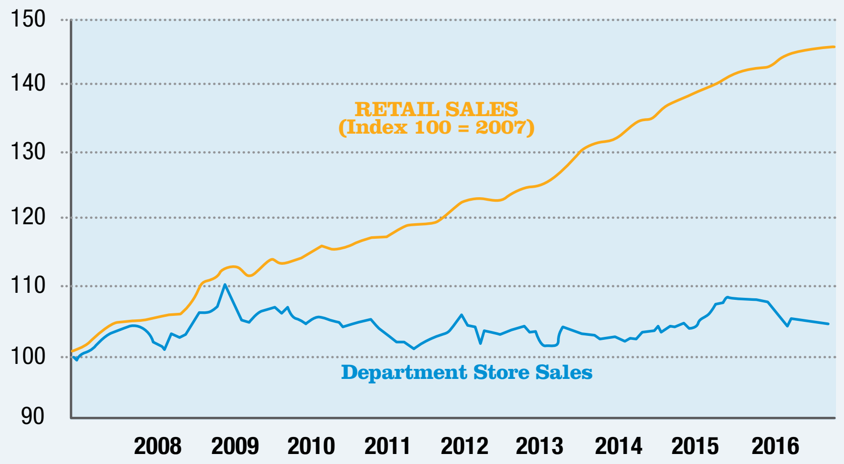
Myer is trading at a 40% discount to the ASX 200 Index. With the exception of a couple of months in early 2015, this represents the largest discount since it re-listed in 2009. You can see that Myer has historically traded at a discount. We think that the 40% discount might be too much compared to the overall market. The average discount of Myer over that period of time has been close to 20%.



DEPARTMENT STORE SALES IN A FUNK

Retail sales versus department store sales over the past 10 years.

Department store sales are one of the components of retail sales, which represent everything that we buy in shops as well as services. The compound annual growth over 10 year period for retail sales was just under 4%; for department store sales it was 0.5%. Retail sales have been growing at 8 times the rate of those from department store sales.



supplied Australians with not only fashion and apparel for both sexes, but accessories, cosmetics, homeware, furniture, electrical goods and general merchandise. Not to mention the Christmas display windows which have become an institution at its flagship Melbourne store.

Does Myer deserve to be priced like it's going out of business?

THE DAMAGE DONE BY PRIVATE EQUITY

We argue it shouldn't be, but acknowledge the damage inflicted by Myer's disastrous re-listing in November 2009. The $2.4bn float delivered private equity owner TPG (who acquired the business from Coles Myer) a huge windfall. But for the 60,000 investors who subscribed at $4.10 a share, the infamous prospectus cover shot of model Jennifer Hawkins was the only pretty aspect of the experience.

During Myer's period of ownership under private equity, management grew EBITDA from $145m to $330m. The IPO valued the business on an ambitious enterprise value to EBITDA multiple of 8.4 times.

The trouble is, these earnings proved unsustainable and plunged post IPO under the same management team. On the current year EBITDA expectation of $210m, the market is pricing the company on an earnings multiple of a mere 3 times.

MYER'S IS HERE TO STAY

We understand that there are many earnings headwinds facing Myer – low wages growth, poor retail sentiment and of course Amazon. But we don't believe that a dominant player like Myer is going the way of the dinosaurs. If it isn't, we also believe that there is good money to be made at the current bargain basement price.

Don't just take our word for it. In building an 11% stake, Solomon Lew thinks so too. But it's a moot point whether he intends to turn this into 100% ownership or whether he's playing a more cunning corporate game. ■

> "Myer is a financially secure group, yet the market is giving it no credit.

THE BIG PICTURE

Taking advantage of Amazonophobia

YOU ONLY HAVE TO GET ONE STOCK RIGHT IN YOUR LIFE, AS LONG AS IT'S CALLED AMAZON

Type in www.relentless.com into Google and guess what comes up? Yes, Amazon.

Amazon strikes fear into its retail competition because the company is embodied by its founder Jeff Bezos, who is as relentless as they come. People who work in the Seattle based group know that to keep their jobs they need to stay at their desks. Only the top executives are well paid, and that's mostly from stock options. It's like working for an investment bank, which is precisely where Bezos comes from.

The story is that in the middle of a New York night, Bezos hears about this thing called the internet and decides that this is the opportunity for him. He piles all his belongings into the car along with his wife and the dog and drives across the country to Seattle, where he starts selling books over the internet.

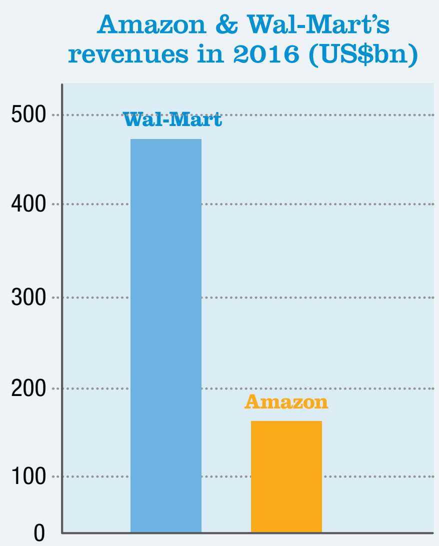
Amazon turns into a pre-dotcom darling. In October 1998, the e-tailer's shares trade at $240 and the Merrill Lynch technology analyst Henry Blodget predicts that they will hit US$400 within a year. This is widely considered unlikely, but they pass that mark weeks later. He then forecasts they'll reach $800. They almost get there, rising as high as US$500, but then comes the dotcom crash. Blodget loses most of the capital he had invested in dot-com firms, and his job at Merrill Lynch.

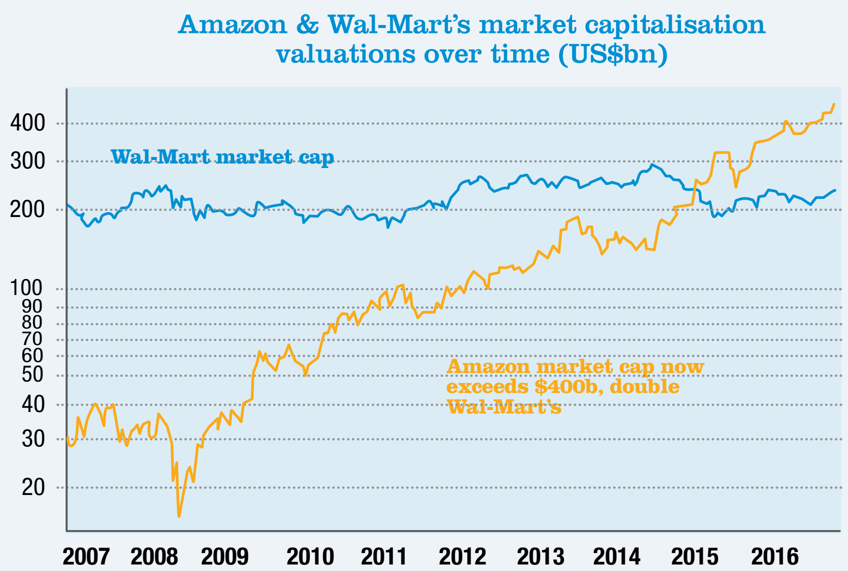
Blodget's career might have stalled along side Amazon's shares, but this proved to be one heck of a buying opportunity.* Late in 2001, post the 9/11 terrorist attack, the stock price fell below $10. These days the stock is nudging $1000, delivering it a remarkable market capitalisation of US$480bn. Put in context, this is about a third of the size of the total Australian stock market.

* Blodget's career also recovered

NEW ECONOMY VERSUS OLD ECONOMY

Even though Amazon's revenue is well short of Wal-Mart, the expectations are for Amazon's revenue and earnings to accelerate (unlike Wal-Mart's).





WHAT AMAZONOPHIA IS ABOUT

In 2017 Jeff Bezos' baby is the world's biggest e-commerce company, having generated US$136bn in revenues in 2016. These come from three sources:

- E-commerce, or online retail;
- Amazon Web Services (AWS) which provides cloud services;
- Digital devices and media (Kindle and e-books).

Australians are used to the books and e-readers, but the local retailers fear Amazon will provide the full range of services, as in the US. There, the group offers everything from consumer electronics, music videos, home and garden supplies, groceries, beauty products, toys, sporting goods, automotive gear, clothing and jewellery.

Now, after many years of preparation, it has launched an all out attack on the food market, with its US$13.7bn purchased of the upscale US grocery retailer Whole Foods. We discuss its move into bricks and mortar retailing when looking at Coles supermarket owner **Wesfarmers (WES)** and **Woolworths (WOW)** on page 12.

At the heart of its strategy has been its popular Amazon Prime subscription services, which offer free two day product delivery, as well as video streaming and special offerings. Prime costs US$99 a year and now has over 80 million subscribers worldwide.

In 2010 Amazon had less than 1% of retail sales in the US; today it has close to 5% and by 2018 it should have well over 7%. Its e-commerce share has grown from 25% to 43% over the past three years.

A key to its future expansion is international sales, which is where Australia comes in. International represented 30% of Amazon's 2016 sales and has similar 20% growth rates to its US business. First mover advantage has enabled Amazon to have number one market share in e-commerce in the US, Germany and the UK.

AMAZON'S IMPACT

The challenge for Australian providers of discretionary retail products such as Myer, is indeed the Amazon threat and increased competition. The other threat is that consumer spending has deteriorated.

It is difficult, in fact impossible, to determine which one of these factors has been responsible for driving the retail sector lower over the past couple of months.

The graphics on page 8 illustrate that it's easy to see that retail sales are not buoyant, but nor are they cause for retailers to slash their wrists. They are in fact quite encouraging! There is a trend of increasing sales, albeit from a low base.

It is clear that the Amazon threat is ill-defined but incumbent retailers should benefit from the demise of many smaller and medium sized participants for some time to come.

There has been a great deal of talk about Amazon, but the fact is that the group hasn't even opened a distribution centre here. It is difficult to incorporate the effect of Amazon into the local industry's structure. This is not impossible, but any efforts should be treated with large doses of scepticism. After all, aside from knowing that Amazon will increase competition, we need to understand both its effect on the industry structure and also the potential reduction in profitability for individual retailers.

We don't know when Amazon will come, and more importantly, in which categories. Some categories are more at risk – such as clothing, and electronics. While others seem less at risk such as furniture, which is bulky to ship. There is a also a question mark over food, with the possible entry of Amazon Fresh, recognising how high food margins are for Australia's food retailing duopoly – Coles and Woolworths. We discuss this on page 12.

The risk of window shopping for retailers increases as they enter the physical stores, check out the goods and then buy elsewhere online. The challenge for retailers is to ensure that once the customer comes in the door they encourage the shopper not to leave and to buy on the spot. Extra generous warrantees are an example of the incentives they could provide.

This is the dialogue retailers will be thinking about: strategically, what vision do we have and how do we execute it?

Amazon's pending arrival is not a disaster. But there will be a tension for retailers between maintaining profit margins through cost reduction and delivering more value to customers.

THE PURSE STRING THREAT

The other key to Australian retail in the short-term is the record low growth in wages, which has produced declining household income. This must be considered along side the record level of household indebtedness.

These two factors are weighing on consumer confidence, which means a lower willingness to spend on discretionary goods like lap tops and flat screen TVs.

CONSOLIDATION HELPING THE INCUMBENTS

Although in the future we see a deteriorating industry structure with the entrance on Amazon, there is no doubt that the bigger retailers in the Australian market place are benefiting from the demise of the smaller and medium sized operators. Companies like electronics store Dick Smith, overseas fashion retailers Zara, H&M and Topshop, as well as children's apparel retailer Pumpkin Patch have all disappeared. This is advantageous to the likes of Myer, Harvey Norman, JB Hi-Fi, the owner of Coles, Wesfarmers and Woolworths.

Happily for the trans-Tasman retailer Kathmandu, we still see people keeping warm in Kathmandu jackets.

There has clearly been a consolidation in retail and investors need to weigh up the unknown potential of the Amazon effect with the potential need for the incumbents to offer large discounts.

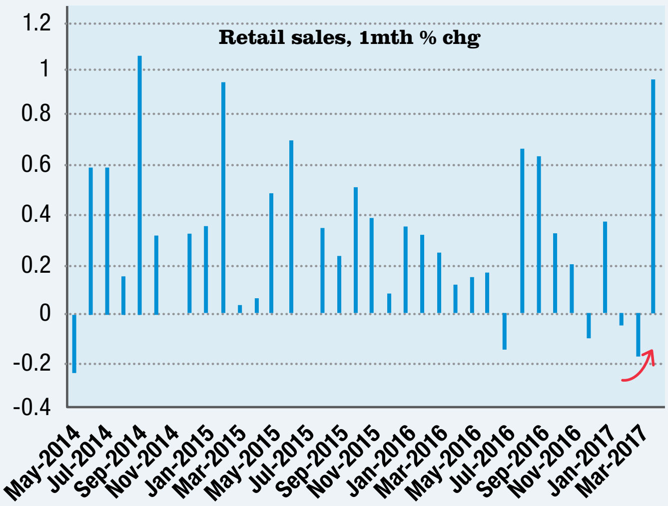
It's worth pointing out too that as investors we're not looking for good or bad companies, but if the negative new flow is reflected in the price. Myer is trading at a large 30% discount to its book value. This is a business that isn't going into receivership any time soon.

Another X factor is that while Amazon will sell thousands of lines of its own goods, it also sells other merchandise. So for retailers with quality, differentiated wares, Amazon could well be a friend as it will provide a powerful sales portal for them. ■

DON'T BE SCARED OF AMAZONOPHIA!

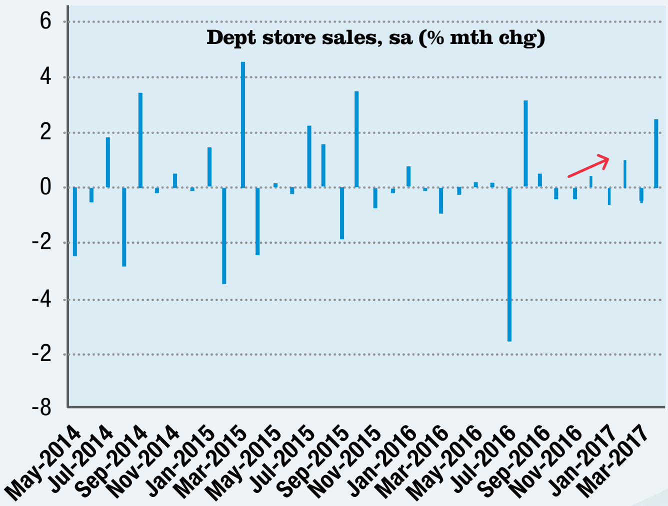
A BUMPY RIDE FOR RETAILERS

The month of April 1% jump in retail sales is the largest monthly increase in 2.5 years. This isn't a trend, but it represents an improvement in the climate for retail spending, which is in sharp contrast to the poor share market performance of Myer, JB Hi-Fi and Harvey Norman.



THINGS CAN ONLY GET BETTER

Aggregate department store sales – seasonally adjusted. You can see a big jump in the latest data point. Department store sales remain volatile but in recent months there's been a trend of increasing sales, albeit from a low base.



AMAZON V'S WAL-MART

International Stocks

AMAZON
Online Retailer

Australian investors will be familiar with Amazon's business even if they have not launched many of their retail services yet in this country. But in a transaction, which astonished the US stock market, Amazon announced last Friday that it will buy Whole Foods Markets, the retailer of premium food, for US$13.7bn cash.

Whole Foods had been put in play by activist investors who were reacting to a sense that the company had lost its way after being a market darling earlier on this decade, so there was no surprise that it was being sold. The surprise was the suitor and a measure of the importance of the deal was the 10% to 15% falls in the share prices of almost every other US grocery retailer.

Over the past three decades there have been numerous attempts to consolidate the still fragmented US grocery retail market. But grocery retailers have largely remained regional, due to regulatory and financial constraints. Food retail is a low margin business, but the advantage of scale, meaning owning a nation-wide presence and reducing unit costs, do exist. It is not an easy market to penetrate. Tesco, the largest UK grocery retailer, lost multiple billions in an effort to build a US business within the last ten years. Market consolidation in the US has been led by general retailers such as Wal-Mart and more recently by Target, whose general retail businesses had an existing presence in many states.

The dramatic reaction of the stock market was driven by the expectation that Amazon can rapidly bring scale and national presence to Whole Foods' business, as well as technology. This should allow Amazon to rapidly grow sales and distribution in this key sector.

Amazon's policy has never been to allow low margins to interfere with its single-minded focus on sales growth.

The biggest loser in dollar terms on the share market was Wal-Mart (WMT:US) – see our analysis of the stock on page 11 – but the bigger losers in percentage terms were regional food retailers which were already facing margin pressure and a lack of volume growth. Many investors thought that the Whole Foods news was a signal to throw in the towel on old supermarket stocks like Kroger or Supervalu.

After initially falling slightly on the news, Amazon's shares themselves climbed back towards a fresh high although much of their strategy to enter the food market through Amazon Fresh was already well known.

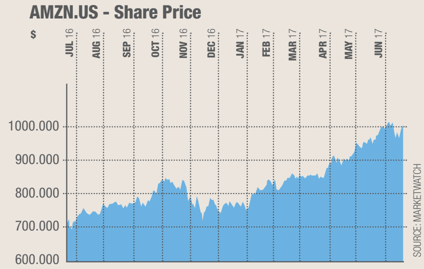
RADAR RATING **WATCH**

ASX CODE **AMZN:US**

CURRENT PRICE **US$1002**

MARKET CAP **US$479BN (A$634BN)**

NET CASH **US$7.6BN**



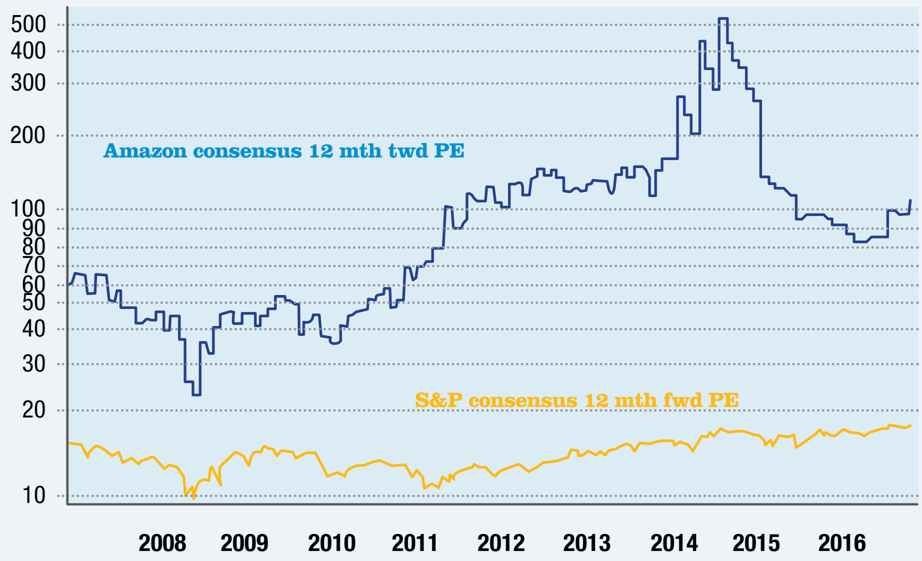
BULL POINTS
- ONLINE DOMINANCE
- GLOBAL GROWTH OPPORTUNITY
- JEFF BEZOS

BEAR POINTS
- LOW MARGINS
- FOOD FIGHT AHEAD
- NO DIVIDEND

AMAZON IS CHEAP?

Amazon's forecast price earnings ratio over time.

Amazon is cheaper because it was trading at over 500 times and now it's at 100 times. In the past year it has been trading at its cheapest for five years. Its stock recently went through $1000 a share, which means the forecast earnings upgrades have outpaced the price appreciation.



Amazon's valuation by the market is almost the polar opposite of Wal-Mart's. AMZN trades on a market capitalisation of more than 3 times sales, while Wal-Mart's enterprise value (market capitalisation plus debt) is a third of its sales.

Another reflection is Amazon's historic price/earnings ratio of 180 times! The market's expectation has always been that Amazon could turn off its spending tap at any time to reap better net margins, bringing its rating down from the stratosphere.

The acquisition of Whole Foods will double down on Amazon's low margin strategy, by exposing the business to an even bigger lower margin retail market where it will compete on price and service (delivery). At the same time, we expect a step change increase in spending as Amazon builds on Whole Foods' existing 400 store footprint by at least 3 times, and introduces technological features that will excite customers.

On traditional measures, Amazon is more expensive than any other large cap stock, and has become even more so in recent years as investors value its revenue growth more and more in a low growth economy. So it is difficult for investors used to traditional metrics to buy the stock, which has been a mistake. Investors have missed out on spectacular stock performance. But that doesn't mean that now is the time to jump in, in our view. At the moment the company's founder and chief executive Jeff Bezos can do no wrong in investors' eyes. But it is inevitable that missteps will be made. For instance, Amazon launched a mobile phone a few years ago on the back of the success of the Kindle E-reader, and that sank without trace. ■

RADAR RATING: Most important in providing a better buying opportunity for Amazon stock will be the broader market, where rising interest rates may eventually provide an attractive investable alternative to a non-dividend paying, opaque business like Amazon. The time is not yet right to commit funds here, but we remain watchful for an opportunity, since Amazon's Bezos is clearly someone to follow and invest in. WATCHLIST.

WAL-MART STORES

General Retailer

Wal-Mart is the giant of US retail, generating US$486bn of revenue in FY17. Based in the heart of the Midwest, the company has almost 12,000 stores operating in 28 countries, including businesses like the supermarket retailer Asda in the UK, and others that operate under independent banners.

FY17 net income was $13.6bn, or $14.3bn from continuing operations, while net operating cash flow was $31.5bn. FY17 EPS was $4.38 per share for a PE ratio of 17 times.

Approximately 56% of sales are delivered by the grocery segment. Sam's Club represents 12% of revenue, and is a member only service offering a similar model to Costco, with a lower gross profit and lower operating expenses than other parts of the business. Wal-Mart have also opened over 700 Wal-Mart neighbourhood market brand stores, compared to the 400 Whole Foods Markets stores being acquired by Amazon.

Prior to Amazon, Wal-Mart was the most feared competitor in the US retail landscape, using its model to build warehouse type stores on the edge of town. Wal-Mart has a relatively low perception in the US market, where it caters to a price sensitive consumer segment and delivers Great Value, which incidentally is one of its trademarks. More recently, Wal-Mart has been buying a number of online businesses, concentrated ironically on businesses addressing premium markets, but the jury is still out on its success in this venture.

Wal-Mart's grocery business seems more likely to be impacted by the arrival of German competitors Aldi and Lidl in the US with substantial expansion plans, than directly by Amazon's acquisition of Whole Foods. At the same time, any hopes that Wal-Mart may have had of building presence in the premium market segment may have been dashed by the Amazon move. ■

RADAR RATING: Wal-Mart remains a staple of US consumer life, and is still three times the size of Amazon. It faces many challenges, but delivers almost a 3% yield, paid quarterly, and represents a stable bet on the US economy. BUY.

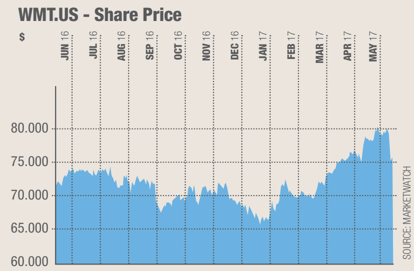
RADAR RATING **BUY**

CODE **WMT:US**

CURRENT PRICE **US$75.60**

MARKET CAP **US$230BN (A$305BN)**

NET DEBT **US$39BN**



BULL POINTS

- 12000 STORES
- GLOBAL PRESENCE
- FINANCIAL FIREPOWER

BEAR POINTS

- ONLINE LAGGING
- AMAZON THREAT
- SLOW GROWTH

THE ASX IMPACT

WESFARMERS & WOOLWORTHS

Supermarkets

It's no wonder Amazon has made a US$13.7bn offer for US Whole Foods. Over night the e-tailer giant has transformed itself into a potential bricks and mortar giant, if the deal goes through. Amazon understands better than anyone that if it's to be a long-term success it needs a bricks and mortar presence, which is why it wants to buy Whole Foods at a 30% premium.

For the likes of the Wesfarmers owned Coles and Woolworths, this represents a bigger threat, simply because their gross profit margins at around 28% are among the fattest, if not the most corpulent in the world. When you're a duopoly with 70% of the market, you're going to have big profit margins.

Amazon does represent a distant threat, but a threat nonetheless. Food retailing is bigger than discretionary goods retail; about a third bigger actually. In Australia people spend about $24bn a quarter on discretionary goods and about $31bn on food. People spend some $30bn a year more on food in Australia. This is serious money, even for Amazon.

Rather than Amazon, the biggest concern in the short term is that the two go head to head in a price war to win market share. This is a good outcome for consumers, but not immediately for shareholders. Profitability will come down as a result, meaning those fat gross margins will come under pressure.

The operating leverage of these companies is phenomenal. They have high fixed costs and when revenue creeps up the bottom line profits expand at a bigger rate. A lot is at stake. Although it must be said that the threat of the German retail giant Aldi hasn't hurt them too much – just look at their big profit margins.

Moreover, Coles and Woolworths do have their issues. Wesfarmers is expanding its Bunnings franchise into the UK and has announced that it will take the group longer to post a profit than originally anticipated. There are also concerns about the ability of the replacement of the long-serving Wesfarmers chief Richard Goyder, Rob Scott. He is relatively unknown, while Goyder was good at self-promotion.

Woolworths' new chief Brad Banducci has been gifted a stellar run following the lacklustre performance of his predecessor Grant O'Brien, who took the hit for the company's failed Master's strategy. Woolworths is finally achieving "lower prices" and has bigger diversity in terms of product range. ■

RADAR RATING: WOW trads on an expensive PE of 22 times, which is a 30% premium to the market; while WES trades in line with the market, and has previously traded at a premium. Investors recognise that the Amazon threat is greater for WES because of its Bunnings business. We would not be sellers or buyers at current prices. HOLD.

WESFARMERS

RADAR RATING **HOLD**

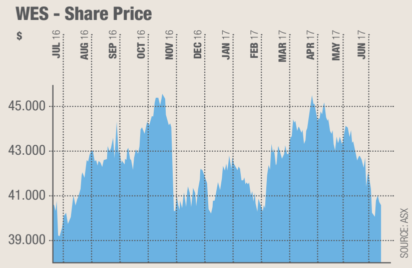
ASX CODE **WES**

CURRENT PRICE **$40.85**

MARKET CAP **$45.9BN**

NET DEBT **$5.9BN**

DIVIDEND YIELD **5.1%**



WOOLWORTHS

RADAR RATING **HOLD**

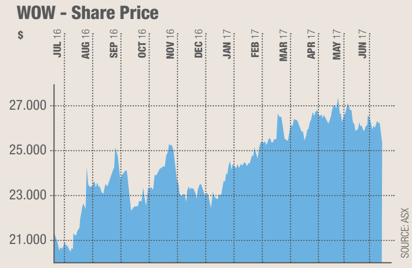
ASX CODE **WOW**

CURRENT PRICE **$25.25**

MARKET CAP **$32.5BN**

NET DEBT **$1.5BN**

DIVIDEND YIELD **3.1%**



HARVEY NORMAN & JB HI-FI

Electrical and consumer goods

Both these companies operate in similar segments, although JBH has more of a focus on electronics, while HVN has a broader offering with concentration on household goods and furnishings in addition to electronics.

Both are trading at a 25% discount to the broader market on the basis of their forecast PEs and both stocks are feeling the pinch around investor concerns relating to Amazon. Plus, there has been weakness in spending on discretionary goods, which are goods people need but don't require.

The discount is important, because it represents a big increase on their historic discount of about 10%, and is similar in quantum to that being experienced by Myer (MYR).

The first point to make is that investor concerns are indeed valid ones. But these companies benefit from the demise of the competitor Dick Smith. They will also benefit from any number of consumer releases, which includes the new iphone, for which there hasn't been a release for over a year. Microsoft's business pro is also due to be launched some time in the next six months. ■

RADAR RATING: If you hold these stocks we wouldn't be selling. In fact, the Under the Radar Big Value portfolio owns a stake in HVN. We think that it is possible for sentiment to remain negative for some time to come with the ongoing anxiety around Amazon. These stocks are right in the firing line. HOLD.

HARVEY NORMAN

RADAR RATING **HOLD**

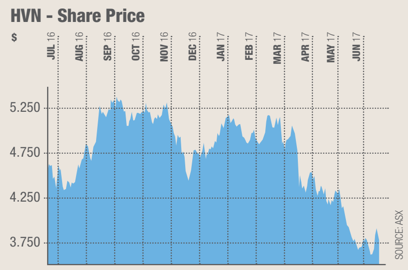
ASX CODE **HVN**

CURRENT PRICE **$3.73**

MARKET CAP **$4.2BN**

NET DEBT **$555M**

DIVIDEND YIELD **8.2%**



JB HI-FI

RADAR RATING **HOLD**

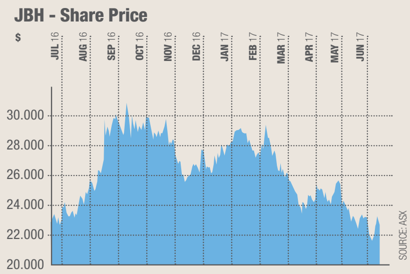
ASX CODE **JBH**

CURRENT PRICE **$22.81**

MARKET CAP **$2.6BN**

NET DEBT **$299M**

DIVIDEND YIELD **4.8%**



SUPER RETAIL GROUP

Diversified discretionary retailer

Super Retail managing director Peter Birtles maintains his group is well placed to fend off any threat from Amazon, because its stores help customers to pursue their hobbies: "We think that's something an online retailer can't do in terms of service, advice and a great in store experience."

Super Retail owns Super Cheap Auto, sports goods chains Rebel and Amart Sports and the outdoor chains Rays and BCF (Boating Camping Fishing).

Although its latest quarterly sales amply illustrate that the group is not impervious to shaky consumer sentiment. Revenues retreated across two of its three categories of auto, leisure and sports. The sports arm was especially weak, with sales growing 1.5% in the second half per store, compared with 6% in the first half. But profit margins expanded thanks to internal work including supply chain investment. Auto sales grew 2.5% compared with 3.7% previously, while the leisure arm saved the day with 7% growth (5.8% previously).

The group expects 3% sales growth in the 2017-18 year, which has not impressed the market. Super Retail's shares have declined almost 25% since mid March, partly due to an "overreaction" according to Birtles, relating to Amazonophobia.

While the group's leisure and auto goods are competitively priced against offshore online offerings, management has factored in the need for a margin haircut in the sports division. Rebel enjoys the strongest margins but its sales growth is running at only half the rate since Super Retail acquired the business in 2011. A serious round of "price investment" should get the tills ringing again. ■

RADAR RATING: While subdued, Super Retail's performance is far from disastrous and management has proved adept at integrating acquisitions. The group has $140m of excess franking credits; so a wildcard is whether management avails of the weak share price and executes a share buy back. Trading on a forecast 2017-18 earnings multiple of around 11 times and yield of 4-5%, the stock is starting to look interesting. WATCH LIST.

RADAR RATING **WATCH**

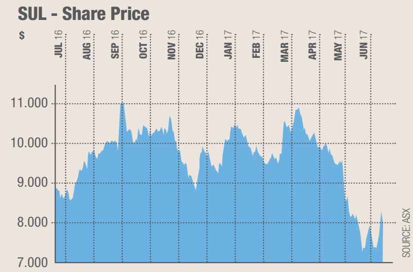
ASX CODE **SUL**

CURRENT PRICE **$7.69**

MARKET CAP **$1.6BN**

NET DEBT **$243M**

DIVIDEND YIELD **5.3%**



BAPCOR

Vehicle parts

Investors in the motor parts and accessories giant already have felt the Amazon effect, with their shares slashed by 17% since early January. Although of the mid-tier retailers, Bapcor arguably has the least to worry about because chunky parts will be way down Amazon's inventory 'must do' list.

Bapcor is protected with about 80% of its sales coming from its trade division. Mechanics need a new fuel pump in an hour – not two days – so it's crucial to have specialised local distribution facilities.

Thanks to acquisitions, Bapcor bears little resemblance to the original Burson Group that listed in April 2014 at $1.82 a share, with a $300m market capitalisation. In 2015 Bapcor paid $283m for Metcash's automotive division, which included the Autobarn and Autopro outlets. This year it completed

RADAR RATING **WATCH**

ASX CODE **BAP**

CURRENT PRICE **$5.23**

MARKET CAP **$1.5BN**

NET CASH **$20M**

DIVIDEND YIELD **2.1%**

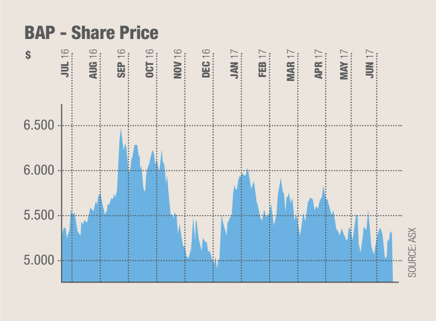
the $350m takeover of the NZ-based Hellaby Holdings, which operates 120 wholesale and trade businesses including Baxters, Roadsafe and MTQ Engines. Both deals were funded by equity capital raisings.

Excluding Hellaby Bapcor reported first-half earnings of $27.8m, up 44%, on revenue of $435m. At the time management said January's trading had met expectations and upped full-year net profit from $54.5-56.7m to $57-59m.

Bapcor should benefit from cost savings flowing from the Hellaby purchase (about $8-9m) and further store rollouts. Hellaby also had unrelated businesses in footwear and mining services, which Bapcor is expected to sell.

Amazon, by the way, is rumoured to be entering the car parts game in the US, but has not yet done so. ■

RADAR RATING: Bapcor shares are trading on a forecast earnings multiple of 17 times for the 2017-18 year. While this is slightly above the industrial sector average, it's about 20% less than the group's historical valuation. The stock is heading into interesting territory valuation-wise. But big acquisitions are notoriously hard to integrate and no word has come from management on this front. WATCH LIST.



METCASH

Grocery retailing and wholesaling

Metcash is known as the third force in grocery retailing, but more recent investor interest has centred on its plans to be the second force in hardware. The owner of the Mitre 10 chain, Metcash last year acquired Home Timber and Hardware Group, which along with Thrifty Link form the Independent Hardware Group (IHG).

The exit of Woolworth's Masters created an obvious opportunity for a substantive player to take on the might of Wesfarmers' Bunnings. And IHG's targeted $2.1bn of annual revenues sounds impressive, until it's benchmarked against Bunnings' $7bn a year turnover.

Metcash owns the IGA and Foodland chains, as well as Campbells wholesale arm that is a key supplier to convenience stores. Metcash's liquor arm encompasses IGA Liquor and the pub-based brands Cellarbrations and Bottle-O.

The group has had its well-documented woes in recent years, partly due to the supermarket price wars and grocery price deflation that ultimately impacts Metcash's margins as well. Excessive debt and corporate costs haven't helped either.

Under new management, Metcash launched a Price Match campaign for its IGA stores, aimed at quelling the perception that IGA is not competitive with the majors. The campaign has not been helped by Woolworths decision to invest in sharpening its grocery prices to claw back market share from Coles. ■

RADAR RATING: While Metcash does not look like being a top target for Amazon, it faces enough challenges already across its other three divisions. Metcash shares have drifted some 15% from their 12-month high of $2.46 in early April and trade at a modest valuation. We would like to see more evidence of a sustained turnaround before we get too excited. AVOID.

RADAR RATING **AVOID**

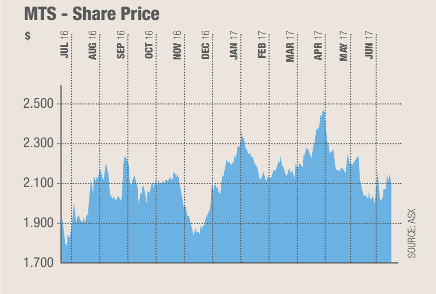
ASX CODE **MTS**

CURRENT PRICE **$2.17**

MARKET CAP **$2.1BN**

NET DEBT **$198M**

DIVIDEND YIELD **0%**



BIG VALUE PORTFOLIO

SAM FERRARO

Under the Radar's portfolio manager Sam Ferraro kicks off the portfolio and we provide a comment on diversification.

CODE	NAME	GICS SECTOR NAME	PORTFOLIO WEIGHT%	ASX200 INDEX WEIGHT%	ACTIVE WEIGHT%
A:HVN	HARVEY NORMAN HOLDINGS	CONSUMER DISCRETIONARY	1.00	0.19	0.81
A:MYR	MYER HOLDINGS	CONSUMER DISCRETIONARY	0.30	0.06	0.24
A:NAB	NATIONAL AUS.BANK	FINANCIALS	12.00	5.80	6.20
A:CBA	COMMONWEALTH BK.OF AUS.	FINANCIALS	15.00	9.67	5.33
A:ANZ	AUS.AND NZ.BANKING GP.	FINANCIALS	13.00	6.17	6.83
A:QAN	QANTAS AIRWAYS	INDUSTRIALS	3.00	0.40	2.60

The portfolio weighting is simply the percentage of the portfolio that the individual stock takes up, and does not include cash. The benchmark against which this is judged is that stock's weighting in the S&P/ASX 200 Index. Subtracting these two gives you the "active weight" which tells you how much you are betting against the market. For example, CBA has a weighting in the S&P/ASX 200 of 9.7%, whereas its weighting in the portfolio is 15%, giving it an "active weight" of 5.3%.

THE CORE SATELLITE APPROACH TO DIVERSFICATION

In last month's issue we talked about the "core/satellite" approach being used increasingly by institutions. We think that this methodology represents the lowest cost avenue for individuals to achieve the benefits of diversification in their portfolio.

Before we go into the core/satellite approach, it's worth considering why diversification is important.

If your portfolio is composed of less than five stocks you are heavily exposed to stock specific risks. This year **ANZ** is down 9% and the other big banks on the ASX aren't fairing much better. If half your portfolio is in the banks then you're going to be in the red. Diversification reduces this stock specific risk.

The **S&P/ASX 200 Index** is heavily concentrated with the top 20 by market capitalisation representing about 65% of its total size. You would need to own at least those 20, plus hold another 30 to safely replicate its performance. Diversification is important, but not at any cost!

THE CORE/SATELLITE APPROACH

The core represents your exposure to market factors, which is what the industry calls "beta".

The market is represented by indexes. In Australia's case, the benchmark is most often the S&P/ASX 200 Index.

An example of a "core" approach is investing in some 60 stocks, or investing in an **index linked ETF** or a **Vanguard fund** which replicates the index. Doing the latter means you achieve diversification at a low cost.

Under the Radar has two portfolios – a **Big Cap Big Value portfolio**, which will have between 25 and 35 stocks; and a **Small Cap portfolio** which currently has 18 stocks in it, plus an **ETF replicating the price of gold (GOLD)**.

These highly concentrated funds are designed to add what the industry terms "alpha" which means performance above that experienced by the market.

The average return of the S&P/ASX 200 Index is close to 10% a year over the long-term. These concentrated funds aim to deliver better than this. If the ASX200 is down 10%, these funds aim to do better, even though they might still be in the red.

NO ONE RIGHT ANSWER

There is not one right answer for everyone because everyone has a different tolerance for risk. If you are risk averse you would put a greater portion of your funds in the core portfolio, for example. If you are able to embrace more risk, you would put more money into growth assets and embrace the concentrated portfolios to achieve that alpha. ■

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Suite 201, 116 Devonshire Street Surry Hills NSW 2010
Telephone +61 2 9211 8899 Email radar@undertheradarreport.com.au

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